

NAVISITE INC  
Form PRER14C  
July 01, 2004

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SCHEDULE 14C INFORMATION  
Information Statement Pursuant to Section 14(c)  
of the Securities Exchange Act of 1934

Check the appropriate box:

- Preliminary Information Statement
- Confidential, for Use of the Commission Only (as permitted by Rule 14c-5(d)(2))
- Definitive Information Statement

NAVISITE, INC.

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(Name of Registrant as Specified in Charter)

Payment of Filing Fee (Check the appropriate box):

- No fee required.
- Fee computed on table below per Exchange Act Rule 14c-5(g) and 0-11.

1) Title of each class of securities to which transaction applies:

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2) Aggregate number of securities to which transaction applies:

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3) Per unit price or other underlying value of transaction computed pursuant to Exchange Act Rule 0-11 (set forth the amount on which the filing fee is calculated and state how it was determined):

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4) Proposed maximum aggregate value of transaction:

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5) Total fee paid:

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- Fee paid previously by written preliminary materials.
- Check box if any part of the fee is offset as provided by Exchange Act Rule 0-11(a)(2) and identify the filing for which the offsetting fee was paid previously. Identify the previous filing by registration statement number, or the Form or Schedule and the date of its filing.

1) Amount Previously Paid:

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2) Form Schedule or Registration Statement No.:

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3) Filing Party:

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4) Date Filed:

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**NAVISITE, INC.**

**400 Minuteman Road  
Andover, Massachusetts 01810**

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**NOTICE OF ACTION TAKEN PURSUANT TO  
WRITTEN CONSENT OF STOCKHOLDERS**

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To the stockholders of NaviSite, Inc.:

This Notice and the accompanying Information Statement are being furnished to the stockholders of NaviSite, Inc., a Delaware corporation (the Company), in connection with action taken by the holders of at least a majority of the issued and outstanding voting securities of the Company, approving, by written consent dated May 6, 2004, the following corporate actions:

1. The issuance of (i) 3,000,000 shares of the Company's Common Stock to Surebridge, Inc., and (ii) the shares of the Company's Common Stock issuable upon the conversion of convertible promissory notes made by the Company to Surebridge, Inc.; and
2. The amendment of the Company's Amended and Restated 2003 Stock Incentive Plan to increase the maximum number of shares of the Company's Common Stock available for issuance thereunder from 3,800,000 to 6,800,000 shares.

**We are not asking you for a proxy and you are requested not to send us a proxy.**

Your vote or consent is not requested or required to approve these matters. The accompanying Information Statement is provided solely for your information. The accompanying Information Statement also serves as the notice required by Section 228 of the Delaware General Corporation Law of the taking of a corporate action without a meeting by less than unanimous written consent of the stockholders of the Company.

By Order of the Board of Directors,

KENNETH DRAKE  
*Secretary*

Andover, Massachusetts  
July [ ], 2004

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Preliminary Copy

**NAVISITE, INC.**

**400 Minuteman Road  
Andover, Massachusetts 01810**

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**INFORMATION STATEMENT**

**We are not asking you for a proxy and you are requested not to send us a proxy.**

**General**

This Information Statement is being furnished by NaviSite, Inc., a Delaware corporation ( NaviSite or the Company ), in connection with action taken by the holders of at least a majority of the issued and outstanding voting securities of the Company, approving, by written consent dated May 6, 2004, the following corporate actions:

1. The issuance of (i) 3,000,000 shares of the Company's Common Stock, \$.01 par value per share (the Common Stock ), to Surebridge, Inc., and (ii) the shares of the Company's Common Stock issuable upon the conversion of convertible promissory notes made by the Company to Surebridge, Inc.; and

2. The amendment of the Company's Amended and Restated 2003 Stock Incentive Plan to increase the maximum number of shares of the Company's Common Stock available for issuance thereunder from 3,800,000 to 6,800,000 shares.

This Information Statement is being provided pursuant to the requirements of Rule 14c-2 of the Securities Exchange Act of 1934, as amended (the Exchange Act ), to inform holders of Common Stock entitled to vote or give an authorization or consent in regard to the matters acted upon by written consent. This Information Statement is being mailed on or about July [ ], 2004, to the Company's stockholders of record as of May 6, 2004 (the Record Date ). The Company anticipates that the actions will take effect on August [ ], 2004.

All share numbers and share prices provided in this Information Statement have been adjusted to reflect all stock splits effected prior to the Record Date, including the 1-for-15 reverse stock split of the Common Stock effected on January 7, 2003.

**Reason for the Written Consent**

*The Surebridge Acquisition*

On June 10, 2004, the Company completed the acquisition of substantially all of the assets and liabilities of Surebridge, Inc. ( Surebridge ), a privately held provider of managed application services for mid-market companies, pursuant to the terms of an asset purchase agreement (as amended, the Asset Purchase Agreement ).

Under the terms of the Asset Purchase Agreement, the Company acquired substantially all of the assets of Surebridge in exchange for two promissory notes in the aggregate principal amount of approximately \$39.3 million, three million shares of Common Stock (the Fixed Shares ) and the assumption of certain liabilities of Surebridge at closing.

The promissory notes issued by the Company to Surebridge consist of a Primary Note and an Escrow Note (collectively, the Notes ). The Primary Note is in the principal amount of approximately

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\$32.5 million. The Escrow Note is in the principal amount of approximately \$6.8 million and has been deposited into escrow for the purpose of satisfying indemnification claims by the Company pursuant to the Asset Purchase Agreement. The principal amount of both Notes is subject to adjustment based on the net working capital of Surebridge at closing.

The Notes accrue interest on the unpaid balance at an annual rate of 10%, however no interest shall accrue on any principal paid within nine months of the closing. The Notes shall be paid in full no later than the second anniversary of the closing. In the event that the Company realizes net proceeds in excess of \$1 million from certain equity or debt financings or sales of assets, the Company is obligated to use a significant portion of the proceeds to make payments on the Notes.

The outstanding principal and accrued interest of the Notes shall be convertible into shares of Common Stock (the Conversion Shares ) at the election of the holder (i) at any time following the first anniversary of the closing if the aggregate principal outstanding under the Notes at such time is greater than or equal to \$20 million, (ii) at any time following the 18-month anniversary of the closing if the aggregate principal outstanding under the Notes at such time is greater than or equal to \$10 million, (iii) at any time following the second anniversary of the closing, and (iv) at any time following an event of default thereunder. The conversion price of each Note is \$4.642, which is the average closing price of the Common Stock for the ten-day period ending one day prior to closing.

For a period of one year following the closing of the acquisition, Surebridge shall not sell, transfer, assign, convey, encumber, gift, distribute or otherwise dispose of the Fixed Shares, the Conversion Shares or the Notes; provided, however, if the Company does not make certain payments under the Notes or otherwise suffers an event of default thereunder, Surebridge may sell the Fixed Shares and the Conversion Shares at any time thereafter.

The Fixed Shares and the Conversion Shares have certain demand and piggyback registration rights pursuant to a Registration Rights Agreement entered into by and between the Company and Surebridge.

*The Stock Plan Amendment*

On May 6, 2004, the Board of Directors of the Company approved, subject to stockholder approval, an amendment (the Stock Plan Amendment ) to the Company s Amended and Restated 2003 Stock Incentive Plan, to increase the maximum number of shares of Common Stock pursuant to which the Company may grant stock options and restricted stock awards thereunder from 3,800,000 to 6,800,000 shares.

*The Written Consent*

On May 6, 2004, Atlantic Investors, LLC, the majority stockholder of the Company ( Atlantic Investors ), delivered to the Company an executed written consent of stockholders, in the form attached as Appendix I, approving (i) the issuance of the Fixed Shares and the Conversion Shares, and (ii) the Stock Plan Amendment.

**Voting and Vote Required**

The Company is not seeking consent, authorizations or proxies from you. Section 228 of the Delaware General Corporation Law ( Section 228 ) provides that the written consent of the holders of outstanding shares of voting capital stock, having not less than the minimum number of votes which would be necessary to authorize or take such action at a meeting at which all shares entitled to vote thereon were present and voted, may be substituted for a meeting. Approval of at least a majority of the outstanding shares of Common Stock present and voting on the matter at a meeting would be required to approve each of (i) the issuance of the Fixed Shares and the Conversion Shares, and (ii) the Stock Plan Amendment.

As of the Record Date, the Company had 24,829,228 shares of Common Stock outstanding and entitled to vote. Each share of Common Stock is entitled to one vote. On the Record Date, Atlantic Investors held 17,292,550 shares, or approximately 69.6%, of the Company s Common Stock. Accordingly,

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the matters approved by Atlantic Investors by written consent on the Record Date have been approved under Section 228 and require no further stockholder action.

### **Notice Pursuant to Section 228**

Pursuant to Section 228, the Company is also required to provide prompt notice of the taking of a corporate action by written consent to the stockholders who have not consented in writing to such action. This Information Statement also serves as the notice required by Section 228.

### **Dissenters' Rights of Appraisal**

The Delaware General Corporation Law does not provide dissenters' rights of appraisal to the Company's stockholders in connection with the matters approved by written consent.

### **Householding of Stockholder Materials**

Some banks, brokers and other nominee record holders may be participating in the practice of householding stockholder materials, such as proxy statements, information statements and annual reports. This means that only one copy of this Information Statement may have been sent to multiple stockholders in your household. The Company will promptly deliver a separate copy of this Information Statement to you if you write or call us at the following address or telephone number: Investor Relations Department, NaviSite, Inc., 400 Minuteman Road, Andover, Massachusetts 01810, telephone: (888) 298-8222. If you want to receive separate copies of stockholder materials in the future, or if you are receiving multiple copies and would like to receive only one copy for your household, you should contact your bank, broker, or other nominee record holder, or you may contact NaviSite at the above address and telephone number.

## **APPROVAL OF THE ISSUANCE OF THE FIXED SHARES AND THE CONVERSION SHARES**

### *The Surebridge Acquisition*

On June 10, 2004, the Company completed the acquisition of substantially all of the assets and liabilities of Surebridge, a privately held provider of managed application services for mid-market companies. Under the terms of the Asset Purchase Agreement, the Company acquired substantially all of the assets of Surebridge in exchange for two promissory notes in the aggregate principal amount of approximately \$39.3 million, the Fixed Shares and the assumption of certain liabilities of Surebridge at closing.

The Primary Note is in the principal amount of approximately \$32.5 million. The Escrow Note is in the principal amount of approximately \$6.8 million and has been deposited into escrow for the purpose of satisfying indemnification claims by the Company pursuant to the Asset Purchase Agreement. The principal amount of both Notes is subject to adjustment based on the net working capital of Surebridge at closing. The Notes accrue interest on the unpaid balance at an annual rate of 10%, however no interest shall accrue on any principal paid within nine months of the closing. The Notes shall be paid in full no later than the second anniversary of the closing. In the event that the Company realizes net proceeds in excess of \$1 million from certain equity or debt financings or sales of assets, the Company is obligated to use a significant portion of the proceeds to make payments on the Notes.

The outstanding principal and accrued interest of the Notes shall be convertible into the Conversion Shares at the election of the holder (i) at any time following the first anniversary of the closing if the aggregate principal outstanding under the Notes at such time is greater than or equal to \$20 million, (ii) at any time following the 18-month anniversary of the closing if the aggregate principal outstanding under the Notes at such time is greater than or equal to \$10 million, (iii) at any time following the second anniversary of the closing, and (iv) at any time following an event of default thereunder. The conversion price of each Note is \$4.642, which is the average closing price of the Common Stock for the ten-day



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period ending one day prior to closing. Assuming no principal adjustments, prepayments or successful indemnification claims by the Company, the maximum number of Conversion Shares issuable upon conversion of the Notes at the maturity date is approximately 10,235,528 shares.

For a period of one year following the closing of the acquisition, Surebridge shall not sell, transfer, assign, convey, encumber, gift, distribute or otherwise dispose of the Fixed Shares, the Conversion Shares or the Notes; provided, however, if the Company does not make certain payments under the Notes or otherwise suffers an event of default thereunder, Surebridge may sell the Fixed Shares and the Conversion Shares at any time thereafter.

The Fixed Shares and the Conversion Shares have certain demand and piggyback registration rights pursuant to a Registration Rights Agreement entered into by and between the Company and Surebridge.

*Nasdaq Stockholder Approval Requirements*

The Common Stock is listed on The Nasdaq SmallCap Market. The NASD rules governing Nasdaq require stockholder approval of any issuance of securities (i) in connection with the acquisition of the stock or assets of another company that will or potentially will result in the issuance of shares representing 20% or more of the issuer's outstanding shares of common stock or voting power prior to the issuance of such securities, or (ii) that will or potentially will result in a change of control of the issuer.

Specifically, NASD Rule 4350(i)(1)(C) requires that the issuer of stock in connection with the acquisition of the stock or assets of another company secure stockholder approval prior to an issuance where the issuance or potential issuance of the shares of common stock, or securities convertible into or exercisable for common stock, would result in the issuance of 20% or more of the common stock or voting power of the issuer before the issuance. In addition, NASD Rule 4350(i)(1)(B) requires that the issuer of stock secure stockholder approval prior to an issuance or potential issuance which will result in a change of control of the issuer.

Nasdaq rules do not require stockholder approval of the acquisition of the assets and liabilities of Surebridge by the Company or the issuance of the Fixed Shares or the Notes. However, the potential issuance of the Conversion Shares upon conversion of the Notes, when added to the issuance of the Fixed Shares, would potentially equal or exceed the 20% threshold and could potentially be deemed a change of control of the Company under applicable Nasdaq rules. Therefore, for purposes of the applicable Nasdaq rules, the Company's stockholders approved the issuance of the Fixed Shares and the Conversion Shares prior to any issuance which would equal or exceed the 20% threshold or be deemed a change of control of the Company.

On May 6, 2004, Atlantic Investors delivered to the Company an executed written consent of stockholders approving the issuance of the Fixed Shares and the Conversion Shares. This Information Statement is being sent to all stockholders of the Company as notice that such action has been taken. The Company is not asking that you vote to approve the issuance of the Fixed Shares and the Conversion Shares. Under federal law governing the taking of stockholder action by written consent, stockholder approval of the issuance of the Fixed Shares and the Conversion Shares will be deemed effective 20 days after the mailing of this Information Statement to stockholders of the Company. Pursuant to the terms of the Asset Purchase Agreement, the Notes shall not be convertible into an aggregate number of shares of Common Stock that is greater than or equal to (i) 19.9% of that number of shares of Common Stock outstanding immediately prior to the closing less (ii) 3,000,000 shares, unless and until such stockholder approval is deemed effective.

**Table of Contents****APPROVAL OF THE STOCK PLAN AMENDMENT**

On May 6, 2004, the Board of Directors of the Company approved, subject to stockholder approval, an amendment to the Company's Amended and Restated 2003 Stock Incentive Plan (as amended, the "2003 Plan"), to increase the maximum number of shares of Common Stock pursuant to which the Company may grant stock options and restricted stock awards thereunder from 3,800,000 to 6,800,000 shares. The Board adopted the Stock Plan Amendment because the number of shares currently available under the 2003 Plan is insufficient to satisfy the expected foreseeable future share requirements thereunder. The Board of Directors believes that continued grants of stock options, as well as grants of restricted stock awards, will be an important element in attracting and retaining key employees who are expected to contribute to the Company's growth and success. NaviSite's management relies on stock options as essential parts of the compensation packages necessary for NaviSite to attract and retain experienced officers and employees. As of May 6, 2004 and following approval by the stockholders of the Stock Plan Amendment, 3,017,691 shares were available for issuance under the 2003 Plan. The closing price of NaviSite Common Stock on May 6, 2004 was \$5.20.

*Summary of the 2003 Plan*

The 2003 Plan was adopted, subject to stockholder approval, by NaviSite's Board of Directors on July 10, 2003, and amended and restated on November 11, 2003 to increase the number of shares of Common Stock available for issuance under such plan from 2,600,000 to 3,800,000. The 2003 Plan was approved by the stockholders of the Company on December 9, 2003 at the Annual Meeting of Stockholders. The 2003 Plan provides for the grant of options that are intended to qualify as incentive stock options within the meaning of Section 422 of the Code, options not intended to qualify as incentive stock options and restricted stock awards (each, an "Award") to NaviSite's employees, officers and directors, consultants or advisors. Incentive stock options may be granted only to employees of NaviSite. A maximum of 6,800,000 shares of Common Stock are eligible for issuance under the 2003 Plan upon the exercise of options or in connection with Awards. If any Award expires, or is terminated, surrendered or canceled without having been fully exercised or forfeited, in whole or in part (including as a result of shares of Common Stock being repurchased by NaviSite at the original issue price pursuant to a contractual repurchase right), or results in the Common Stock not being issued, the unissued Common Stock covered by such Award shall again be available for the grant of Awards under the 2003 Plan.

As of May 6, 2004, approximately 397 persons were eligible to receive Awards under the 2003 Plan, including the Company's five executive officers and three non-employee directors. The granting of Awards under the 2003 Plan is discretionary, and the Company cannot now determine the number or type of Awards to be granted in the future to any particular person or group of persons. The following table summarizes options awarded under the 2003 Plan as of May 6, 2004 to designated individuals and groups since the adoption of the 2003 Plan in July 2003:

<b>Name and Principal Position</b>	<b>Number of Options Granted</b>
Arthur P. Becker Chief Executive Officer and President	460,000
Gabriel Ruhan Chief Operating Officer	460,000
Patricia Gilligan Former Chief Executive Officer	
Kevin H. Lo Former Chief Financial Officer and Former Senior Vice President of Finance and Strategy	
Current Executive Officers, as a group	1,160,000
Current Non-Executive Officer Directors, as a group	170,000
Non-Executive Officer Employees, as a group	2,765,125

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The purpose of the 2003 Plan is to provide Awards to employees, officers, directors, consultants and advisors of NaviSite and its present or future parent or subsidiary corporations (each a Participant ), all of whom are eligible to receive Awards under the 2003 Plan. A copy of the 2003 Plan is attached to this Information Statement as Appendix II. The following is a summary of the 2003 Plan and should be read together with the 2003 Plan. The summary is qualified in its entirety by reference to the 2003 Plan.

*Administration.* The 2003 Plan is administered by the Board of Directors. The Board of Directors has the power to grant Awards and to adopt, amend and repeal such administrative rules, guidelines and practices relating to the 2003 Plan as it may deem advisable. The Board of Directors may correct any defect, supply any omission or reconcile any inconsistency in the 2003 Plan or any Award in the manner and to the extent it shall deem expedient to carry the 2003 Plan into effect and it shall be the sole and final judge of such expediency. All decisions by the Board shall be made in the Board's sole discretion and shall be final and binding on all persons having or claiming any interest in the Plan or in any Award. The Board may delegate its powers to one or more committees of the Board or to one or more executive officers of NaviSite (provided, that the Board of Directors shall fix the terms of the Awards granted by the executive officer and the maximum number of shares that the executive officer may grant and that no executive officer shall have the power to grant Awards to another executive officer (as defined in Rule 3b-7 of the Exchange Act, or to any officer (as defined in Rule 16a-1 of the Exchange Act) of NaviSite).

*Per-Participant Limit.* No Participant may be granted Awards during any one calendar year to purchase more than 650,000 shares of Common Stock.

*Exercise Price.* The Board establishes the exercise price at the time each option is granted.

*Exercise of Options.* Each option granted under the 2003 Plan shall either be fully exercisable at the time of grant or shall become exercisable in such installments as the Board may specify. Once an installment becomes exercisable it shall remain exercisable until expiration or termination of the option, unless otherwise specified by the Board. Each option or installment may be exercised at any time or from time to time, in whole or in part, for up to the total number of shares with respect to which it is then exercisable. During the Participant's lifetime, Awards may be exercised only by the Participant.

*Payment for Exercise of Options.* Payment for the exercise of options under the 2003 Plan may be made by one or any combination of the following forms of payment (a) by cash or check payable to the order of NaviSite; (b) except as otherwise explicitly provided in the applicable option agreement, by delivery of an irrevocable and unconditional undertaking by a creditworthy broker to deliver promptly to NaviSite sufficient funds to pay the exercise price or any required tax withholding, or delivery by the Participant to NaviSite of a copy of irrevocable and unconditional instructions to a creditworthy broker to deliver promptly to NaviSite cash or a check sufficient to pay the exercise price and any required tax withholding; (c) when the Common Stock is registered under the Exchange Act, by delivery of shares of Common Stock owned by the Participant valued at fair market value (as determined by or in a manner approved by the Board) provided that such method of payment is then permitted by law and such Common Stock, if acquired directly from NaviSite, was owned by the Participant for at least six months; or (d) to the extent permitted by the Board, (x) by delivery of a promissory note of the Participant to NaviSite (on terms determined by the Board) or (y) payment of such other lawful consideration as the Board may determine.

*Transferability.* Except as otherwise provided in the applicable option agreement, options are not transferable except by will or by the laws of descent and distribution.

*Restricted Stock.* The Board may grant Awards entitling recipients to acquire shares of Common Stock, subject to the right of NaviSite to repurchase all or part of such shares at their issue price or other stated or formula price from the Participant in the event that conditions specified by the Board in the applicable Award are not satisfied prior to the end of the applicable restriction period or periods established by the Board for such Award.

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*Acquisition of NaviSite.* Upon the occurrence of a Reorganization Event (as defined below) or the execution by NaviSite of any agreement with respect to any Reorganization event, the Board shall provide that all outstanding options outstanding under the 2003 Plan shall be assumed, or equivalent options shall be substituted, by the acquiring or succeeding corporation (or an affiliate thereof). If the acquiring or succeeding corporation (or an affiliate thereof) does not agree to assume, or substitute for, such options, then all then unexercised options will become exercisable in full as of a time specified by the Board prior to the Reorganization Event and will terminate immediately prior to the consummation of such Reorganization Event; provided, however, that in the event of a Reorganization Event under the terms of which holders of Common Stock will receive a cash payment for each share of Common Stock surrendered pursuant to such Reorganization Event (the Acquisition Price), then the Board may instead provide that all outstanding options outstanding under the 2003 Plan shall terminate upon consummation of such Reorganization Event and that each optionholder shall receive, in exchange therefor, a cash payment equal to the amount (if any) by which (A) the Acquisition Price multiplied by the number of shares of Common Stock subject to such outstanding options (whether or not then exercisable), exceeds (B) the aggregate exercise price of such options.

Upon the occurrence of a Reorganization Event, the repurchase and other rights of NaviSite under each outstanding restricted stock award shall inure to the benefit of NaviSite's successor and shall apply to the cash, securities or other property which the Common Stock was converted into or exchanged for pursuant to such Reorganization Event in the same manner and to the same extent as they applied to the Common Stock subject to such restricted stock award. Reorganization Event is defined in the 2003 Plan as follows: (a) any merger or consolidation of NaviSite with or into another entity as a result of which all of the Common Stock of NaviSite is converted into or exchanged for the right to receive cash, securities or other property or (b) any exchange of all of the Common Stock of NaviSite for cash, securities or other property pursuant to a share exchange transaction.

*Effect of Termination, Disability or Death.* The Board determines the effect on an Award of the disability, death, retirement, authorized leave of absence or other change in the employment or other status of a Participant and the extent to which, and the period during which, the Participant, or the Participant's legal representative, conservator, guardian or designated beneficiary, may exercise rights under the Award.

*Amendment of Award.* The Board of Directors may amend, modify or terminate any outstanding Award, including but not limited to, by substituting therefor another Award of the same or a different type, changing the date of exercise or realization, and converting an ISO (as defined below) to a non-qualified stock option, provided that the Participant's consent to such action shall be required unless the Board of Directors determines that the action, taking into account any related action, would not materially and adversely affect the Participant.

*Termination and Amendment of Plan.* The Board may amend, suspend or terminate the 2003 Plan or any portion thereof at any time. Unless terminated sooner, no Awards may be granted under the 2003 Plan after July 9, 2013, but Awards previously granted may extend beyond that date.

*United States Federal Income Tax Consequences*

THE FOLLOWING DISCUSSION OF UNITED STATES FEDERAL INCOME TAX CONSEQUENCES OF THE ISSUANCE AND EXERCISE OF OPTIONS GRANTED UNDER THE 2003 PLAN IS BASED UPON THE PROVISIONS OF THE INTERNAL REVENUE CODE AS IN EFFECT ON THE DATE OF THIS INFORMATION STATEMENT, CURRENT REGULATIONS, AND EXISTING ADMINISTRATIVE RULINGS OF THE INTERNAL REVENUE SERVICE. THIS DISCUSSION IS NOT INTENDED TO BE A COMPLETE DISCUSSION OF ALL OF THE UNITED STATES FEDERAL INCOME TAX CONSEQUENCES OF THE 2003 PLAN OR OF THE REQUIREMENTS THAT MUST BE MET IN ORDER TO QUALIFY FOR THE DESCRIBED TAX TREATMENT.

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*Incentive Stock Options* ( ISOs ). The following general rules are applicable under current United States federal income tax law to ISOs granted under the 2003 Plan:

1. In general, an optionee will not recognize any taxable income upon the grant of an ISO or upon the issuance of shares to him or her upon the exercise of an ISO, and NaviSite will not be entitled to a federal income tax deduction upon either the grant or the exercise of an ISO.
2. If shares acquired upon exercise of an ISO are not disposed of within (i) two years from the date the ISO was granted or (ii) one year from the date the shares are issued to the optionee pursuant to the exercise of the ISO (the Holding Periods ), the difference between the amount realized on any subsequent disposition of the shares and the exercise price generally will be treated as capital gain or loss to the optionee.
3. If shares acquired upon exercise of an ISO are disposed of and the optionee does not satisfy the Holding Periods (a Disqualifying Disposition ), then in most cases the lesser of (i) any excess of the fair market value of the shares at the time of exercise of the ISO over the exercise price or (ii) the actual gain on disposition, will be treated as compensation to the optionee and will be taxed as ordinary income in the year of such disposition.
4. The difference between the amount realized by an optionee as the result of a Disqualifying Disposition and the sum of (i) the exercise price and (ii) the amount of ordinary income recognized under the above rules generally will be treated as capital gain or loss to the optionee.
5. In any year that an optionee recognizes ordinary income on a Disqualifying Disposition of shares acquired upon exercise of an ISO, NaviSite generally will be entitled to a corresponding federal income tax deduction.
6. An optionee may be entitled to exercise an ISO by delivering shares of NaviSite Common Stock to NaviSite in payment of the exercise price, if the optionee s ISO agreement so provides. If an optionee exercises an ISO in such fashion, special rules will apply.
7. In addition to the tax consequences described above, the exercise of an ISO may result in an alternative minimum tax to the optionee. In general, the amount by which the fair market value of the shares received upon exercise of the ISO exceeds the exercise price is included in the optionee s alternative minimum taxable income. A taxpayer is required to pay the greater of his regular tax liability or the alternative minimum tax. A taxpayer who pays alternative minimum tax attributable to the exercise of an ISO may be entitled to a tax credit against his or her regular tax liability in later years.
8. Capital gain or loss recognized by an optionee on a disposition of shares will be long-term capital gain or loss if the optionee s holding period for the shares exceeds one year.
9. Special rules apply if the shares acquired upon the exercise of an ISO are subject to vesting, or are subject to certain reporting requirements and restrictions on resale under federal securities laws applicable to directors, certain officers or 10% stockholders.

*Non-Qualified Options*. The following general rules are applicable under current United States federal income tax law to Non-Qualified Options granted under the 2003 Plan:

1. In general, an optionee will not recognize any taxable income upon the grant of a Non-Qualified Option, and NaviSite will not be entitled to a federal income tax deduction upon such grant.
2. An optionee generally will recognize ordinary income at the time of exercise of the Non-Qualified Option in an amount equal to the excess, if any, of the fair market value of the shares on the date of exercise over the exercise price. NaviSite may be required to withhold tax on this amount.
3. When an optionee sells the shares acquired upon the exercise of a Non-Qualified Option, he or she generally will recognize capital gain or loss in an amount equal to the difference between the amount realized upon the sale of the shares and his or her basis in the shares (generally, the

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exercise price plus the amount taxed to the optionee as ordinary income). If the optionee's holding period for the shares exceeds one year, such gain or loss will be a long-term capital gain or loss.

4. When an optionee recognizes ordinary income attributable to a Non-Qualified Option, NaviSite generally should be entitled to a corresponding federal income tax deduction.
5. An optionee may be entitled to exercise a Non-Qualified Option by delivering shares of NaviSite Common Stock to NaviSite in payment of the exercise price, if the optionee's option agreement so provides. If an optionee exercises a Non-Qualified Option in such fashion, special rules will apply.
6. Special rules apply if the shares acquired upon the exercise of a Non-Qualified Option are subject to vesting, or are subject to certain reporting requirements and restrictions on resale under federal securities laws applicable to directors, certain officers or 10% stockholders.

*Restricted Stock Awards.* The following general rules are applicable under current United States federal income tax law to Awards comprised of restricted Common Stock under the 2003 Plan:

Persons receiving restricted Common Stock under the under the 2003 Plan pursuant to Awards generally will not recognize taxable income upon the grant of the Award, unless the Participant makes an election under Section 83(b) of the Code (an 83(b) Election). If the Participant makes an 83(b) Election within 30 days of the date of grant, the Participant will recognize ordinary income, for the year the Award is granted, in an amount equal to the difference between the fair market value of the shares received (determined on the date of the Award) over the purchase price. If an 83(b) Election is not made, then the Participant will recognize ordinary income, at the time that the forfeiture provisions or restrictions on transfer lapse, in an amount equal to the difference between the fair market value of the Common Stock at the time of such lapse and the original purchase price paid for the Common Stock. The Participant will have a tax basis in the Common Stock acquired equal to the sum of the price paid and the amount of ordinary income recognized.

Upon the disposition of the Common Stock acquired pursuant to a restricted stock Award, the Participant will recognize capital gain or loss equal to the difference between the sale price of the Common Stock and the Participant's basis in the Common Stock. The capital gain or loss will be a long-term capital gain or loss if the shares are held for more than one year.

*Equity Compensation Plan Information as of July 31, 2003*

The following table sets forth certain information regarding NaviSite's equity compensation plans as of July 31, 2003.

Plan Category	(a) Number of Securities to be Issued Upon Exercise of Outstanding Options, Warrants and Rights	(b) Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights	(c) Number of Securities Available for Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in Column (a))
Equity compensation plans approved by security holders	273,506	\$ 67.93	683,464
Equity compensation plans not approved by security holders(1)	2,272,000	\$ 2.55	328,000
Total	2,545,506	\$ 9.57	1,011,464

(1) Consists of options to purchase 2,272,000 shares of Common Stock granted under the 2003 Plan. The 2003 Plan was originally approved, subject to stockholder approval, by the Board of Directors on July 10, 2003, and amended and restated by the Board of Directors on



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2003 Plan was approved by NaviSite's stockholders on December 9, 2003 at the Annual Meeting of Stockholders.

On May 6, 2004, Atlantic Investors delivered to the Company an executed written consent of stockholders approving the Stock Plan Amendment. This Information Statement is being sent to all stockholders of the Company as notice that such action has been taken. The Company is not asking that you vote to approve the Stock Plan Amendment. Under federal law governing the taking of stockholder action by written consent, stockholder approval of the Stock Plan Amendment will be deemed effective 20 days after the mailing of this Information Statement to stockholders of the Company.

**SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT**

The following table sets forth certain information as of June 17, 2004 (unless otherwise indicated), with respect to the beneficial ownership of Common Stock by the following:

each person known by the Company to beneficially own more than 5% of the outstanding shares of Common Stock;

each of the Company's directors;

each of the Named Executive Officers (as defined below under the heading "Executive Compensation"); and

all of the current executive officers and directors as a group.

For purposes of the following table, beneficial ownership is determined in accordance with the rules promulgated by the Securities and Exchange Commission and the information is not necessarily indicative of beneficial ownership for any other purpose. Except as otherwise noted in the footnotes to the respective tables, the Company believes that each person or entity named in the tables has sole voting and investment power with respect to all shares of Common Stock shown as beneficially owned by them (or shares such power with his or her spouse). Under such rules, shares of Common Stock issuable under options that are currently exercisable or exercisable within 60 days after June 17, 2004 (Presently Exercisable Options) are deemed outstanding and are included in the number of shares beneficially owned by a person named in the table and are used to compute the percentage ownership of that person. These shares are not, however, deemed outstanding for computing the percentage ownership of any other person or entity. Unless otherwise indicated, the address of each person listed in the table is c/o NaviSite, Inc., 400 Minuteman Road, Andover, Massachusetts 01810. The percentage ownership of Common Stock of each person or entity named in the following table is based on 27,918,049 shares of Common Stock outstanding as of June 17, 2004 plus any shares subject to Presently Exercisable Options held by such person.

Name and Address of Beneficial Owner	NaviSite Common Stock	
	Number of Shares Beneficially Owned	Percentage of Common Stock Outstanding
<b>5% Stockholders</b>		
Atlantic Investors, LLC(1) 20 East 66th Street New York, NY 10021	17,121,652	61.3%
Hewlett-Packard Financial Services Company 420 Mountain Ave. Murray Hill, NJ 07974	4,416,592	15.8%
Surebridge, Inc. c/o Spectrum Equity Investors, L.P. One International Place, 29th Floor Boston, MA 02210	3,000,000	10.7%



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Name and Address of Beneficial Owner	NaviSite Common Stock	
	Number of Shares Beneficially Owned	Percentage of Common Stock Outstanding
<b>Directors and Named Executive Officers</b>		
Andrew Ruhan(2)		*
Arthur P. Becker	415,150(3)	1.5%
Gabriel Ruhan	202,083(4)	*
Larry Schwartz	28,888(4)	*
James Dennedy	31,666(4)	*
Thomas R. Evans	13,889(4)	*
Patricia Gilligan(5)		*
Kevin H. Lo(6)		*
All current executive officers and directors as a group (8 persons)	728,342(7)	2.6%

\* Less than 1%.

- (1) Based on information provided by Atlantic Investors in a Form 4 dated April 29, 2004 filed with the Securities and Exchange Commission on May 3, 2004. Excludes 170,898 shares subject to an option granted to Mr. Denis Martin.
- (2) Excludes 17,121,652 shares of Common Stock owned by Atlantic Investors and 426,134 shares of Common Stock owned by Global Unicorn Worldwide Holdings S.A.R.L., a wholly owned subsidiary of Unicorn Worldwide Holdings Limited, with respect to all of which Mr. A. Ruhan disclaims beneficial ownership. Mr. A. Ruhan holds a 10% equity interest in Unicorn Worldwide Holdings Limited, a managing member of Atlantic Investors.
- (3) Consists of 213,067 shares of Common Stock owned by Madison Technology LLC and 202,083 shares of Common Stock issuable upon the exercise of Presently Exercisable Options. Excludes 17,121,652 shares of Common Stock owned by Atlantic Investors with respect to which Mr. Becker disclaims beneficial ownership. Mr. Becker is the managing member of Madison Technology LLC, a managing member of Atlantic Investors.
- (4) Consists of shares of Common Stock issuable upon the exercise of Presently Exercisable Options.
- (5) Served as the Company's Chief Executive Officer until February 2003 and her relationship with the Company terminated in March 2003.
- (6) Served as the Company's Chief Financial Officer and Vice President of Finance and Strategy until April 2003.
- (7) Consists of 213,067 shares of Common Stock owned by Madison Technology LLC and 515,275 shares of Common Stock issuable upon the exercise of Presently Exercisable Options.

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**ADDITIONAL INFORMATION ABOUT NAVISITE**

**Director Compensation**

In November 2003, after completing a review of director compensation for comparable companies, the Board of Directors agreed (i) to grant to future independent directors upon initial election to the Board options to purchase 50,000 shares of NaviSite Common Stock and (ii) that any independent director be paid \$7,500 per year, payable in quarterly installments. Additionally, upon re-election to the Board of Directors subsequent to the 2003 Annual Meeting of Stockholders, independent directors of the Board of Directors will be granted an annual option to purchase 15,000 shares of NaviSite Common Stock. The initial option grant of 50,000 shares shall vest monthly over three years (1/36th of the number of shares vest monthly). The subsequent annual option grant of 15,000 shares shall vest monthly over 12 months. The Chairperson of each of the Audit Committee and the Compensation Committee also will receive, upon re-election to the Board of Directors at each annual meeting of stockholders, an option to purchase 10,000 shares of NaviSite Common Stock. This option shall vest monthly over a period of 12 months.

During the 2003 fiscal year, directors did not receive any option grants. Messrs. Dennedy and Schwartz each received \$1,500 during fiscal year 2003 for service on the Board of Directors and \$6,000 each paid in October 2003 for participating on a special committee of the Board of Directors during and subsequent to fiscal year 2003.

On October 3, 2003, Mr. Evans was elected to the Board of Directors of the Company. At such time, the Company did not have an existing stock option plan pursuant to which Mr. Evans was eligible to participate and receive an initial option grant. On December 9, 2003, the stockholders of the Company approved the 2003 Plan. On such date, Mr. Evans was granted an option to purchase 50,000 shares of Common Stock under such plan. A Special Committee of the Board of Directors determined that the exercise price of such option be set at \$3.53 per share, equal to the closing price of the Company's Common Stock on October 3, 2003. The option was vested and exercisable as to 2/36th of the number of shares subject to the option on the date of grant. The option vests and becomes exercisable as to 1/36th of the number of shares subject to the option on the third day of each month commencing January 3, 2004 until fully vested on October 3, 2006.

On April 3, 2003, Mr. Schwartz was elected to the Board of Directors of the Company. On July 10, 2003, the Company granted stock options to substantially all of its executive officers and employees. At such time, the Company did not have an existing stock option plan pursuant to which Mr. Schwartz was eligible to participate and receive an initial option grant. On December 9, 2003, the stockholders of the Company approved the 2003 Plan. On such date, Mr. Schwartz was granted an option to purchase 50,000 shares of Common Stock under such plan. A Special Committee of the Board of Directors determined that the exercise price of such option be set at \$2.55 per share, equal to the closing price of the Company's Common Stock on July 10, 2003. The option was vested and exercisable as to 8/36th of the number of shares subject to the option on the date of grant. The option vests and becomes exercisable as to 1/36th of the number of shares subject to the option on the third day of each month commencing January 3, 2004 until fully vested on April 3, 2006.

On January 27, 2003, Mr. Dennedy was elected to the Board of Directors of the Company. On July 10, 2003, the Company granted stock options to substantially all of its executive officers and employees. At such time, the Company did not have an existing stock option plan pursuant to which Mr. Dennedy was eligible to participate and receive an initial option grant. On December 9, 2003, the stockholders of the Company approved the 2003 Plan. On such date, Mr. Dennedy was granted an option to purchase 50,000 shares of Common Stock under such plan. A Special Committee of the Board of Directors determined that the exercise price of such option be set at \$2.55 per share, equal to the closing price of the Company's Common Stock on July 10, 2003. The option was vested and exercisable as to 10/36th of the number of shares subject to the option on the date of grant. The option vests and becomes

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exercisable as to 1/36th of the number of shares subject to the option on the 27th day of each month commencing December 27, 2003 until fully vested on January 27, 2006.

In connection with his chairmanship of the Compensation Committee of the Board of Directors, on December 9, 2003, Mr. Schwartz was granted an option to purchase 10,000 shares of Common Stock. The option vests and becomes exercisable as to 1/12th of the number of shares subject to the option on each monthly anniversary date of the date of grant until fully vested on the first anniversary of the date of grant.

In connection with his chairmanship of the Audit Committee of the Board of Directors, on December 9, 2003, Mr. Denedy was granted an option to purchase 10,000 shares of Common Stock. The option vests and becomes exercisable as to 1/12th of the number of shares subject to the option on each monthly anniversary date of the date of grant until fully vested on the first anniversary of the date of grant.

Apart from the arrangements discussed above, NaviSite does not pay any cash compensation to members of its Board of Directors for their services as members of the Board of Directors, although directors are reimbursed for their reasonable travel expenses incurred in connection with attending Board of Directors and committee meetings. Directors who are also NaviSite officers or employees are eligible to participate in the 2003 Plan. Following approval by NaviSite's stockholders in December 2003 of the 2003 Plan, no additional option grants shall be made under the 1998 Equity Incentive Plan, the 1999 Stock Option Plan for Non-Employee Directors or the 2000 Stock Option Plan. However, all then-outstanding options under such plans shall remain in effect and the option grants to the independent directors, as described above, will be made under the 2003 Plan.

NaviSite and each member of the Board of Directors have entered into an indemnification agreement pursuant to which the directors will be indemnified by NaviSite, subject to certain limitations, for any liabilities incurred by the directors in connection with their role as directors of NaviSite.

**Executive Compensation**

*Summary Compensation Table*

The following table sets forth certain summary information with respect to the compensation paid during the fiscal years ended July 31, 2003, 2002 and 2001 earned by each of (i) all individuals who served as the Chief Executive Officer during the fiscal year ended July 2003, (ii) one other executive officer who was serving as an executive officer on July 31, 2003 whose total annual salary and bonuses for fiscal year 2003 exceeded \$100,000 and (iii) one former executive officer who would have been among the most highly compensated executive officers during fiscal year 2003 had he remained as an executive officer as of July 31, 2003 (collectively, the Named Executive Officers). In the table below, columns required by the regulations of the SEC have been omitted where no information was required to be disclosed under those columns.

**Table of Contents****SUMMARY COMPENSATION TABLE**

Name and Principal Position	Annual Compensation			Long-Term Compensation	All Other Compensation
	July 31,	Salary	Bonus	Awards	
				Securities Underlying Options	
Arthur P. Becker(1) Chief Executive Officer and President	2003	\$ 121,635		40,000	
Gabriel Ruhan(2) Chief Operating Officer	2003	\$ 205,769		40,000	
Patricia Gilligan Former Chief Executive Officer	2003	\$ 176,634			\$ 276,756(3)
	2002	\$ 262,724	\$ 122,025(4)	33,333	\$ 2,921(5)
	2001	\$ 215,909	\$ 180,713(6)	19,833	\$ 3,501(5)
Kevin H. Lo Former Chief Financial Officer and Former Senior Vice President of Finance and Strategy	2003	\$ 147,692			\$ 210,615(7)
	2002	\$ 175,628	\$ 117,000(8)	33,333	
	2001	\$ 100,660	\$ 8,274	12,333	

- (1) Mr. Becker became NaviSite's Chief Executive Officer and President in February 2003.
- (2) Mr. Ruhan served as NaviSite's Executive Vice President for Business Development from October 2002 until April 2003, when he became NaviSite's Chief Operating Officer.
- (3) Includes \$275,000 of severance and \$1,756 to cover certain health benefits. Ms. Gilligan's relationship with NaviSite ended in March 2003.
- (4) Includes \$50,000 retention bonus paid on March 15, 2002 and \$72,025 management incentive bonus paid on August 19, 2002.
- (5) Represents the amount of matching contributions made by NaviSite under CMGI's 401(k) Plan.
- (6) Includes \$125,000 retention bonus paid on July 31, 2001.
- (7) Consists of a severance payment of \$200,000, plus \$1,000 to cover certain health benefits and a vacation payout of \$9,615. Mr. Lo's employment with NaviSite ended in April 2003.
- (8) Consists of \$50,000 retention bonus, \$25,000 of which was paid on December 14, 2001 and \$25,000 of which was paid on March 15, 2002, and \$67,000 management incentive bonus paid on August 19, 2002.

*Option Grants During the Fiscal Year Ended July 31, 2003*

The following table sets forth information regarding options to purchase NaviSite Common Stock granted to the Named Executive Officers during the fiscal year ended July 31, 2003. The exercise price per share of each option is equal to the fair market value of NaviSite Common Stock on the date of grant, as determined pursuant to the 1998 Equity Incentive Plan. Potential realizable values set forth in the table are net of the exercise price, but before taxes associated with the exercise, and are based on the assumption that NaviSite Common Stock appreciates at the annual rate shown from the date of the grant until the expiration of the ten-year option term. These numbers are calculated based on rules of the SEC and do not represent NaviSite's estimate or projection of future stock prices. The actual amount a Named Executive Officer may realize, if any, will depend upon the future performance of NaviSite Common Stock and the optionholder's continued employment with NaviSite through the vesting period. Accordingly, the potential realizable values reflected in the table may not be achieved. NaviSite has never granted any stock appreciation rights.



**Table of Contents****STOCK OPTION GRANTS IN THE FISCAL YEAR ENDED JULY 31, 2003**

Name	Individual Grants		Exercise Price (Per Share)	Expiration Date	Potential Realizable Value at Assumed Annual Rates of Stock Price Appreciation for Option Term	
	Number of Securities Underlying Options Granted	Percent of Total Options Granted to Employees in Fiscal Year			5%	10%
Arthur P. Becker(1)	40,000	31.21%(2)	\$ 2.55	7/9/2013	\$ 64,147	\$ 162,562
Gabriel Ruhan(1)	40,000	31.21%(2)	\$ 2.55	7/9/2013	\$ 64,147	\$ 162,562
Patricia Gilligan						
Kevin H. Lo						

- (1) On July 10, 2003, each was granted this option under the 1998 Equity Incentive Plan. The options are exercisable with respect to 50% of the underlying shares as of the grant date, July 10, 2003, and thereafter, exercisable in equal monthly installments of 1/24th of the number of shares and shall be exercisable in full on the first anniversary of the grant date. With respect to each option grant, 100% of the option vests and becomes exercisable in the event of a change in control and termination of employment within twelve months from such change in control.
- (2) Based on option grants under all of NaviSite's equity incentive plans other than the grants made pursuant to the 2003 Plan, which were subject to stockholder approval at July 31, 2003.

*Options Exercised During Fiscal Year Ended July 31, 2003*

The following table sets forth information concerning options to purchase NaviSite Common Stock exercised by the Named Executive Officers during the fiscal year ended July 31, 2003, and the number and value of unexercised options to purchase NaviSite Common Stock held by the Named Executive Officers as of July 31, 2003.

**AGGREGATED OPTION EXERCISES IN LAST FISCAL YEAR AND FISCAL YEAR-END OPTION VALUES**

Name	Number of Securities Underlying Unexercised Options at July 31, 2003		Value of Unexercised In-the-Money Options at July 31, 2003(1)	
	Exercisable	Unexercisable	Exercisable	Unexercisable
Arthur P. Becker	20,000	20,000	\$ 8,000	\$ 8,000
Gabriel Ruhan	20,000	20,000	\$ 8,000	\$ 8,000
Patricia Gilligan				
Kevin H. Lo				

- (1) The value of the unexercised in-the-money NaviSite options is calculated by multiplying the number of shares of NaviSite Common Stock underlying the options by the difference between \$2.95, which was the closing price per share of NaviSite Common Stock on the Nasdaq SmallCap Market on July 31, 2003 and the applicable per share exercise price of the option.

**Compensation Committee Interlocks and Insider Participation**

The Compensation Committee currently consists of Messrs. Denedy, Schwartz and Evans. During fiscal year 2003, Messrs. David Wetherell, Andrew Ruhan and Arthur Becker served as members of the Compensation Committee. Mr. Wetherell is the Chairman of CMGI, with whom NaviSite had a significant relationship until September 2002. Since 2000, Mr. Andrew Ruhan, our Chairman, has served as Chief Executive Officer of ClearBlue and Mr. Becker, our Chief Executive Officer and President and a member of the Board of Directors, has served as Vice Chairman and a director of ClearBlue. CMGI, NaviSite, ClearBlue and certain of ClearBlue's affiliates engaged in various transactions during fiscal year 2003. ClearBlue was the majority stockholder of NaviSite until August 2003, when it distributed the



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Common Stock it held in NaviSite to its equityholders. As a result of such distribution, Atlantic Investors is now the holder of a majority of our outstanding stock. As of May 6, 2004, Atlantic Investors and its affiliates owned, directly or indirectly, approximately 69.6% of the outstanding capital stock of NaviSite. Mr. Becker is a co-founder of Atlantic Investors. Since 1999, Mr. Becker has been a Managing Member of Madison Technology LLC, an investment fund that is focused on technology and telecommunications companies, which is a managing member of Atlantic Investors.

**Compensation Committee Report**

This report discusses the Compensation Committee's compensation objectives and policies with respect to NaviSite's executive officers. The report reviews the compensation of senior executive officers as a group for the last fiscal year and, specifically, the compensation of Arthur P. Becker, NaviSite's Chief Executive Officer.

*Compensation Philosophy.* NaviSite's executive compensation program has three objectives: (i) to align the interests of its executive officers with the interests of NaviSite's stockholders by basing a significant portion of an executive's compensation on NaviSite's performance; (ii) to attract and retain highly talented and productive executives; and (iii) to provide incentives for superior performance by NaviSite's executives. To achieve these objectives, the Compensation Committee has crafted a program that consists of base salary, short-term incentive compensation in the form of a bonus, and long-term incentive compensation in the form of stock options. These compensation elements are in addition to the general benefit programs that are offered to all of NaviSite's employees.

The Compensation Committee reviews NaviSite's executive compensation program annually. In its review, the Compensation Committee assesses the competitiveness of NaviSite's executive compensation program and reviews NaviSite's performance for the previous fiscal year. In future years, the Compensation Committee will gauge the success of the compensation program in achieving its objectives in the previous year and will consider NaviSite's overall performance objectives. Each element of NaviSite's executive compensation program is discussed below.

*Benefits.* The Compensation Committee believes that NaviSite must offer a competitive benefits program to attract and retain key executives. NaviSite provides the same medical and other benefits to its executive officers that are generally available to its other employees. Senior executives, along with all eligible employees of NaviSite, may also choose to participate in NaviSite's 401(k) plan.

*Long-Term Incentive Compensation.* The Compensation Committee believes that placing a portion of an executive's total compensation in the form of stock options achieves three objectives: (i) it aligns the interest of NaviSite's executives directly with those of NaviSite's stockholders; (ii) it gives executives a significant long-term interest in NaviSite's success; and (iii) it helps NaviSite retain key executives. In determining the number and terms of options to grant an executive, the Compensation Committee will primarily consider subjectively the executive's past performance and the degree to which an incentive for long-term performance would benefit NaviSite.

*Compensation of the Chief Executive Officer.* The Compensation Committee believes that the compensation of the Chief Executive Officer is consistent with NaviSite's general policies concerning executive compensation and is appropriate in light of NaviSite's financial objectives and performance. Awards of intermediate and long-term incentive compensation to the Chief Executive Officer are considered concurrently with awards to other executive officers and follow the same general policies as such other intermediate and long-term incentive awards.

Mr. Becker has served as a director of NaviSite since September 11, 2002 and became its Chief Executive Officer and President in February 2003. Mr. Becker's base salary for the portion of the last fiscal year during which he served as Chief Executive Officer was at a rate of \$275,000 per year. In July 2003, Mr. Becker also received an option to acquire 40,000 shares of NaviSite Common Stock at an exercise price of \$2.55 per share. Mr. Becker's compensation was designed to align his interests with those of NaviSite's stockholders by tying the value of the stock option award and his eligibility for periodic cash



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bonuses to the success of his efforts towards building NaviSite's management team, business and infrastructure and improving the operating and financial performance of NaviSite. The Compensation Committee believes that Mr. Becker's compensation has been consistent with the Compensation Committee's compensation philosophy.

During NaviSite's last fiscal year, under the leadership of Mr. Becker, NaviSite successfully executed its business plan and stabilized its business. Operationally, during fiscal year 2003, NaviSite experienced a significant transition, including the acquisitions discussed in "Certain Relationships and Related Transactions" and a balance sheet restructuring, to position NaviSite among the leaders in the outsourced hosting and managed application services market. NaviSite also expanded its service offerings and diversified its customer base, while at the same time implemented an operational plan that should bring costs more in line with projected revenue growth.

*Policy on Deductibility of Executive Compensation.* Section 162(m) of the Internal Revenue Code of 1986, as amended (the "Code"), generally disallows a federal income tax deduction to public companies for certain compensation over \$1,000,000 paid to a company's chief executive officer and four other most highly compensated executive officers. Qualifying performance-based compensation will not be subject to the deduction limit if certain requirements are met. The Compensation Committee intends to review the potential effects of Section 162(m) periodically and intends to structure NaviSite's stock option grants and certain other equity-based awards in a manner that is intended to avoid disallowances under Section 162(m) of the Code unless the Compensation Committee believes that such compliance would not be in the best interest of NaviSite or its stockholders.

### COMPENSATION COMMITTEE

Larry Schwartz, Chairman  
James Dennedy  
Thomas R. Evans

## **Change in Control**

On September 11, 2002, each of CMGI, Inc. ("CMGI") and Hewlett-Packard Financial Services Company sold and transferred to ClearBlue Technologies, Inc., a privately-held managed service provider based in San Francisco, California ("ClearBlue"), and certain of its subsidiaries, the following equity and debt interests in the Company:

Pursuant to a Note and Stock Purchase Agreement by and between CMGI and ClearBlue, CMGI sold and transferred to ClearBlue approximately 4.7 million shares of Common Stock, representing approximately 76% of the outstanding capital stock of the Company, warrants to purchase approximately 345,000 shares of Common Stock and a convertible note with an aggregate principal amount outstanding of \$10 million. The \$10 million convertible note was convertible into approximately 2.5 million shares of Common Stock. ClearBlue issued 131,579 shares of ClearBlue common stock to CMGI in the transaction, representing approximately 2% of the issued and outstanding equity of ClearBlue after giving effect to the transactions on such date with CMGI and Hewlett-Packard Financial Services Company.

Pursuant to a Note and Stock Purchase Agreement by and between Hewlett-Packard Financial Services Company and ClearBlue, Hewlett-Packard Financial Services Company sold and transferred to ClearBlue approximately 213,000 shares of Common Stock, and convertible notes with an aggregate principal amount outstanding of approximately \$55 million. The \$55 million convertible notes were convertible into approximately 14.1 million shares of Common Stock. ClearBlue issued 1,447,368 shares of ClearBlue common stock to Hewlett-Packard Financial Services Company in the transaction, representing approximately 22% of the issued and outstanding equity of ClearBlue after giving effect to the transactions on such date with CMGI and Hewlett-Packard Financial Services Company.

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As a result of the foregoing transactions, ClearBlue became NaviSite's majority stockholder. In August 2003, ClearBlue transferred to its stockholders, including Atlantic Investors, its majority stockholder, the shares of Common Stock owned by it. On May 6, 2004, Atlantic Investors held 17,292,550 shares, or approximately 69.6%, of the Company's Common Stock.

**Stock Performance Graph**

The following graph compares the cumulative total return to stockholders of NaviSite Common stock for the period from October 22, 1999, the date NaviSite Common Stock was first traded on The Nasdaq National Market, through July 31, 2003, with the cumulative total return over the same period of (i) the Nasdaq Composite Index and (ii) a peer group index of publicly traded companies that provide similar services to those of NaviSite (the "Peer Group Index"). The graph assumes the investment of \$100 in NaviSite Common Stock (at the closing price on the date of NaviSite's initial public offering) and in each of such indices (and the reinvestment of all dividends, if any) on October 22, 1999. The performance shown is not necessarily indicative of future performance.

**Comparison of Cumulative Total Return**

(Assumes Initial Investment of \$100)  
October 22, 1999 Through July 31, 2003

Measurement Period (Fiscal Year Covered)	NaviSite, Inc.	Nasdaq Composite Index	Peer Group Index(1)
10/22/99	\$ 100.00	\$ 100.00	\$ 100.00
7/31/00	\$ 243.30	\$ 133.70	\$ 97.14
7/31/01	\$ 4.31	\$ 71.76	\$ 82.27
7/31/02	\$ 0.69	\$ 47.43	\$ 47.83
7/31/03	\$ 1.13	\$ 62.13	\$ 49.56

- (1) The Peer Group Index is a modified-capitalization weighted index of stocks selected by NaviSite that represents the following publicly traded companies: International Business Machines Corporation, Electronic Data Systems Corporation, Computer Sciences Corporation, Level 3 Communications, Inc., Qwest Communications International Inc., divine, inc., AT&T Corp., Digex, Incorporated, Akamai Technologies, Inc., Corio, Inc. and SBC Communications Inc.

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Notwithstanding anything to the contrary set forth in any of NaviSite's filings under the Securities Act or the Exchange Act that might incorporate other filings with the SEC, including this Information Statement, in whole or in part, the Compensation Committee Report and the Stock Performance Graph shall not be deemed incorporated by reference into any such filings.

**Employment Agreements and Severance and Change of Control Arrangements**

NaviSite entered into an employment agreement with Arthur P. Becker as of February 21, 2003, pursuant to which he would be employed as NaviSite's Chief Executive Officer and President. His agreement is for a continuous term, but subject to the provisions described below, may be terminated by either party at any time. Pursuant to this agreement, Mr. Becker is entitled to receive:

a base salary, currently \$275,000 per year, which is reviewed by our Board of Directors annually (but no more frequently than annually);

an annual bonus upon NaviSite's achievement of various financial and/or other goals established by the Board; and

fringe benefits, including stock options and health insurance and other benefits available to our employees.

If Mr. Becker's employment is terminated (i) by reason of death or disability, (ii) by NaviSite with cause or (iii) due to his voluntarily resignation, then he will receive no additional salary or benefits other than what has accrued through the date of termination.

If Mr. Becker's employment is terminated without cause and he signs a general release of known and unknown claims in a form satisfactory to NaviSite, Mr. Becker will receive severance payments at his final base salary rate, less applicable withholding, until the earlier of (i) six months after the date of his termination without cause, or (ii) the date on which he first commences other employment.

In connection with the termination of their employment with us, each of Ms. Gilligan and Mr. Lo entered into a Severance Agreement and General Release which provided for the following in exchange for the general release of all claims against NaviSite and related parties:

Ms. Gilligan received a severance payment of \$275,000, plus \$1,756 to cover certain health benefits.

Mr. Lo received a severance payment of \$200,000, plus \$1,000 to cover certain health benefits and a vacation payout of \$9,615.

**Financial and Other Information**

Certain financial and other information regarding NaviSite and Surebridge is included in the financial pages to this Information Statement.

By Order of the Board of Directors,

KENNETH DRAKE  
*Secretary*

July [ ], 2004

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

The Board of Directors and Stockholders  
NaviSite, Inc. and Subsidiaries:

We have audited the accompanying consolidated balance sheets of NaviSite, Inc. and Subsidiaries as of July 31, 2003 and 2002, and the related consolidated statements of operations, changes in stockholders' equity (deficit), and cash flows for each of the years in the three-year period ended July 31, 2003. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these 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 financial statements referred to above present fairly, in all material respects, the financial position of NaviSite, Inc. and Subsidiaries as of July 31, 2003 and 2002, and the results of their operations and their cash flows for each of the years in the three-year period ended July 31, 2003, in conformity with accounting principles generally accepted in the United States of America.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 3 to the financial statements, the Company has incurred recurring losses from operations since inception and has an accumulated deficit. These factors, among others as discussed in Note 3 to the financial statements, raise substantial doubt about the Company's ability to continue as a going concern. Management's plans in regard to these matters are also described in Note 3. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

/s/ KPMG LLP

Boston, Massachusetts

October 21, 2003

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**Table of Contents****NAVISITE, INC. AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS**

	July 31,	
	2003	2002
	(In thousands, except par value)	
<b>ASSETS</b>		
Current Assets:		
Cash and cash equivalents	\$ 3,862	\$ 21,842
Accounts receivable, less allowance for doubtful accounts of \$2,030 and \$617 at July 31, 2003 and 2002, respectively	14,741	3,553
Due from related parties		3,724
Prepaid expenses and other current assets	4,011	3,292
Assets held for sale		1,022
	<hr/>	<hr/>
Total current assets	22,614	33,433
Property and equipment, net	22,165	12,412
Customer lists, net of \$3,724 of accumulated amortization	12,052	
Goodwill	3,206	
Other assets	6,280	3,839
Restricted cash	3,054	3,850
	<hr/>	<hr/>
Total assets	\$ 69,371	\$ 53,534
	<hr/>	<hr/>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current Liabilities:		
Accounts receivable financing line	\$ 6,358	\$
Current notes payable	1,211	
Capital lease obligations, current portion	3,268	2,123
Current note payable to related party	3,000	
Due to CMGI		3,241
Accounts payable	4,371	1,803
Accrued expenses	17,580	7,932
Deferred revenue	2,993	1,619
Customer deposits	134	199
	<hr/>	<hr/>
Total current liabilities	38,915	16,917
Capital lease obligations, less current portion	1,907	378
Accrued lease abandonment costs, less current portion	3,476	
Note to the AppliedTheory estate	6,000	
Other long-term liabilities	2,194	
Convertible notes payable to HPFS, net		23,440
Convertible notes payable to CMGI, net		4,255
	<hr/>	<hr/>
Total liabilities	52,492	44,990
Commitments and contingencies (note 10)		
Stockholders' equity (deficit):		
Preferred Stock, \$0.01 par value. Authorized 5,000 shares; no shares issued or outstanding at July 31, 2003 and 2002		
Common Stock, \$0.01 par value. Authorized 395,000 shares; issued and outstanding 23,412 and 6,248 at July 31, 2003 and 2002	235	62

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Accumulated other comprehensive income (loss)	(16)	
Additional paid-in capital	432,399	345,820
Accumulated deficit	(415,739)	(337,338)
	<u>          </u>	<u>          </u>
Total stockholders' equity	16,879	8,544
	<u>          </u>	<u>          </u>
Total liabilities and stockholders' equity	\$ 69,371	\$ 53,534
	<u>          </u>	<u>          </u>

See accompanying notes to consolidated financial statements.

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**Table of Contents****NAVISITE, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF OPERATIONS**

	Years Ended July 31,		
	2003	2002	2001
(In thousands, except per share data)			
Revenue:			
Revenue	\$ 75,281	\$ 40,968	\$ 66,358
Revenue, related parties	1,310	18,453	36,368
Total revenue	<u>76,591</u>	<u>59,421</u>	<u>102,726</u>
Cost of revenue	70,781	67,000	127,155
Impairment, restructuring and other		68,317	1,930
Total cost of revenue	<u>70,781</u>	<u>135,317</u>	<u>129,085</u>
Gross profit (deficit)	<u>5,810</u>	<u>(75,896)</u>	<u>(26,359)</u>
Operating expenses:			
Product development	950	5,281	14,072
Selling and marketing	5,960	9,703	32,251
General and administrative	20,207	19,272	33,011
Impairment, restructuring and other	8,882	(2,633)	8,011
Total operating expenses	<u>35,999</u>	<u>31,623</u>	<u>87,345</u>
Loss from operations	(30,189)	(107,519)	(113,704)
Other income (expense):			
Interest income	851	1,060	2,753
Interest expense	(43,403)	(14,718)	(8,042)
Other income (expense), net	(733)	(516)	292
Loss before cumulative effect of change in accounting principle and income tax expense	<u>(73,474)</u>	<u>(121,693)</u>	<u>(118,701)</u>
Income tax expense	(153)		
Loss before cumulative effect of change in accounting principle	<u>(73,627)</u>	<u>(121,693)</u>	<u>(118,701)</u>
Cumulative effect of change in accounting principle			(4,295)
Net loss	<u>\$ (73,627)</u>	<u>\$ (121,693)</u>	<u>\$ (122,996)</u>
Basic and diluted net loss per common share:			
Before cumulative effect of change in accounting principle	\$ (6.32)	\$ (22.30)	\$ (30.18)
Cumulative effect of change in accounting principle			(1.09)
Basic and diluted net loss per common share	<u>\$ (6.32)</u>	<u>\$ (22.30)</u>	<u>\$ (31.27)</u>
Basic and diluted weighted average number of common shares outstanding	11,654	5,457	3,933





See accompanying notes to consolidated financial statements.

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**Table of Contents****NAVISITE, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY (DEFICIT)**

	Common Stock		Deferred Compensation	Cumulative Translation Adjustment	Additional Paid-in Capital	Accumulated Deficit	Stockholders Equity (Deficit)
	Shares	Amount					
(In thousands)							
Balance at July 31, 2000	3,891	\$ 39	\$ (762)	\$	\$190,846	\$ (92,649)	\$ 97,474
Issuance of common stock in connection with employee stock purchase plan and exercise of stock options	48	0			982		982
Issuance of stock warrants in connection with convertible debt					12,918		12,918
Issuance of common stock in connection with the interest on convertible debt	186	2			3,607		3,609
Deferred stock compensation related to acquisition			(289)		289		
Amortization of deferred stock compensation			1,051				1,051
Net loss						(122,996)	(122,996)
Balance at July 31, 2001	4,125	\$ 41	\$	\$	\$208,642	\$ (215,645)	\$ (6,962)
Issuance of common stock in connection with employee stock purchase plan and exercise of stock options	35	0			36		36
Conversion of CMGI convertible debt and other amounts due to CMGI	1,624	16			87,137		87,153
Issuance of common stock in connection with the interest on convertible debt	464	5			2,980		2,985
Beneficial conversion feature of debt issued to CMGI and HPFS					42,561		42,561
Net settlement of debt to CMGI					4,464		4,464
Net loss						(121,693)	(121,693)
Balance at July 31, 2002	6,248	\$ 62	\$	\$	\$345,820	\$ (337,338)	\$ 8,544
Issuance of common stock in connection with employee stock purchase plan and exercise of stock options	2				2		2
Common control merger with CBTM	568	6			3,360	(515)	2,851
Common control merger with CBT					16,664	(4,259)	12,405
Conversion of CBT convertible debt and other amounts due to CBT	16,363	165			65,816		65,981
Issuance of common stock in connection with the acquisition of Avasta	231	2			367		369
Issuance of stock warrants to Silicon Valley Bank					370		370
Net loss						(73,627)	(73,627)
Change in foreign currency translation adjustment				(16)			(16)
Comprehensive loss							(73,643)
Balance at July 31, 2003	23,412	\$ 235	\$	\$ (16)	\$432,399	\$ (415,739)	\$ 16,879



**Table of Contents****NAVISITE, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS**

	Years Ended July 31,		
	2003	2002	2001
	(In thousands)		
Cash flows from operating activities:			
Net loss	\$(73,627)	\$(121,693)	\$(122,996)
Adjustments to reconcile net loss to net cash used for operating activities:			
Depreciation and amortization	14,148	20,649	15,154
Amortization of beneficial conversion feature to interest expense	37,398	5,163	
Interest on debt paid in stock	2,098	3,695	
Impairment of long-lived assets	1,190	68,317	
Impairment of goodwill and intangibles	1,831	186	
Write-down of assets held for sale		524	
(Gain) loss on disposal of assets	250	1,363	(133)
Gain on sale of Streaming Media assets		(524)	
Costs associated with abandoned leases	6,127		
Amortization of warrants	66		
Provision for bad debts	1,583	3,490	11,948
Amortization of deferred compensation			1,051
Interest on convertible notes payable to CMGI			3,609
Accretion of debt discount		1,172	2,691
Changes in operating assets and liabilities, net of impact of acquisitions:			
Accounts receivable	(1,371)	3,600	(6,373)
Due from CMGI and affiliates	(22)	(266)	1,623
Prepaid expenses and other current assets, net	1,820	178	1,016
Due to CMGI	(3,241)	7,218	9,511
Long-term assets	675	(379)	(58)
Accounts payable	(2,614)	(8,537)	(3,116)
Customer deposits	(65)	(19)	218
Long-term liabilities	163		
Accrued expenses and deferred revenue	(958)	(11,172)	(2,945)
Net cash used for operating activities	(14,549)	(27,035)	(88,800)
Cash flows from investing activities:			
Net cash acquired in acquisitions	3,981		
Purchase of property and equipment	(1,067)	(4,182)	(25,515)
Purchase of debt securities	(1,963)		
Cash used to acquire Interliant assets	(5,830)		
Loan to related party	(1,596)		
Proceeds from repayment of loan to related party	200		
Proceeds from the sale of Streaming Media assets		1,600	
Proceeds from the sale of equipment	475	1,440	13,884
Restricted cash	3,878	1,201	(5,051)
Other assets		577	(747)
Net cash provided by (used for) investing activities	(1,922)	636	(17,429)
Cash flows from financing activities:			
Issuance of convertible notes payable to CMGI			80,000

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Issuance of convertible notes payable to CMGI and HPFS		30,000	
Proceeds from exercise of stock options and employee stock purchase plan		35	982
Repayment of note payable		(1,874)	
Debt repayment to the AppliedTheory estate	(6,100)		
Borrowing under note to affiliate	5,850		
Net borrowings under accounts receivable line	6,359		
Payments under note to affiliates	(2,600)		
Payment of capital lease obligations	(5,018)	(1,218)	(29,646)
Payments of software vendor obligations		(916)	(840)
Net cash provided by (used for) financing activities	(1,509)	26,027	50,496
Net decrease in cash	(17,980)	(372)	(55,733)
Cash and cash equivalents, beginning of year	21,842	22,214	77,947
Cash and cash equivalents, end of year	\$ 3,862	\$ 21,842	\$ 22,214
Supplemental disclosure of cash flow information:			
Cash paid for interest	\$ 704	\$ 3,553	\$ 1,364

See accompanying notes to consolidated financial statements.

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**NAVISITE, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(1) Description of Business**

NaviSite, Inc. provides outsourced hosting and managed application services for middle-market organizations which include mid-sized companies, divisions of large multi-national companies and government agencies. Substantially all revenues are generated from customers in the United States.

**(2) Summary of Significant Accounting Policies**

**(a) Basis of Presentation**

*Restatement of Previously Filed Financial Statements as of and for the Year Ended July 31, 2003*

We completed a business combination of entities under common control on August 8, 2003. The transaction was consummated after the end of fiscal year 2003, but before we filed our July 31, 2003 annual report on Form 10-K on October 22, 2003. The Financial Statements have been restated herein to account for this business combination in a manner similar to a pooling-of-interest (see Impact of Acquisitions, below).

*One-for-fifteen Reverse Stock Split*

On December 12, 2002, our Board of Directors, pursuant to authority previously granted by our stockholders at the annual meeting on December 19, 2001, approved a reverse stock split of our common stock at a ratio of one-for-fifteen (1:15) effective January 7, 2003. All per-share amounts and number of shares outstanding have been restated to give effect to the reverse stock split.

*Change in Controlling Ownership*

Through September 10, 2002, we were a majority owned subsidiary of CMGI, Inc. (CMGI). On September 11, 2002, each of CMGI and Hewlett-Packard Financial Services Company (HPFS) sold and transferred to ClearBlue Technologies, Inc. (ClearBlue), a privately-held managed service provider based in San Francisco, California, the following equity and debt interests in NaviSite:

Pursuant to a Note and Stock Purchase Agreement by and between ClearBlue and CMGI (the CMGI Agreement), CMGI sold and transferred to ClearBlue 4,735,293 shares of our common stock, \$0.01 par value per share, representing approximately 76% of the outstanding capital stock of NaviSite, warrants to purchase 346,883 shares of our common stock and a convertible note of NaviSite with an aggregate principal amount outstanding of \$10.0 million. The \$10.0 million convertible note was convertible into 2,564,103 shares of our common stock, under certain circumstances as defined therein.

Pursuant to a Note and Stock Purchase Agreement by and between ClearBlue and HPFS (the HPFS Agreement), HPFS sold and transferred to ClearBlue 213,804 shares of our common stock, representing approximately 3.4% of our outstanding capital stock, and convertible notes of NaviSite with an aggregate principal amount outstanding of approximately \$55.0 million, convertible into 14,126,496 shares of our common stock, under certain circumstances as defined therein.

On December 12, 2002, ClearBlue Finance, Inc., a wholly-owned subsidiary of ClearBlue (ClearBlue Finance), (i) converted in full the \$10.0 million note formerly held by CMGI and (ii) converted \$10.0 million of the \$55.0 million notes formerly held by HPFS. We issued 5,128,205 shares of our common stock to ClearBlue Finance upon the conversion and partial conversion, respectively, of the \$10.0 million note formerly held by CMGI and \$10.0 million of the \$55.0 million notes formerly held by HPFS and issued 458,943 shares of our common stock for payments of interest due under the convertible notes. A new note (New Note) in the amount of \$45.0 million was issued to ClearBlue Finance with

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**NAVISITE, INC. AND SUBSIDIARIES**

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

respect to the portion of the outstanding principal and interest due under the note formerly held by HPFS that was not converted.

On December 13, 2002, ClearBlue transferred beneficial ownership of all of its shares of our common stock (except for a fractional share which it retained) to its shareholders, ClearBlue Atlantic, LLC (ClearBlue Atlantic), HPFS, CMGI and an employee of ClearBlue Technologies Management, Inc. (CBTM) on a pro rata basis according to its shareholders' ownership of ClearBlue.

Also, as a result of the change in ownership, the agreement between NaviSite and CMGI, whereby CMGI provided certain facilities and administrative support services for us, automatically terminated. CMGI continued to provide certain services to us pursuant to a Transition Services Agreement we entered into with CMGI on November 25, 2002 as we transitioned to a service agreement with ClearBlue or to other third-party suppliers. This transition agreement concluded during the second quarter of fiscal year 2003, and we have completely severed our administrative ties with CMGI; however, CMGI remains a third-party customer. During the second quarter of fiscal year 2003, we contracted with ClearBlue and other third-party suppliers for these services.

On December 31, 2002, NaviSite, a majority owned subsidiary of ClearBlue and its affiliates, completed the acquisition of CBTM, a wholly-owned subsidiary of ClearBlue which, in June 2002, acquired certain assets from the bankrupt estate of AppliedTheory, Inc., in exchange for 567,978 shares of our common stock, representing 4.5% of our total then outstanding common stock, inclusive of the common stock issued as part of the acquisition. The market price of our stock at the time of the transaction was \$2.25 per share. As ClearBlue had a controlling interest in both companies at the time of the combination, the transaction was accounted for as a combination of entities under common control (i.e., as if pooling) whereby the assets and liabilities of CBTM and NaviSite were combined at their historical amounts. Accordingly, our historical consolidated financial statements have been restated to include the financial results of CBTM beginning on September 11, 2002, the initial date on which ClearBlue acquired a controlling interest in both NaviSite and CBTM. CBTM's balance sheet has been included in our Consolidated Balance Sheet at July 31, 2003, and CBTM's results of operations and cash flows for the eleven-months ended July 31, 2003 have been included in our Consolidated Statements of Operations and Consolidated Statements of Cash Flows for the fiscal year ended July 31, 2003. CBTM is operated as a wholly-owned subsidiary of NaviSite.

On June 16, 2003, we repaid approximately \$3.9 million of the \$45.0 million of outstanding New Note to ClearBlue Finance, Inc. by offsetting amounts due to us by ClearBlue. On June 17, 2003, we received written notice from ClearBlue Finance, Inc. stating its election to convert the remaining approximately \$41.2 million of the New Note into 10,559,248 shares of common stock effective June 19, 2003. As of July 31, 2003 ClearBlue Technologies Equity, Inc., ClearBlue Finance, ClearBlue and ClearBlue Atlantic beneficially owned 19,284,994 shares of our common stock, representing approximately 78.6% of the outstanding shares of common stock on a fully converted basis. As a result of these changes in ownership since September 11, 2002 involving ClearBlue and its affiliates, the utilization of our federal and state tax net operating loss carryforwards will be severely limited pursuant to Internal Revenue Code Section 382.

*Impact of Acquisitions*

In addition to the acquisition of CBTM, as discussed above, during fiscal year 2003, we completed the acquisitions of Avasta, Inc., a California corporation (Avasta), Conxion Corporation, a California corporation (Conxion), and substantially all of the assets of Interliant, Inc. (Interliant Assets) through our wholly-owned subsidiary, Intrepid Acquisition Corp. (Intrepid). Each of these acquisitions was accounted for using the purchase method of accounting. The results of operations and cash flows from Avasta, Conxion, and Intrepid are included in our Consolidated Statements of Operations and Consolidated Statements of Cash Flows for the twelve-month period ended July 31, 2003 from their respective dates of

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**NAVISITE, INC. AND SUBSIDIARIES**

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

acquisition, February 5, 2003, April 2, 2003, and May 16, 2003. See Note 6 for further discussion of our fiscal year 2003 acquisitions.

On August 8, 2003, we completed the acquisition of certain assets and the assumption of certain liabilities of ClearBlue Technologies, Inc. (CBT) pursuant to a Stock and Asset Acquisition Agreement (the CBT Agreement) in a business combination accounted for in a manner similar to a pooling-of-interest due to common control ownership. We acquired all outstanding shares of six (6) wholly-owned subsidiaries of CBT with data centers located in Chicago, Las Vegas, Los Angeles, Milwaukee, Oakbrook and Vienna. In addition, we exercised effective control over and assumed the revenue and expense, as of the date of acquisition, of four (4) additional wholly-owned subsidiaries of CBT with data centers located in Dallas, New York, San Francisco and Santa Clara. Ownership of these subsidiaries will automatically be transferred, under certain conditions, to NaviSite for no additional consideration in February 2004.

As Atlantic Investors, LLC had a controlling interest in both NaviSite and CBT at the time of the combination, the transaction was accounted for as a combination of entities under common control (i.e., as if pooling ) whereby the assets and liabilities of CBT and NaviSite were combined at their historical amounts. Accordingly, the Company's consolidated financial statements have been restated for all periods prior to the business combination to include CBT's financial results beginning on September 11, 2002, the date on which CBT acquired the controlling interest in the Company after the elimination of intercompany balances. CBT's balance sheet has been included in the Consolidated Balance Sheet of NaviSite at July 31, 2003, and CBT's results of operations and cash flows for the eleven months ended July 31, 2003 have been included in the Consolidated Statement of Operations and Consolidated Statement of Cash Flows of NaviSite for the fiscal year ended July 31, 2003.

**(b) Principles of Consolidation**

The accompanying consolidated financial statements include the accounts of NaviSite and our wholly-owned subsidiaries, ClickHear, Inc., NaviSite Acquisition Corp., ClearBlue Technologies Management, Inc., Avasta, Inc., Conxion Corporation, Intrepid Acquisition Corp., ClearBlue Technologies/ Chicago-Wells, Inc., ClearBlue Technologies/ Las Vegas, Inc., ClearBlue Technologies/ Los Angeles, Inc., ClearBlue Technologies/ Milwaukee, Inc., ClearBlue Technologies/ Oakbrook, Inc., and ClearBlue Technologies/ Vienna, Inc. after elimination of all significant intercompany balances and transactions.

**(c) Use of Estimates**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect certain reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates. Significant estimates made by management include the useful lives of fixed assets and intangible assets, recoverability of long-lived assets and the collectibility of receivables.

**(d) Cash and Cash Equivalents**

Cash equivalents consist of a money market fund, which invests in high quality short-term debt obligations, including commercial paper, asset-backed commercial paper, corporate bonds, U.S. government agency obligations, taxable municipal securities, and repurchase agreements.

During fiscal year 2003, non-cash financing activities included the repayment of approximately \$3.9 million of the New Note to ClearBlue Finance, Inc. with amounts due us by ClearBlue. In addition, fiscal year 2003 non-cash financing activities included the conversion of the then outstanding \$41.2 million New Note into 10,559,248 shares of our common stock. This conversion also resulted in non-cash charges



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**NAVISITE, INC. AND SUBSIDIARIES**

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

of (a) \$195,000 related to deferred financing costs; (b) \$2.7 million in deferred interest expense; and (c) \$21.6 million related to the amortization of the remaining balance of the beneficial conversion feature.

During fiscal year 2002, non-cash financing activities included a \$35.0 million obligation to Compaq Financial Services Corporation, a wholly-owned subsidiary of Compaq Computer Corporation subsequently acquired by HPFS, incurred for the purchase of equipment previously held under operating lease agreements with a fair value, based on a third-party appraisal, of \$9.6 million.

During fiscal year 2002, non-cash financing activities included the conversion of the \$70.9 million, net, carrying amount (\$80.0 million face value) of convertible notes payable to CMGI including interest of \$1.5 million, and \$16.2 million of amounts due to CMGI into an aggregate of 1,641,993 shares of our common stock.

During fiscal 2002 and 2001, non-cash financing activities included the issuance of 464,800 and 186,000 shares of common stock, respectively, in satisfaction of interest associated with convertible notes outstanding during fiscal 2002 and 2001.

In August 2002, the Company settled its intercompany liability to and receivables from CMGI, as of May 31, 2002, for \$3.2 million in cash. The \$3.2 million was remitted to CMGI in August 2002. As a result of the transaction, the Company realized a \$4.5 million gain on the settlement, which was recorded as a contribution to additional paid-in capital as of July 31, 2002 as the transaction was considered to be a settlement of debt between entities under common control.

**(e) Revenue Recognition**

Revenue consists of monthly fees for Web site and Internet application management, application rentals, hosting, and professional services. Revenue (other than installation fees) is generally billed and recognized over the term of the contract, generally one to three years, based on actual usage. Payments received in advance of providing services are deferred until the period such services are provided. Revenue from professional services is recognized on a time-and-material basis as the services are performed or under the percentage of completion method for revenue relating to fixed-price contracts. We generally sell our professional services under contracts with terms ranging from one to five years. Revenue and profits on long-term Internet solutions contracts, which represent approximately 3.0% of total revenues for the fiscal year period ended July 31, 2003, performed over extended periods are recognized under the percentage-of-completion method of accounting, principally, with adjustments recorded in the period in which the revisions are made. Any anticipated losses on contracts are charged to operations as soon as they are determinable.

**(f) Concentration of Credit Risk**

Our financial instruments include cash, accounts receivable, obligations under capital leases, software agreements, accounts payable, and accrued expenses. As of July 31, 2003, the carrying cost of these instruments approximated their fair value. The financial instruments that potentially subject us to concentration of credit risk consist primarily of accounts receivable. Concentration of credit risk with respect to trade receivables is limited due to the large number of customers across many industries that comprise our customer base. One third-party customer accounted for 21% of our total revenues for the twelve-months ended July 31, 2003. Accounts receivable at July 31, 2003 included approximately \$2.3 million due from this third-party customer.

**(g) Comprehensive Income (Loss)**

Comprehensive income (loss) is defined as the change in equity from foreign currency translation adjustments.

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**NAVISITE, INC. AND SUBSIDIARIES**

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

**(h) Property and Equipment**

Property and equipment are stated at cost. Depreciation is computed using the straight-line method over the estimated useful lives of the assets. Leasehold improvements and assets acquired under capital leases are amortized using the straight-line method over the shorter of the lease term or estimated useful life of the asset. Assets acquired under capital leases in which title transfers to us at the end of the agreement are amortized over the useful life of the asset. Expenditures for maintenance and repairs are charged to expense as incurred.

**(i) Goodwill and Intangible Assets**

Prior to July 31, 2002, goodwill related to purchase acquisitions completed in fiscal years 1998 and 2000. Such costs were amortized on a straight-line basis over five years, the period expected to be benefited. In fiscal year 2002, goodwill of \$3,400 was written-off as part of the sale of the majority of the operating assets of one of the prior acquisitions. As part of our impairment analysis performed at July 31, 2002, it was determined that the unamortized goodwill at July 31, 2002 of \$186,000 was fully impaired and was included in the accompanying consolidated statements of operations as a component of general and administration expense.

At July 31, 2003, our intangible assets consisted of customer lists resulting from our acquisition of CBTM, and the acquisitions of the certain assets and liabilities of Interliant and CBT. Our intangible assets were recorded at a gross carrying value of \$15.8 million, less accumulated amortization of \$3.7 million at July 31, 2003. Amortization expense related to our customer lists of \$3.2 million for the fiscal year period ended July 31, 2003 was recorded as a component of our cost of revenue. Goodwill, resulting from our acquisition of CBTM, is recorded at its gross carrying value of \$3.2 million. We perform our annual impairment analysis in our fiscal fourth quarter.

**(j) Accounting for Impairment of Long-Lived Assets**

We assess the need to record impairment losses on long-lived assets used in operations when indicators of impairment are present. On an ongoing basis, management reviews the value and period of amortization or depreciation of long-lived assets, including goodwill. During this review, the significant assumptions used in determining the original cost of long-lived assets are reevaluated. Although the assumptions may vary from transaction to transaction, they generally include revenue growth, operating results, cash flows, and other indicators of value. Management then determines whether there has been a permanent impairment of the value of long-lived assets by comparing future undiscounted cash flows to the asset's carrying value. If the estimated future undiscounted cash flows are less than the carrying value of the asset, a loss is recorded based on the excess of the asset's carrying value over fair value.

**(k) Income Taxes**

We account for income taxes under the asset and liability method. 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 and tax credit 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. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

Prior to the initial public offering on October 21, 1999, we were greater than 80% owned by CMGI, and as such, CMGI realized the full benefit of all federal and part of the state net operating losses that had been incurred by us for those periods before the fiscal year ended July 31, 2001. Therefore, such net operating losses incurred by NaviSite were not available to us. The tax sharing agreement between NaviSite and CMGI required us to reimburse CMGI for the amounts it contributed to the consolidated

**Table of Contents****NAVISITE, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

tax liability of the CMGI group; however, under the policy, CMGI was not obligated to reimburse us for any losses utilized in the consolidated CMGI group. After our public offering, CMGI's ownership fell below 80% and we were no longer included in the federal consolidated group of CMGI. Thus, our federal and state net operating losses can be carried forward to offset our future taxable income. As a result of the transaction on September 11, 2002, NaviSite had a change in ownership as defined in Section 382 of the Internal Revenue Code. As a result of the change in ownership, the utilization of its federal and state tax net operating losses generated prior to the transaction is severely limited.

**(l) Advertising Costs**

We recognize advertising costs as incurred. Advertising expense was approximately \$0, \$4,000, and \$3.1 million for the fiscal years ended July 31, 2003, 2002, and 2001, respectively, and is included in the accompanying consolidated statements of operations as a component of selling and marketing expenses.

**(m) Stock-Based Compensation Plans**

We account for our stock option plans under the recognition and measurement principles of APB Opinion No. 25, Accounting for Stock Issued to Employees, and related Interpretations. No stock-based compensation cost is reflected in net income for these plans, as all options granted under these plans had an exercise price equal to the market value of the underlying common stock on the date of grant. The following table illustrates the effect on net income (loss) and earnings (loss) per share if we had applied the fair value recognition provisions of FASB Statement No. 123, Accounting for Stock-Based Compensation, to stock based compensation.

	2003	2002	2001
	(In thousands, except per share data)		
Net loss, as reported	\$(73,627)	\$(121,693)	\$(122,996)
Deduct: Total stock based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(8,062)	(24,778)	(40,072)
Net loss, as adjusted	\$ (81,689)	\$ (146,471)	\$ (163,068)
Loss per share:			
Basic and diluted as reported	\$ (6.32)	\$ (22.30)	\$ (31.27)
Basic and diluted as adjusted	\$ (7.01)	\$ (26.84)	\$ (41.46)
<b>NaviSite:</b>			
Risk-free interest rate	1.93%	2.23%	4.50%
Expected dividend yield	0.00%	0.00%	0.00%
Expected volatility	160.16%	250.00%	185.10%
Expected life (years)	3.07	2.12	2.08
Weighted average fair value of options granted during the period	\$ 2.56	\$ 4.35	\$ 219.30
<b>CMGI:</b>			
Risk-free interest rate	2.79%	2.79%	4.19%
Expected dividend yield	0.00%	0.00%	0.00%
Expected volatility	97.05%	97.05%	126.95%
Expected life (years)	5.85	5.85	2.91
Weighted average fair value of options granted during the period	N/A	N/A	N/A

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## NAVISITE, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**(n) Historical and Unaudited Pro Forma Basic and Diluted Net Loss Per Share**

Basic earnings (loss) per share is computed using the weighted average number of common shares outstanding during the period. Diluted earnings (loss) per share is computed using the weighted average number of common and diluted common equivalent shares outstanding during the period, using either the if-converted method for convertible preferred stock and notes or the treasury stock method for options, unless amounts are anti-dilutive.

For fiscal years ended July 31, 2003, 2002, and 2001, net loss per basic and diluted share is based on weighted average common shares and excludes any common stock equivalents, as they would be anti-dilutive due to the reported losses. There were 2,741, 29,503 and 167,793 of diluted shares related to employee stock options that were excluded as they have an anti-dilutive effect due to the loss for fiscal years 2003, 2002, and 2001 respectively.

**(o) Segment Reporting**

We currently operate in one segment, outsourced hosting and application management services. The Company's chief operating decision maker reviews financial information at a consolidated level. The Company has determined that reporting revenue at a service offering level is impracticable.

**(p) New Accounting Pronouncements**

In May 2003, the Financial Accounting Standards Board (FASB) finalized Emerging Issues Task Force (EITF) Issue 01-8, Determining Whether an Arrangement is a Lease (EITF 01-8). Under EITF 01-8, our relationships with our customers no longer meet the definition of a lease arrangement and as such, on a prospective basis after May 31, 2003, we no longer account for new customer agreements as direct financing agreements. Customer agreements that were classified as direct financing agreements before June 1, 2003 will continue to be treated as direct financing agreements through the term of the agreements.

In June 2001, the FASB issued SFAS No. 141, Business Combinations, and SFAS No. 142, Goodwill and Other Intangible Assets. SFAS No. 141 applies to all business combinations that we enter into after June 30, 2001, and eliminates the pooling-of-interests method of accounting. SFAS No. 142 is effective for fiscal years beginning after December 15, 2001. Under the new statements, goodwill and intangible assets deemed to have indefinite lives will no longer be amortized but will be subject to annual impairment tests in accordance with the statements. Other intangible assets will continue to be amortized over their useful lives.

During the first quarter of fiscal 2003 (effective August 1, 2002), the Company adopted Statement of Financial Accounting Standards No. 142 (SFAS 142), Goodwill and Intangible Assets, which supersedes APB Opinion No. 17, Intangible Assets. SFAS No. 142 eliminates the current requirement to amortize goodwill and indefinite-lived intangible assets, addresses the amortization of intangible assets with a defined life and addresses the impairment testing and recognition of goodwill and intangible assets. The following information describes the impact that the adoption of SFAS No. 142 had on the Company for the fiscal years ended July 31:

**Intangible Assets:**

Intangible assets as of July 31, 2003 are as follows:

	Gross Carrying Amount	Accumulated Amortization
	(In thousands)	
Customer Lists	\$ 15,776	\$ 3,724



**Table of Contents****NAVISITE, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The accumulated amortization of \$3.7 million above includes \$507,000 of accumulated amortization relating to the CBT customer lists (acquired in fiscal year 2004), which were accounted for in a manner similar to a pooling-of-interest due to common control ownership. Intangible asset amortization expense for the years ended July 31, 2003, 2002, and 2001 aggregated \$3.2 million, \$0 and \$0 respectively. Amortization expense related to intangible assets for the next five years is as follows:

Year Ending July 31,	(In thousands)
2004	\$ 3,232
2005	\$ 2,940
2006	\$ 2,577
2007	\$ 1,627
2008	\$ 1,047

**Goodwill:**

The changes in the carrying amount of goodwill for the fiscal years ended July 31 are as follows:

	Fiscal 2003	Fiscal 2002	Fiscal 2001
	(In thousands)		
Goodwill as of August 1	\$	\$ 394	\$ 601
Goodwill acquired	3,206		
Goodwill amortization		(208)	(207)
Goodwill impairment		(186)	
Goodwill as of July 31	\$ 3,206	\$	\$ 394

The impact that the adoption of SFAS 142 had on net income and earnings per share for the fiscal years ended July 31 are presented as follows:

	2003	2002	2001
	(In thousands)		
Net loss	\$ (73,627)	\$ (121,693)	\$ (122,996)
Add back goodwill amortization		208	207
Adjusted net loss	\$ (73,627)	\$ (121,485)	\$ (122,789)
Basic and diluted earnings per share:			
Net loss	\$ (6.32)	\$ (22.30)	\$ (31.27)
Goodwill amortization		0.05	0.04
Adjusted net loss	\$ (6.32)	\$ (22.25)	\$ (31.23)

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SFAS No. 143, *Accounting for Asset Retirement Obligations*, issued in August 2001, addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and was adopted beginning in the first quarter of fiscal year 2003. The adoption of SFAS 143 did not have a material impact on our financial condition or results of operations.

SFAS 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, issued in October 2001, addresses financial accounting and reporting for the impairment or disposal of long-lived assets and is effective for fiscal years beginning after December 15, 2001. SFAS 144 establishes a single accounting model for long-lived assets to be disposed of by sale as well as revising certain criteria specified in

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**NAVISITE, INC. AND SUBSIDIARIES**

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

SFAS 121 for the recognition and measurement of impairment losses related to long-lived assets. The adoption of SFAS 144 did not have a material impact on our financial condition or results of operations.

SFAS 146, *Accounting for Costs Associated with Exit or Disposal Activities*, issued in July 2002, addresses financial accounting and reporting for costs associated with exit or disposal activities and rescinds Emerging Issues Task Force (EITF) Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*. SFAS 146 requires that a liability for a cost associated with an exit or disposal activity be recognized when the liability is incurred. Under EITF Issue No. 94-3, a liability for an exit cost as defined in EITF Issue No. 94-3 was recognized at the date of an entity's commitment to an exit plan. SFAS 146 also establishes that fair value is the objective for initial measurement of the liability. The provisions of SFAS 146 are effective for exit and disposal activities that are initiated after December 31, 2002. We applied the provisions of SFAS 146 in January 2003 in connection with the lease abandonments.

In November 2002, the FASB issued Interpretation No. 45 (FIN 45), *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, which clarifies disclosure and recognition/ measurement requirements related to certain guarantees. The disclosure requirements are effective for financial statements issued after December 15, 2002 and the recognition/ measurement requirements are effective on a prospective basis for guarantees issued or modified after December 31, 2002. The application of the requirements of FIN 45 did not have a material impact on our financial position or results of operations.

In December 2002, the FASB issued SFAS No. 148, *Accounting for Stock-Based Compensation - Transition and Disclosure*. SFAS No. 148 amends SFAS No. 123 to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, SFAS No. 148 amends the disclosure requirements of SFAS No. 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. The transition guidance and annual disclosure provisions of SFAS No. 148 are effective for fiscal years ending after December 15, 2002. The interim disclosure provisions are effective for financial reports containing financial statements for interim periods beginning after December 15, 2002. As we did not make a voluntary change to the fair value based method of accounting for stock-based employee compensation in fiscal year 2003, the adoption of SFAS No. 148 did not have a material impact on our financial position and results of operations.

In May 2003, the FASB issued SFAS 150, *Accounting For Certain Financial Instruments with Characteristics of Both Liabilities and Equity* which establishes standards for how an issuer of financial instruments classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances) if, at inception, the monetary value of the obligation is based solely or predominantly on a fixed monetary amount known at inception, variations in something other than the fair value of the issuer's equity shares or variations inversely related to changes in the fair value of the issuer's equity shares. This Statement is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. The adoption of SFAS 150 is not expected to have a material impact on our financial position or results of operations.

**(q) Reclassifications**

Certain fiscal year 2002 balances have been reclassified to conform with the fiscal year 2003 financial statement presentation.



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**NAVISITE, INC. AND SUBSIDIARIES**

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

**(r) Foreign Currency**

The functional currencies of our wholly-owned subsidiaries are the local currencies. The financial statements of the subsidiaries are translated into U.S. dollars using period-end exchange rates for assets and liabilities and average exchange rates during corresponding period for revenues, cost of revenues and expenses. Translation gains and losses are deferred and accumulated as a separate component of stockholders equity (accumulated other comprehensive income (loss)).

**(3) Liquidity**

Our cash and cash equivalents decreased to approximately \$3.9 million at July 31, 2003 from approximately \$21.8 million at July 31, 2002. Net cash used in operating activities was approximately \$14.5 million for the year ended July 31, 2003, resulting primarily from net losses, decreases in accrued expenses and accounts payables, and a decrease in amounts due to CMGI, partially offset by non-cash charges for the write-off and amortization of the beneficial conversion feature of the convertible debt, interest paid in stock, costs related to abandoned leases, impairment of assets, depreciation and amortization, and provision for bad debt. Net cash used in investing activities was approximately \$1.9 million for the year ended July 31, 2003, resulting primarily from purchases of property and equipment, the purchase of certain assets of Interliant, the purchase of convertible notes of Interliant, a loan made to a related party, partially offset by cash acquired in acquisitions and the release of restricted cash. Net cash used for financing activities was approximately \$1.5 million for the fiscal year ended July 31, 2003, resulting primarily from repayment of debt to the estate of AppliedTheory, repayment of notes to affiliates, the payment of capital lease obligations, partially offset by borrowings from affiliates and borrowings from our accounts receivable financing line.

At July 31, 2003, we had a working capital deficit of \$16.3 million, an accumulated deficit of \$416 million, and have reported losses from operations since incorporation. We have used cash from continuing operations of \$14.5 million, \$27.0 million and \$88.8 million in the years ended July 31, 2003, 2002, and 2001, respectively. We anticipate incurring additional losses throughout our next fiscal year. NaviSite has taken several actions it believes will allow us to continue as a going concern through July 31, 2004, including the closing and integration of strategic acquisitions, the change in our Board of Directors and senior management and bringing costs more in line with projected revenues. Based upon our cash flow estimates we believe that we will more than likely need to raise funds to meet our anticipated needs for working capital and capital expenditures for at least the next twelve months. Our cash flow estimates are based upon attaining certain levels of sales, maintaining budgeted levels of operating expenses, collections of accounts receivable and maintaining our current borrowing line with Silicon Valley Bank among other assumptions, including the improvement in the overall macroeconomic environment. Our sales estimate includes revenue from new and existing customers which may not be realized and we may be required to further reduce expenses if budgeted sales are not attained. We may be unsuccessful in reducing expenses in proportion to any shortfall in projected sales and our estimate of collections of accounts receivable may be hindered by our customers' ability to pay.

We believe that we will more than likely need to raise funds to meet our anticipated needs for working capital and capital expenditures. We believe that the sources of liquidity include the issuance of equity or convertible debt securities, sales of assets, or through credit arrangements with financial institutions. If we are unable to successfully complete any one of such capital-raising transactions, we will turn to one or more of the other transactions. The accompanying consolidated financial statements have been prepared assuming NaviSite will continue as a going concern and, as such, do not include any adjustments that may result from the outcome of these uncertainties.

**Table of Contents****NAVISITE, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(4) Impairment of Long-Lived Assets**

During fiscal year 2002, the Company recorded a net \$1.9 million charge representing the future estimated remaining minimum lease payments related to certain idle equipment held under various operating leases. The equipment had previously been rented to former customers under operating leases, and upon the loss of the customer, the equipment became idle. Based on the Company's forecasts, the equipment will not be utilized before the related operating leases expire and/or the equipment becomes obsolete.

During fiscal year 2002, the Company evaluated the current and forecasted utilization of its purchased software licenses. As a result of this evaluation, during the second quarter of fiscal year 2002, the Company recorded a \$365,000 impairment for software licenses that would not be utilized before the licenses expired or became obsolete.

During fiscal year 2002, the Company finalized agreements with various equipment lessors whereby the Company purchased equipment previously held under operating lease for approximately \$42.0 million. The fair market value of the equipment at the time of purchase, based on third party appraisal, was approximately \$13.1 million. As the aggregate fair market value of the equipment, based on third party appraisal, was less than the aggregate consideration given, the Company recorded an asset impairment charge of \$25.4 million, as a separate component of cost of revenue, in fiscal year 2002.

A number of factors occurring during the fourth quarter of fiscal 2002 impacted the Company's long-lived assets including both their expected future cash flow generation and the Company's expected utilization of the assets within revised operating plans. These factors included the further deterioration of market conditions within the web hosting industry, excess capacity in the industry and in the Company's two data centers, deterioration of the Company's revenue base.

Based on these factors and their impact on current and future projected cash flows, the Company performed an assessment of the carrying value of its long-lived assets pursuant to SFAS No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of. The conclusion of this assessment was that the decline in market conditions within the Company's industry were significant and other than temporary. In this assessment, the Company reviewed its long-lived assets, which included property and equipment and goodwill. The carrying amount of goodwill, which totaled \$186,000, was considered unrecoverable and was written-off as of July 31, 2002 and was included as a component of general and administration expense.

In accordance with SFAS No. 121, the measurement of the impairment loss of property and equipment was based on the fair value of the asset, as determined by a third party appraisal. The following is a summary of the impairment charge, by asset classification, as of July 31, 2002:

	<u>Carrying Value</u>	<u>Appraised Fair Value</u>	<u>Impairment</u>
		(In thousands)	
Office furniture and equipment	\$ 3,062	\$ 837	\$ 2,225
Computer equipment	8,470	5,675	2,795
Software licenses	3,720	2,158	1,562
Leasehold improvements	35,280	3,742	31,538
	<u>          </u>	<u>          </u>	<u>          </u>
Total	\$ 50,532	\$ 12,412	\$ 38,120
	<u>          </u>	<u>          </u>	<u>          </u>

In addition, approximately \$3.0 million of other impairment charges were recorded throughout the year as appropriate.

**Table of Contents****NAVISITE, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Management determined that the best measure of fair value for the property and equipment was a combination of the market and cost approaches. The cost approach was utilized to determine the fair value of certain computer hardware, leasehold improvements, office furniture and equipment, and construction in progress. The cost approach utilizes estimated replacement/reproduction costs, with allowances for physical depreciation and functional obsolescence (i.e. asset utilization). For certain equipment and leasehold improvements, the market approach was used. The market approach typically includes comparing recent sales of similar assets and adjusting these comparable transactions based on factors such as age, condition, and type of sale to determine fair value.

The following is a summary of the fiscal 2002 impairment charges described above, by asset classification:

Net impairment of fixed assets purchased from operating leases	\$24,881
Impairment of software that would not be utilized before expiration of license or software became obsolete	365
Impairment of idle leased equipment	1,937
Impairment of fixed assets under SFAS 121 based on the fair value of the assets versus the carrying value	41,134
	<hr/>
Total	\$68,317
	<hr/>

All impairment charges were recorded in the consolidated statements of operations based upon the nature of the asset being impaired and the nature of the asset's use. The impairments recorded as a separate component of cost of revenue related to assets that were either being utilized or had at some time been utilized to generate revenue. The determination was based upon how the assets had historically been expensed, either as lease expense or depreciation/ amortization.

As a result of our abandoning our administrative space located on the second floor of our leased facility at 400 Minuteman Road in Andover, MA on January 31, 2003, certain long-lived assets consisting mostly of leasehold improvements and furniture and fixtures were abandoned. We took a charge against our earnings in the second quarter of fiscal 2003 of approximately \$62,000 in accordance with SFAS 144, Accounting for the Impairment or Disposal of Long-Lived Assets.

During the third fiscal quarter of 2003, we evaluated the net realizable value of our assets held for sale and determined, based upon third party quotes for purchase of these assets, that the net fair market value of our assets held for sale was less than the carrying value. As a result, we recorded a \$1.0 million charge related to the reduction in the net realizable value of our assets held for sale as a component of other expense. These assets were sold to third parties in the fourth fiscal quarter of 2003.

During the fourth quarter of 2003, we evaluated the net realizable value of our intangible assets and determined, due to changes in certain real estate markets where we operate, that the net fair market value of our market advantaged leases was less than the carrying value. As a result, we recorded a charge of approximately \$1.8 million related to the impairment of the market advantage leases.

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Property and equipment at July 31, 2003 and 2002 are summarized as follows:

	July 31,	
	2003	2002
	(In thousands)	
Office furniture and equipment	\$ 2,613	\$ 1,232
Computer equipment	28,368	15,237
Software licenses	9,308	8,982
Leasehold improvements	12,549	3,717
	<u>52,838</u>	<u>29,168</u>
Less accumulated depreciation and amortization	(30,673)	(16,756)
Property and equipment, net	<u>\$ 22,165</u>	<u>\$ 12,412</u>

The estimated useful lives of our fixed assets are as follows: office furniture and equipment, 5 years; computer equipment, 3 years; software licenses, 3 years or life of the license; and leasehold improvements, 4 years or life of the lease.

The cost and related accumulated amortization of property and equipment held under capital leases (classified as computer equipment above) are as follows:

	July 31,	
	2003	2002
	(In thousands)	
Cost	\$ 6,349	\$ 457
Accumulated depreciation and amortization	(2,181)	(189)
	<u>\$ 4,168</u>	<u>\$ 268</u>

**(6) Acquisitions**

*CBTM*. We acquired *CBTM* in December 2002 in a transaction accounted for as a combination of entities under common control (i.e., as if pooling) (see Note 1). In June 2002, prior to our acquisition of *CBTM*, *CBTM* acquired substantially all of the assets used or useful in the web hosting and Internet solutions business and assumed certain associated liabilities from the bankruptcy estate of AppliedTheory Corporation (AppliedTheory), which had filed for bankruptcy on April 17, 2002. On June 13, 2002, the acquisition of AppliedTheory by *CBTM* was consummated, effective June 6, 2002. The results of operations of AppliedTheory have been included in the financial statements of *CBTM* since June 6, 2002.

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The aggregate purchase price paid by CBTM for the AppliedTheory assets, excluding assumed liabilities, was \$16.0 million of which \$3.9 million was paid in cash and \$12.1 million was paid with the issuance of four notes payable to the AppliedTheory Estate: two unsecured promissory notes totaling \$6.0 million, bearing interest at 8% per annum and due June 10, 2006, a secured promissory note totaling \$700,000, bearing interest at 8% per annum and due December 10, 2002 and a \$5.4 million secured promissory note, non-interest bearing, due December 10, 2002. The two notes due December 10, 2002 were paid in December 2002.

Of the \$6.2 million in identifiable intangible assets, \$5.8 million was assigned to customer lists which are being amortized over eight years, except for the New York State Department of Labor customer contract, which is being amortized over five years, and represents the remaining life on the contract. The

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remaining \$440,000 of acquired intangible assets was allocated to proprietary software, which is being amortized over five years.

*Avasta, Inc.* On February 5, 2003, we acquired Avasta, a provider of remote hosting and managed service operations in an all-stock transaction valued at approximately \$370,000. The acquisition was made to enhance our ability to be a full service provider of applications management services and technology to our customers. The purchase price consisted of 231,039 shares of common stock at a per share value of \$1.60 (representing a five-day average of the market value of our common stock at the time of the acquisition). The purchase price of \$442,000 consists of the issuance of common stock for approximately \$370,000 and approximately \$72,000 in acquisition costs. The Agreement and Plan of Merger provided that up to an additional 1,004,518 shares of common stock could be issued in the event certain revenue targets are achieved through June 2003. As a result of the earnout calculation, in September 2003 we issued 179,353 shares of our common stock at a per share value of \$4.14 (representing the market value of our common stock the day preceding the issuance of the additional shares for the attainment of certain revenue targets). The negative goodwill of approximately \$342,000 reduced the recorded basis of property and equipment. This acquisition was accounted for using the purchase method of accounting.

The following table summarizes the fair value of the assets acquired and liabilities assumed at the date of acquisition:

	<b>Avasta</b>
	<b>(In thousands)</b>
Current assets	\$ 488
Property and equipment	3,239
	<hr/>
Total assets acquired	3,727
Current liabilities	3,285
Long-term debt	<hr/>
	<hr/>
Total liabilities assumed	3,285
	<hr/>
Net assets acquired	\$ 442
	<hr/>

*Conxion Corporation.* On April 2, 2003, we completed the acquisition of Conxion, a provider of software distribution services and network/server security expertise for its customers, pursuant to an Agreement and Plan of Merger, dated as of March 26, 2003 (Conxion Agreement), by and between us, Union Acquisition Corp., a Delaware corporation and our wholly-owned subsidiary and Conxion. Pursuant to the Conxion Agreement, the shareholders of Conxion received an aggregate of \$1.9 million in cash. The acquisition was made to enhance our ability to be a full service provider of applications management services and technology to our customers. The source of funds used for the acquisition of Conxion was our cash on hand. The acquisition price was based on the parties' determination of the fair value of Conxion and the terms of the Conxion Agreement were derived from arms-length negotiation among the parties. The purchase price of \$2.0 million consisted of the \$1.9 million paid to the Conxion shareholders and approximately \$106,000 in acquisition costs. The negative goodwill of approximately \$2.5 million reduced the recorded basis of property and equipment. This acquisition was accounted for using the purchase method of accounting.

**Table of Contents****NAVISITE, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The following table summarizes the fair value of the assets acquired and liabilities assumed at the date of acquisition:

	<b>Conxion</b>
	<b>(In thousands)</b>
Current assets	\$7,819
Property and equipment	187
	<hr/>
Total assets acquired	8,006
Current liabilities	5,976
Long-term debt	<hr/>
	<hr/>
Total liabilities assumed	5,976
	<hr/>
Net assets acquired	\$2,030
	<hr/>

*Interliant.* On May 16, 2003, we completed the acquisition of substantially all of the assets relating to the managed infrastructure solutions business, encompassing messaging and collaboration, managed hosting, bundled-in managed security, and integrated and related professional services in the United States and in Europe of Interliant, Inc., a Delaware corporation, and several of its subsidiaries (Debtors) in the bankruptcy proceedings of the Debtors under Chapter 11 of Title 11 of the United States Bankruptcy Code pending in the Southern District of New York (White Plains), pursuant to an Asset Purchase Agreement, dated as of May 15, 2003 (the Agreement), by and between our subsidiary, Intrepid Acquisition Corp. and the Debtors, approved by order of the Bankruptcy Court on May 15, 2003. Pursuant to the Agreement, the aggregate purchase price for the Interliant assets was approximately \$7.2 million after adjustments, based upon the Debtors' adjusted net worth, comprised of approximately \$5.8 million in cash, \$624,000 in the form of a credit of future distributions to be paid on the Interliant Notes, \$550,000 in principal amount of a non-interest bearing, 180-day promissory note, secured by the Interliant Debt and approximately \$200,000 in acquisition-related costs. On May 16, 2003, our subsidiary closed on the purchase of all of the Interliant Assets, other than the Debtors' accounts receivable. On June 6, 2003 our subsidiary closed on the purchase of the accounts receivable. The source of funds used for the initial closing was our cash on hand combined with the funds provided from and through financing of our accounts receivable with Silicon Valley Bank (SVB), as discussed below, cash acquired with the Interliant assets, and cash receipts from the purchased accounts receivable. The acquisition price was determined through arms-length negotiations and competitive bidding for the Interliant Assets at an auction conducted under the auspices of the Bankruptcy Court. Finalization of the purchase accounting is pending resolution of the net worth calculation. However, we do not believe that any adjustment relating to this matter will be material to our consolidated financial statements.

**Table of Contents****NAVISITE, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The following table summarizes the fair value of the assets acquired and liabilities assumed at the date of acquisition:

	<b>Interliant</b>
	<b>(In thousands)</b>
Current assets	\$ 3,966
Long-term assets	5,940
Property and equipment	2,178
Total assets acquired	12,084
Current liabilities	4,880
Long-term debt	
Total liabilities assumed	4,880
Net assets acquired	\$ 7,204

On August 8, 2003, we completed the acquisition (the "CBT Acquisition") of certain assets and the assumption of certain liabilities of ClearBlue Technologies, Inc., a Delaware corporation (ClearBlue), pursuant to a Stock and Asset Acquisition Agreement, dated as of August 8, 2003 (the "Agreement"). At the time of the Agreement, we were a majority owned subsidiary of ClearBlue and its affiliates. See Notes 2(a) and 16 for further discussion.

The following unaudited pro forma results of operations for the twelve-months ended July 31, 2003 and 2002 give effect to CBTM's acquisition of AppliedTheory assets, our fiscal year 2003 acquisitions and the CBT Acquisition as if the transactions had occurred at the beginning of fiscal year 2002. The pro forma information does not necessarily reflect the results of operations that would have occurred had the acquisitions taken place at the beginning of the fiscal 2002 period and is not necessarily indicative of results that may be obtained in the future.

	<b>Year Ended July 31,</b>	
	<b>2003</b>	<b>2002</b>
	<b>(In thousands, except for per share amounts)</b>	
Revenue	\$ 113,528	\$ 197,726
Net loss before extraordinary items	(88,502)	(321,919)
Net loss	(88,502)	(286,962)
Pro forma net loss per share	\$ (7.59)	\$ (52.59)

**(7) Investment in Debt Securities**

In a privately negotiated transaction with Fir Tree Recovery Master Fund, LP and Fir Tree Value Partners, LDC, pursuant to an Assignment Agreement dated October 11, 2002 and in a series of open market transactions from certain other third-party holders, we acquired an aggregate principal amount of approximately \$36.3 million face value, 10% convertible senior notes (Interliant Notes) due in 2006 of Interliant, Inc. (Interliant) for a total consideration of approximately \$2.0 million. Interliant is a provider of managed services, which filed a petition under Chapter 11 of Title 11 of the United States Bankruptcy Code in the Southern District of New York on August 5, 2002, and we made this investment with the intention of participating in the reorganization/sale of Interliant.



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On May 16, 2003, the Southern District of New York (White Plains) confirmed us as the successful bidder for the purchase of the Interliant Assets (see Note 6). We used \$624,000 of the value of our

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**Table of Contents****NAVISITE, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Interliant Notes as partial payment for the assets acquired. As such, we have reduced the carrying value of the Interliant Notes by this amount. The final value we will receive for the Interliant Notes has not been determined, however, we estimate the value to approximate the \$1.4 million carrying value included in other assets on our Consolidated Balance Sheet. The Interliant Estate has filed a plan of liquidation with the bankruptcy court which is subject to creditor approval and resolution of further contested claims.

**(8) Accrued Expenses**

Accrued expenses consist of the following:

	July 31,	
	2003	2002
	(In thousands)	
Accrued payroll, benefits and commissions	\$ 3,088	\$ 2,037
Accrued accounts payable	3,694	1,328
Due to AppliedTheory estate	1,461	
Accrued lease abandonment costs	2,536	189
Accrued interest	351	1,565
Accrued contract termination fees	2,096	
Accrued other	4,354	2,813
	\$ 17,580	\$ 7,932

**(9) Debt****(a) Convertible Notes Payable**

On September 11, 2002, CMGI and HPFS sold their equity and convertible interests in NaviSite to ClearBlue Technologies, Inc. (ClearBlue). Subsequent to July 31, 2002, we had not paid the interest payable on the Notes due on September 30, 2002. We were also no longer listed on the Nasdaq National Market and were instead listed on the Nasdaq SmallCap Market. Pursuant to the Notes, this new listing on the Nasdaq SmallCap Market requires us to seek ClearBlue's prior written consent before paying interest and principal in the form of common stock. On October 10, 2002, we received a waiver from ClearBlue permitting the payment of interest to be made in the form of stock consistent with our listing on the Nasdaq SmallCap Market and the waiver for any noncompliance of timely payments of interest or principal and we paid the interest due to ClearBlue.

On December 12, 2002, ClearBlue gave us the right, at our option, to prepay 100% of the interest accrued at December 12, 2002 on the New Note in shares of our common stock. On December 12, 2002, we paid approximately \$1.1 million of interest owing on the balance of the New Note with 317,932 shares of our common stock. In addition, ClearBlue waived all interest for the period December 12, 2002 through December 31, 2003 resulting from the unconverted notes. We recognized an imputed interest charge for this interest free period.

In connection with ClearBlue Finance's conversion of \$20.0 million of convertible notes to common stock (see Note 2), \$10.7 million of the unamortized beneficial conversion related to the converted notes was charged to interest expense during the second fiscal quarter of 2003. As part of the conversion of the converted notes, \$469,000 in accrued interest related to the Converted Notes was converted into approximately 141,011 shares of our common stock.

**Table of Contents****NAVISITE, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

On June 16, 2003, we repaid approximately \$3.9 million of the \$45.0 million of outstanding New Note payable to ClearBlue Finance with amounts due to us by ClearBlue. The \$3.9 million consisted of \$1.9 million of intercompany amounts due to us by ClearBlue and a \$2.0 million ClearBlue note payable to us. On June 17, 2003, we received written notice from ClearBlue Finance stating its election to convert the remaining \$41.2 million of the New Note into 10,559,248 shares of our common stock effective June 19, 2003. Concurrent with the conversion, in the fourth fiscal quarter of 2003 we realized a \$21.6 million interest charge for the unamortized beneficial conversion feature related to the converted and repaid convertible notes payable. ClearBlue had previously waived all interest for the period December 12, 2002 through December 31, 2003 on the \$45.0 million of convertible notes payable and, accordingly, we had been accruing an imputed interest expense for this period. Subsequent to the conversion, in the fourth fiscal quarter of 2003, we recorded a \$2.6 million contribution to additional paid in capital for the imputed accrued interest on the converted and repaid convertible notes payable, as ClearBlue is a related party.

In fiscal year 2002, the Company issued 446,724 shares of common stock in satisfaction of accrued interest associated with the \$65.0 million notes payable to CMGI and HPFS.

**(b) Accounts Receivable Financing Agreements**

On May 26, 2003, we entered into an Accounts Receivable Financing Agreement (Financing Agreement) with SVB whereby we can finance up to a maximum of \$12.5 million of our eligible accounts receivables with an 80% advance rate. Under the Financing Agreement, we are required to repay advances upon the earlier of our receipt of payment on the financed accounts receivables from our customers, or the financed accounts receivable being aged greater than ninety days from date of service. The Financing Agreement has a one-year term and bears an annual interest rate of prime rate plus 4.0%, with a minimum \$10,000 monthly finance charge. The Financing Agreement also contains certain affirmative and negative covenants and is secured by substantially all of our assets, tangible and intangible. As part of the Financing Agreement, on May 27, 2003 we issued to Silicon Valley Bank (SVB) warrants to purchase up to 165,000 shares of NaviSite common stock with an exercise price of \$2.50, the closing price of our stock on the last business day before the issuance of the warrant. We fair valued the warrants at \$370,000 using the Black-Scholes option-pricing model. The value of the warrants is being amortized into interest expense over the term of the Financing Agreement. At July 31, 2003, we had \$6.7 million outstanding under the Financing Agreement, which represented the maximum borrowings under the Financing Agreement at that time.

**(c) Note Payable to Atlantic Investors, LLC (Atlantic)**

On January 29, 2003, we entered into a \$10.0 million Loan and Security Agreement (Atlantic Loan) with Atlantic, a related party. The Atlantic Loan has a termination date of February 1, 2004 and bears an interest rate of 8% per annum. Interest is payable upon demand or, at Atlantic's option, interest may be added to the outstanding balance due to Atlantic by NaviSite. Atlantic may make demand for payment of amounts excess of the minimum Atlantic Loan amount of \$2.0 million (Minimum Loan Amount), with 60 days notice, but not such that the payment would be required before February 1, 2004. Atlantic can demand payment of the Minimum Loan Amount with 90 days notice, but not such that payment would be required before August 1, 2003. Under the Atlantic Loan agreement, we can require Atlantic to loan us (1) up to \$2.0 million to repay an amount due from CBTM to Unicorn, a related party to NaviSite and Atlantic; (2) \$1.0 million for costs associated with our acquisition of Avasta; and (3) up to \$500,000 for the post-acquisition working capital needs of Avasta, Atlantic, at its sole and absolute discretion, may advance other amounts to us such that the aggregate amount borrowed by NaviSite does not exceed the maximum loan amount, defined as the lesser of \$10.0 million or 65% of our consolidated accounts receivables. On May 30, 2003 we repaid \$2.0 million of the approximate \$3.0 million outstanding under the Atlantic Loan and on June 11, 2003, we borrowed \$2.0 million under the Atlantic Loan. At July 31,

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**NAVISITE, INC. AND SUBSIDIARIES**

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

2003, we had \$3.0 million outstanding under the Atlantic Loan. This amount is shown as Current Note Payable to Related Party on our Consolidated Balance Sheet. The Atlantic Loan is secured by all of our receivables.

**(d) Note Payable to the AppliedTheory Estate**

As part of CBTM's acquisition of certain AppliedTheory assets, CBTM entered into a long-term liability of \$6.0 million (Estate Liability) due to the AppliedTheory Estate in June 10, 2006. The Estate Liability bears interest at 8% per annum, which is due and payable at the termination date of the Estate Liability. At July 31, 2003, we had approximately \$80,000 in accrued interest related to this note.

**(e) Notes Payable to the Interliant Estate**

As part of our acquisition of certain Interliant Assets, we entered into a promissory note with the Interliant Estate (Interliant Promissory Note) in the amount of \$550,000, payable without interest on the earlier of (i) the 180th day following the Second Closing Date or (ii) the date Interliant estates make distributions to their general unsecured creditors. The Interliant Promissory Note is secured by the Interliant Notes (see Note 6).

**(10) Commitments and Contingencies**

**(a) Leases**

*Abandoned Leased Facilities.* On January 31, 2003, we abandoned our administrative space on the second floor of our 400 Minuteman Road, Andover, MA leased location. We continue to maintain and operate our Data Center on the first floor of the building, which also serves as our corporate headquarters. While we remain obligated under the terms of the lease for the rent and other costs associated with the second floor of the building, we ceased to use the space on January 31, 2003 and have no foreseeable plans to occupy the second floor in the future. Therefore, in accordance with SFAS 146, Accounting for Costs Associated with Exit or Disposal Activities, issued in July 2002, we recorded a charge to our current earnings in fiscal year 2003 of approximately \$5.4 million to recognize the costs of exiting the space. The amount is included in the caption Impairment and restructuring in the accompanying Consolidated Statements of Operations. The liability is equal to the total amount of rent and other direct costs for the period of time the second floor of the building was expected to remain unoccupied plus the present value of the amount by which the rent paid by us to the landlord exceeds any rent paid to us by a tenant under a sublease over the remainder of the lease term, which is May 2011.

Near the end of our fiscal year 2002, we abandoned our sales office space in La Jolla, CA. At that time we were able to sublet the space to a third party. During the second quarter of fiscal year 2003, the sublease tenant stopped making payments under the sublease and has abandoned the space. The facility is currently empty and we remain obligated under the terms of the lease for the rent and other costs associated with the building. We have no foreseeable plans to occupy the space, therefore, under SFAS 146, we recorded a charge to our earnings of approximately \$1.4 million to recognize the costs of exiting the building. The amount is included in the caption Impairment and restructuring in the accompanying Consolidated Statements of Operations. We are actively pursuing options for subleasing or otherwise terminating the lease, but have not reached any agreement at this time. We believe it is more likely than not that we will be able to sublet the building to a tenant at, at a rate below our current rent rate or will have otherwise ended the lease via a lease termination agreement, by January 2004. As such, we have recorded a liability equal to the present value of our estimated future payments.

**Table of Contents****NAVISITE, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Details of activity in the lease exit accrual for the year ended July 31, 2003 were as follows:

	<b>Balance at July 31, 2002</b>	<b>Expense</b>	<b>Payments</b>	<b>Adjustments</b>	<b>Balance at July 31, 2003</b>
	<b>(In thousands)</b>				
400 Minuteman lease abandonment costs	\$	\$ 5,409	\$ (2,069)	\$	\$ 3,340
La Jolla lease abandonment costs		1,431	(322)		1,109
Chicago and Virginia lease abandonment costs			(301)	1,700(1)	1,399
Amsterdam lease abandonment costs				164(1)	164
	\$	\$ 6,840	\$ (2,692)	\$ 1,864	\$ 6,012(2)

(1) Recorded in purchase accounting for the acquisition of Conxion Corporation

(2) The current portion of the balance of \$2.5 million is included in accrued expenses (Note 8)

We are obligated under various capital and operating leases for facilities and equipment. CMGI had entered into non-cancelable operating and capital leases on our behalf covering certain of our office facilities and equipment, which expire through 2012. In addition, until we moved our headquarters in January 2000, we paid CMGI for office facilities used as our headquarters for which we were charged based upon an allocation of the total costs for the facilities at market rates. Prior to our IPO, substantially all leases for real property were guaranteed by CMGI. CMGI charged us the actual lease fees under these arrangements. Our total rent expense amounted to \$10.2 million, \$19.6 million, and \$58.5 million for the fiscal years ended July 31, 2003, 2002, and 2001, respectively. In June 2000, we sold certain equipment and leasehold improvements in our data centers in a sale-leaseback transaction to a bank for approximately \$30.0 million. We entered into a capital lease for the leaseback of those assets. In January 2001, we paid-off these capital lease obligations for approximately \$27.0 million. During the second quarter of fiscal year 2001, we sold certain equipment in sale-leaseback transactions for a total of approximately \$13.9 million. Simultaneously with the sales, we entered into operating leases for the equipment.

During fiscal 2002, we renegotiated or bought out the majority of the operating lease obligations for equipment.

Minimum annual rental commitments under operating leases and other commitments are as follows as of July 31, 2003:

<b>Description</b>	<b>Total</b>	<b>Less than 1 Year</b>	<b>1-3 Years</b>	<b>4-5 Years</b>	<b>After 5 Years</b>
	<b>(In thousands)</b>				
Short/ Long-term debt	\$ 10,211	\$ 4,211	\$ 6,000	\$	\$
Interest on debt	1,610	650	960		
Capital leases	5,175	3,273	1,902		
Operating leases	1,336	1,008	328		
Bandwidth commitments	6,717	3,542	2,384	791	
Maintenance for hardware/software	1,405	1,405			
Property leases	87,155	13,357	25,306	19,169	29,323
	\$ 113,609	\$ 27,446	\$ 36,880	\$ 19,960	\$ 29,323

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With respect to the property lease commitments listed above, certain cash is restricted pursuant to terms of lease agreements with landlords. At July 31, 2003, this restricted cash of \$3,054,000 on the

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**NAVISITE, INC. AND SUBSIDIARIES**

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

balance sheet consisted of certificates of deposit at one major financial institution and are recorded at cost, which approximates fair value.

**(b) Legal Matters**

On or about June 13, 2001, Stuart Werman and Lynn McFarlane filed a lawsuit against us, BancBoston Robertson Stephens, an underwriter of our initial public offering in October 1999, Joel B. Rosen, our then chief executive officer, and Kenneth W. Hale, our then chief financial officer. The suit was filed in the United States District Court for the Southern District of New York. The suit generally alleges that the defendants violated federal securities laws by not disclosing certain actions allegedly taken by Robertson Stephens in connection with our initial public offering. The suit alleges specifically that Robertson Stephens, in exchange for the allocation to its customers of shares of our common stock sold in our initial public offering, solicited and received from its customers agreements to purchase additional shares of our common stock in the aftermarket at pre-determined prices. The suit seeks unspecified monetary damages and certification of a plaintiff class consisting of all persons who acquired shares of our common stock between October 22, 1999 and December 6, 2000. Three other substantially similar lawsuits were filed between June 15, 2001 and July 10, 2001 by Moses Mayer (filed June 15, 2001), Barry Feldman (filed June 19, 2001), and Binh Nguyen (filed July 10, 2001). Robert E. Eisenberg, our president at the time of the initial public offering in 1999, also was named as a defendant in the Nguyen lawsuit.

On or about June 21, 2001, David Federico filed in the United States District Court for the Southern District of New York a lawsuit against us, Mr. Rosen, Mr. Hale, Robertson Stephens and other underwriter defendants including J.P. Morgan Chase, First Albany Companies, Inc., Bank of America Securities, LLC, Bear Stearns & Co., Inc., B.T. Alex. Brown, Inc., Chase Securities, Inc., CIBC World Markets, Credit Suisse First Boston Corp., Dain Rauscher, Inc., Deutsche Bank Securities, Inc., The Goldman Sachs Group, Inc., J.P. Morgan & Co., J.P. Morgan Securities, Lehman Brothers, Inc., Merrill Lynch, Pierce, Fenner & Smith, Inc., Morgan Stanley Dean Witter & Co., Robert Fleming, Inc. and Salomon Smith Barney, Inc. The suit generally alleges that the defendants violated the anti-trust laws and the federal securities laws by conspiring and agreeing to raise and increase the compensation received by the underwriter defendants by requiring those who received allocation of initial public offering stock to agree to purchase shares of manipulated securities in the after-market of the initial public offering at escalating price levels designed to inflate the price of the manipulated stock, thus artificially creating an appearance of demand and high prices for that stock, and initial public offering stock in general, leading to further stock offerings. The suit also alleges that the defendants arranged for the underwriter defendants to receive undisclosed and excessive brokerage commissions and that, as a consequence, the underwriter defendants successfully increased investor interest in the manipulated initial public offering of securities and increased the underwriter defendants individual and collective underwritings, compensation, and revenues. The suit further alleges that the defendants violated the federal securities laws by issuing and selling securities pursuant to the initial public offering without disclosing to investors that the underwriter defendants in the offering, including the lead underwriters, had solicited and received excessive and undisclosed commissions from certain investors. The suit seeks unspecified monetary damages and certification of a plaintiff class consisting of all persons who acquired shares of our common stock between October 22, 1999 and June 12, 2001.

Those five cases, along with lawsuits naming more than 300 other issuers and over 50 investment banks which have been sued in substantially similar lawsuits, have been assigned to the Honorable Shira A. Scheindlin (the Court) for all pretrial purposes (the IPO Securities Litigation). On September 6, 2001, the Court entered an order consolidating the five individual cases involving us and designating Werman v. NaviSite, Inc., et al., Civil Action No. 01-CV-5374 as the lead case. A consolidated, amended complaint was filed thereafter on April 19, 2002 (the Class Action Litigation) on behalf of plaintiffs

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**NAVISITE, INC. AND SUBSIDIARIES**

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

Arvid Brandstrom and Tony Tse against underwriter defendants Robertson Stephens (as successor-in-interest to BancBoston), BancBoston, J.P. Morgan (as successor-in-interest to Hambrecht & Quist), Hambrecht & Quist and First Albany and against us and Messrs. Rosen, Hale and Eisenberg (collectively, the NaviSite Defendants). Plaintiffs uniformly allege that all defendants, including the NaviSite Defendants, violated the federal securities laws (i.e., Sections 11 and 15 of the Securities Act, Sections 10(b) and 20(a) of the Exchange Act and Rule 10b-5) by issuing and selling our common stock pursuant to the October 22, 1999, initial public offering, without disclosing to investors that some of the underwriters of the offering, including the lead underwriters, had solicited and received extensive and undisclosed agreements from certain investors to purchase aftermarket shares at pre-arranged, escalating prices and also to receive additional commissions and/or other compensation from those investors. At this time, plaintiffs have not specified the amount of damages they are seeking in the Class Action Litigation.

Between July and September 2002, the parties to the IPO Securities Litigation briefed motions to dismiss filed by the underwriter defendants and the issuer defendants, including NaviSite. On November 1, 2002, the Court held oral argument on the motions to dismiss. The plaintiffs have since agreed to dismiss the claims against Messrs. Rosen, Hale and Eisenberg without prejudice, in return for their agreement to toll any statute of limitations applicable to those claims. By stipulation entered by the Court on November 18, 2002, Messrs. Rosen, Hale and Eisenberg were dismissed without prejudice from the Class Action Litigation. On February 19, 2003, an opinion and order was issued on defendants' motion to dismiss the IPO Securities Litigation, essentially denying the motions to dismiss of all 55 underwriter defendants and of 185 of the 301 issuer defendants.

We believe that the allegations against us are without merit and we intend to vigorously defend against the plaintiffs' claims. We are not able to predict the possible outcome of the suits and their ultimate effect, if any, on our financial condition.

In March 2001, we engaged Goldman Sachs & Co. to serve as our financial advisor in connection with the possible sale of all or a portion of NaviSite. On September 17, 2002, Goldman made a written demand for payment of a \$3 million success fee in connection with the September 2002 acquisition by ClearBlue of the stock and convertible debt of NaviSite from CMGI and Hewlett-Packard Financial Services Company. We have rejected Goldman's demands, as we believe they are without merit. No legal actions have been filed concerning the Goldman claim. As this matter is in the initial stage, we are not able to predict the possible outcome of this matter and the effect, if any, on our financial condition.

On or about September 27, 2002, we received a demand for a wage payment of \$850,000 from our former Procurement Director, Joseph Cloonan. We rejected the demand, alleging that Mr. Cloonan's claim is based, among other things, on a potentially fraudulent contract. Mr. Cloonan also claimed \$40,300 for allegedly unpaid accrued vacation and bonuses and that he may be statutorily entitled to treble damages and legal fees. On October 11, 2002, NaviSite filed a civil complaint with the Massachusetts Superior Court, Essex County, seeking a declaratory judgment and asserting claims against Mr. Cloonan for civil fraud, misrepresentation, unjust enrichment and breach of duty of loyalty. We believe the allegations are without merit and intend to vigorously defend against Mr. Cloonan's claims. As the litigation is in the initial discovery stage, we are not able to predict the possible outcome of this matter and the effect, if any, on our financial condition.

On October 28, 2002, ClearBlue Technologies Management, Inc., one of our subsidiaries, filed a complaint in United States District Court for the Southern District of New York against Lighthouse International, alleging six causes of action for copyright infringement, breach of contract, account stated, unjust enrichment, unfair competition, and misappropriation and/or conversion. The total claimed damages are in the amount of \$1.9 million. On or about January 16, 2003, Lighthouse filed and served its answer and counterclaimed against ClearBlue Technologies Management, Inc. claiming \$3.1 million in damages and \$5.0 million in punitive relief.



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**NAVISITE, INC. AND SUBSIDIARIES**

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

On June 17, 2003, the U.S. Bankruptcy Court for the Southern District of New York heard oral argument on Lighthouse's Motion for an Order Compelling the Debtor (AppliedTheory) to Assume or Reject an Agreement, filed in response to ClearBlue Technologies Management, Inc.'s complaint, and the objections to Lighthouse's motion filed by ClearBlue Technologies Management and AppliedTheory. Lighthouse made this motion on the basis that it never received notice of ClearBlue Technologies Management assuming the AppliedTheory contract for the LighthouseLink Web site. The Bankruptcy Court declined to grant Lighthouse's motion, and instead ordered that an evidentiary hearing be conducted to determine whether Lighthouse received appropriate notice of the proposed assignment of the contract by AppliedTheory to ClearBlue Technologies Management. The Bankruptcy Court ordered that the parties first conduct discovery, and upon completion of discovery, which is expected to be completed on or about the end of November 2003, the Bankruptcy Court would schedule an evidentiary hearing on the issue of notice.

As to the U.S. District Court matter, the exchange of written discovery is near completion, with a number of discovery disputes to be resolved by the Court in October 2003 at a discovery status conference. All depositions of witnesses have been stayed pending completion of the Bankruptcy Court evidentiary hearing. Because of the continuing discovery, and the uncertain outcome of the evidentiary hearing before the Bankruptcy Court, we are not able to predict the possible outcome of this matter, if any, on our financial condition.

On December 12, 2002, our Board of Directors, pursuant to authority previously granted by our stockholders at the annual meeting of stockholders held on December 19, 2001, approved a reverse stock split of our common stock at a ratio of one-for-fifteen (1:15) (the Reverse Split). The Reverse Split was effective on January 7, 2003. On May 28, 2003 we received a letter from Mr. Edward W. Roberts, as trustee of The Roberts Family Trust, stating that in June 2002 the trust had purchased 13,000 shares of our common stock and due to the Reverse Split, the trust now owns 866 shares of common stock (i.e. 13,000 shares divided by 15). As a result of the Reverse Split, Mr. Roberts states an intention to institute a derivative action requesting \$7.5 million in damages. On October 20, 2003, we received a letter dated October 13, 2003, from Mr. Robertson, as trustee on behalf of The Roberts Family Trust, stating his intention to prove conspiracy and collusion relating to the September 11, 2002 transactions between ClearBlue Technologies, Inc. and Hewlett-Packard Financial Services Company and relating to the later Reverse Split. No legal actions have been filed concerning this matter. This matter is in its initial stages and we are not able to predict the possible outcome of this matter, and the effect, if any, on our financial condition. We believe the claim is without merit and intend to vigorously defend any action that may be brought against us.

On October 14, 2003, we received a letter purportedly on behalf of the former stockholders of Avasta relating to the issuance of additional shares of common stock pursuant to the earnout calculations pursuant to the Agreement and Plan of Merger and Reorganization dated as of January 29, 2003 among Avasta Corp., Avasta, Inc. and NaviSite. No legal actions have been filed concerning this matter. As this matter is in the initial stage, we are not able to predict the possible outcome of this matter and the effect, if any, on our financial condition.

We are also subject to other legal proceedings and claims which arise in the ordinary course of our business. In the opinion of management, the amount of ultimate liability with respect to these actions will not materially affect our consolidated financial position or results from our operations.

**(11) Income Taxes**

Prior to the initial public offering on October 21, 1999, we were greater than 80% owned by CMGI, and as such, CMGI realized the full benefit of all federal and part of the state net operating losses that had been incurred by us for those periods before the fiscal year ended July 31, 2001. Therefore, such net

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operating losses incurred by NaviSite were not available to us. The tax sharing agreement between NaviSite and CMGI required us to reimburse CMGI for the amounts it contributed to the consolidated tax liability of the CMGI group; however, under the policy, CMGI was not obligated to reimburse us for any losses utilized in the consolidated CMGI group. After our public offering, CMGI's ownership fell below 80% and we were no longer included in the federal consolidated group of CMGI. Thus, our federal and state net operating losses can be carried forward to offset our future taxable income.

Total federal and state income tax expenses (benefit) for the periods ending July 31, 2003, July 31, 2002, and July 31, 2001, consist of the following:

	7/31/2003			7/31/2002			7/31/2001		
	Current	Deferred	Total	Current	Deferred	Total	Current	Deferred	Total
	(In thousands)								
Federal	\$ (513)	\$ 513	\$	\$	\$	\$	\$	\$	\$
State	153		153						
	<u>\$ (360)</u>	<u>\$ 513</u>	<u>\$ 153</u>	<u>\$</u>	<u>\$</u>	<u>\$</u>	<u>\$</u>	<u>\$</u>	<u>\$</u>

The actual tax expense for the periods ending July 31, 2003, July 31, 2002, and July 31, 2001, differs from the expected tax expense for the these periods as follows:

	7/31/2003	7/31/2002	7/31/2001
	(In thousands)		
Computed expected tax expense (benefit)	\$ (24,981)	\$ (41,376)	\$ (40,358)
State taxes, net of federal income tax benefit	101		
Losses not benefited	25,033	41,376	40,358
Total	<u>\$ 153</u>	<u>\$</u>	<u>\$</u>

Temporary differences between the financial statement carrying and tax bases of assets and liabilities that give rise to significant portions of deferred tax assets (liabilities) are comprised of the following:

	7/31/03	7/31/02
	(In thousands)	
Deferred tax assets:		
Accruals and reserves	\$ 4,455	\$ 2,206
Loss Carryforwards	20,709	103,311
Depreciation and amortization	33,134	36,958
Total deferred tax assets	<u>\$ 58,298</u>	<u>\$ 142,475</u>
Less: Valuation allowance	(58,298)	(142,475)
Net deferred tax (assets) liabilities	<u>\$</u>	<u>\$</u>

Valuation allowance decreased by \$84.2 million and increased by \$47.0 million for the years ended July 31, 2003 and 2002, respectively. The Company has recorded a full valuation allowance against its deferred tax assets since management believes that, after considering all the available objective evidence, both positive and negative, historical and prospective, with greater weight given to historical evidence, it is not more likely than not that these assets will be realized.

As a result of the transaction on September 11, 2002, the Company experienced a change in ownership as defined in Section 382 of the Internal Revenue Code. As a result of the change in ownership, the utilization of its federal and state tax net operating losses generated prior to the transaction is subject

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**NAVISITE, INC. AND SUBSIDIARIES**

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

to an annual limitation of approximately \$1.2 million. As a result of this limitation, the Company expects that a substantial portion its federal and state net operating loss carryforwards will expire unused.

The company has net operating loss carryforwards for federal and state tax purposes of approximately \$50.2 million, after taking into consideration net operating losses expected to expire unused due to the Section 382 limitation. The federal net operating loss carryforwards will expire from fiscal year 2011 to fiscal year 2023.

**(12) Stockholders Equity**

**(a) Issuance of Common Stock**

On December 12, 2002, ClearBlue cancelled warrants to purchase 346,883 shares of our common stock at an exercise price ranging from \$86.55 to \$103.80 per share.

The 567,978 shares issued to ClearBlue on December 31, 2002 in connection with the acquisition of CBTM have been accounted for by us as a dividend distribution to ClearBlue because ClearBlue and its affiliates are considered to have controlling interest over both CBTM and NaviSite. As a result, we reported a reduction of retained earnings of \$1.3 million, which represents the number of common shares issued at the then current market value of \$2.25 per share.

On February 5, 2003, we issued 231,039 shares of our common stock at a per share value of \$1.60 in connection with the acquisition of Avasta (see Note 6). In September 2003 we issued 179,353 shares of our common stock at a per share value of \$4.14 (representing the market value of our common stock the day preceding the issuance of the addition shares) for the attainment of certain revenue targets in conjunction with the Avasta acquisition.

**(13) Stock Option Plans**

**(a) 1999 Employee Stock Purchase Plan**

The 1999 Employee Stock Purchase Plan (the Stock Purchase Plan) was adopted by NaviSite's board of directors and stockholders in October 1999. The Stock Purchase Plan provides for the issuance of a maximum of 16,666 shares of our common stock. The Plan allows participants to purchase shares at 85% of the closing price of common stock on the first business day of the Plan period or the last business day of the Plan period, whichever closing price is less. During fiscal year 2002, no additional shares were issued under this plan.

During fiscal year 2003, no additional shares were issued under this plan. We issued a total of 16,657 shares since the plan's inception.

**(b) Deferred Compensation Plan**

A Deferred Compensation Plan (the Deferred Compensation Plan) was adopted by NaviSite's board of directors in October 1999. Under the terms of the Deferred Compensation Plan, our employees who are selected by the board of directors (as well as certain of our employees who previously participated in a deferred compensation plan sponsored by CMGI) will be able to elect to defer a portion of their compensation for the following calendar year. We also may make discretionary contributions to a participant's account, to which the participant generally will become entitled after five years of service with us. Effective December 18, 2001, the plan was terminated. During 2001 and through the termination date in 2002, we did not make any discretionary contributions to the plan.

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**NAVISITE, INC. AND SUBSIDIARIES**

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

**(c) 1999 Director Stock Option Plan**

In October 1999, NaviSite ceased issuing options under the 1998 Director Plan and the board of directors and the stockholders approved and adopted the 1999 Stock Option Plan for Non-employee Directors (the 1999 Director Plan). A total of 33,333 shares of Common Stock are reserved for issuance under the 1999 Director Plan. Directors who are not NaviSite employees or otherwise affiliates, employees or designees of an institutional or corporate investor that owns more than 5% of outstanding Common Stock will be eligible to receive non-statutory stock options under the 1999 Director Plan. On March 5, 2002, the 1999 Director Plan was amended to increase the initial options granted to each eligible director to 3,333 shares from the original 1,667 shares and to increase the subsequent annual grants to directors to 667 shares from the original 417 shares.

The board of directors has discretion to increase to up to 6,667 shares the number of shares of Common Stock subject to any initial option or additional option covering any vesting period of up to 48 months that may be granted to an eligible director after the date of the increase.

During fiscal year 2003 no options were granted and there were no outstanding options under this plan. Upon the approval of the 2003 Plan by NaviSite's stockholders, no further option grants shall be made under the 1999 Director Plan.

**(d) 1998 Director Stock Option Plan**

In December 1998, NaviSite's board of directors and stockholders approved the 1998 Director Stock Option Plan (the 1998 Director Plan). In October 1999, we ceased issuing options under the 1998 Director Plan. Upon the adoption of the 1999 Director Plan, each NaviSite director (who is not also an employee of NaviSite, any subsidiary of NaviSite or of CMGI) was entitled to receive, upon the date of his or her election, a non-statutory option to purchase Common Stock as defined. A maximum number of 16,666 shares of Common Stock were authorized for issuance under the 1998 Director Plan. Each automatic grant had an exercise price equal to the current fair market value of the Common Stock at the time of grant and a maximum term of ten years, subject to earlier termination following the optionee's cessation of service on the board of directors.

During fiscal 2003, no options were granted and no options were outstanding under the 1998 Director Plan.

**(e) NaviSite 2000 Stock Option Plan**

In November 2000, NaviSite's board of directors approved the 2000 Stock Option Plan (the Plan). Under the Plan, nonqualified stock options or incentive stock options may be granted to NaviSite's employees, other than those who are also officers or directors, and our consultants and advisors, as defined, up to a maximum number of shares of Common Stock not to exceed 66,666 shares. The board of directors administers this plan, selects the individuals who are eligible to be granted options under the Plan and determines the number of shares and exercise price of each option. Options granted under the Plan have a five-year maximum term and typically vest over a one-year period. Upon the approval of the 2003 Plan by

**Table of Contents****NAVISITE, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

NaviSite's stockholders, no further option grants shall be made under the Plan. The following table reflects activity of stock options under our Plan for the year ended July 31, 2003:

	2003		2002		2001	
	Number of Shares	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price
Options outstanding beginning of year	16,266	\$ 128.44	32,157	\$ 128.44		\$
Granted					53,037	128.44
Exercised						
Cancelled	(11,394)	128.44	(15,891)	128.44	(20,880)	128.44
Options outstanding, end of year	4,872	\$ 128.44	16,266	\$ 128.44	32,157	\$ 128.44
Options exercisable, end of year	4,872		16,266			
Options available for grant, end of year	61,794		50,400		34,509	

**(f) NaviSite 1998 Equity Incentive Plan**

In December 1998, NaviSite's board of directors and stockholders approved the 1998 Equity Incentive Plan, as amended (the 1998 Plan). The 1998 Plan replaced NaviSite Internet Services Corporation's 1997 Equity Incentive Plan (the 1997 Plan). All options outstanding under the 1997 Plan were cancelled and replaced with an equivalent amount of options issued in accordance with the 1998 Plan. Under the original 1998 Plan, nonqualified stock options or incentive stock options may be granted to NaviSite's or its affiliates' employees, directors, and consultants, as defined, up to a maximum number of shares of Common Stock not to exceed 333,333 shares. In August 1999, the board of directors approved an increase in the number of shares authorized under the 1998 Plan to 741,628. In December 2000, the board of directors approved an additional increase in the number of shares authorized under the 1998 Plan to 1,000,000 shares. The board of directors administers this plan, selects the individuals who are eligible to be granted options under the 1998 Plan and determines the number of shares and exercise price of each option. The chief executive officer, upon authority granted by the board of directors, is authorized to approve the grant of options to purchase Common Stock under the 1998 Plan to certain persons. Options are granted at fair market value. Options granted under the 1998 Plan have a five-year maximum term and typically vest over a four year period, with 25% of options granted becoming exercisable one year from the date of grant and the remaining 75% vesting monthly for the next thirty-six (36) months. Upon the approval of the 2003 Plan by NaviSite's stockholders, no further option grants shall be made under the

**Table of Contents****NAVISITE, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

1998 Plan. The following table reflects activity and historical exercise prices of stock options under our 1998 Plan for the three years ended July 31, 2003.

	2003		2002		2001	
	Number of Shares	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price
Options outstanding beginning of year	452,801	\$ 149.40	522,560	\$ 276.00	534,262	\$ 416.85
Granted	128,164	2.57	268,397	4.65	427,638	100.20
Exercised	(1,905)	1.18	(34,901)	1.05	(35,153)	9.00
Cancelled	(313,091)	160.79	(303,255)	256.35	(404,187)	297.60
Options outstanding, end of year	265,969	\$ 66.14	452,801	\$ 149.40	522,560	\$ 276.00
Options exercisable, end of year	175,555	\$ 84.18	131,156	\$ 294.60	198,472	\$ 266.85
Options available for grant, end of year	571,661		386,606		351,781	

Range of Exercise Prices	Options Outstanding			Options Exercisable		
	Number Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Number Outstanding	Weighted Average Exercise Price	
\$ .01 \$ 2.40	6,413	1.12	\$ 0.90	5,214	\$ 0.58	
2.41 2.55	120,000	9.94	2.55	60,000	2.55	
2.56 3.90	42,511	3.64	3.90	22,771	3.90	
3.91 9.60	37,157	3.30	4.87	36,948	4.86	
9.61 27.75	29,153	22.39	2.68	24,610	23.32	
27.76 73.13	5,042	2.04	51.16	3,839	51.52	
73.14 182.82	7,160	1.31	113.02	6,537	110.86	
182.83 671.25	7,054	1.82	620.52	5,504	618.92	
671.26 up	11,479	1.53	943.99	10,132	932.79	
	265,969			175,555		

**(g) NaviSite 2003 Stock Option Plan**

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On July 10, 2003, the 2003 Stock Incentive Plan (the 2003 Plan ) was approved by the Board of Directors. The 2003 Plan has not yet been approved by NaviSite s Stockholders. The 2003 Plan provides that stock options or restricted stock awards may be granted to employees, officers, directors, consultants, and advisors or NaviSite (or any present or future parent or subsidiary corporations and any other business venture (including, without limitation, joint venture or limited liability company) in which NaviSite has a controlling interest, as determined by the Board of Directors of NaviSite) The board of directors has authorized 2,600,000 shares of common stock for issuance under the 2003 Plan.

The 2003 Plan is administered by the Board of Directors of NaviSite or any committee to which the Board delegates its powers under the 2003 Plan. Subject to the provisions of the 2003 Plan, the Board of Directors will determine the terms of each award, including the number of shares of common stock subject to the award and the exercise thereof.

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**Table of Contents****NAVISITE, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The Board of Directors may, in its sole discretion, amend, modify or terminate any award granted or made under the 2003 Plan, so long as such amendment, modification or termination would not materially and adversely affect the participant. The Board of Directors may also provide that any stock option shall become immediately exercisable, in full or in part, or that any restricted stock granted under the 2003 Plan shall be free of some or all restrictions.

As of July 31, 2003, stock options to purchase 2,272,000 shares of common stock at an average exercise price of \$2.55 per share were outstanding under the 2003 Plan. During fiscal year 2003, no options were exercised or cancelled. The options do not become exercisable until the stockholders of the Company have duly approved the plan. Once approved, the options will become exercisable as to 25% of the original number of shares on grant date and thereafter in equal amounts monthly over the three year period commencing on the grant date.

**(h) CMGI 1986 Stock Option Plan**

Certain NaviSite employees have been granted options for the purchase of CMGI Common Stock under the CMGI 1986 Stock Option Plan (the 1986 Plan). Options under the 1986 Plan are granted at fair market value on the date of grant and are generally exercisable in equal cumulative installments over a four-to-ten year period beginning one year after the date of grant. Outstanding options under the 1986 Plan expire through 2007. Under the 1986 Plan, nonqualified stock options or incentive stock options may be granted to CMGI or its subsidiaries employees, as defined. The board of directors of CMGI administers this plan, selects the individuals to whom options will be granted and determines the number of shares and exercise price of each option.

The following table reflects activity and historical exercise prices of stock options granted to NaviSite employees under the 1986 Plan for the three years ended July 31, 2003. Options held by employees who transferred to NaviSite from CMGI or CMGI subsidiaries kept their CMGI options and during fiscal year 2003, 2002 and 2001 are shown as transfers into the 1986 plan. Employees that transferred to CMGI from an affiliate could not keep their affiliate options.

On September 11, 2002 each of CMGI and Hewlett-Packard Financial Services Company (HPFS) sold and transferred to ClearBlue Technologies, Inc. (ClearBlue), a privately-held managed service provider based in San Francisco, California equity and debt interests. Due to this transaction, NaviSite employees had 30 days from September 11, 2002 to exercise vested CMGI options. There were no options exercised and subsequently all outstanding options were cancelled.

The following table summarizes information about stock options granted NaviSite employees under the 1986 Plan outstanding at July 31, 2003:

	2003		2002		2001	
	Number of Shares	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price
Options outstanding beginning of year	106,582	\$ 8.76	349,562	\$ 26.10	510,923	\$ 27.85
Granted						
Transfers			(2,834)	20.26	14,615	24.40
Exercised					(48,803)	4.72
Cancelled	(106,582)	8.76	(240,146)	32.44	(127,173)	44.60
Options outstanding, end of year		\$	106,582	\$ 8.76	349,562	\$ 26.10
Options exercisable, end of year			97,486	\$ 7.86	261,090	\$ 31.39



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**NAVISITE, INC. AND SUBSIDIARIES**

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

**(i) Other Stock Option Grants**

At July 31, 2003, we had 2,665 outstanding stock options issued outside of existing plans to certain directors at an average exercise price of \$135.56. These stock options were fully vested on the grant date and have a contractual life of 10 years.

**(j) Other Disclosure**

SFAS No. 123, Accounting for Stock-Based Compensation (SFAS 123), sets forth a fair-value based method of recognizing stock-based compensation expense. As permitted by SFAS No. 123, we have elected to continue to apply APB No. 25 to account for the stock-based compensation plans in which NaviSite's employees participate.

**(14) Related Party Transactions**

For the period August 1, 2002 through September 11, 2002, we classified revenue from CMGI and CMGI affiliates as revenue from related parties. For the period September 12, 2002 through July 31, 2003, we classified revenue from CMGI and CMGI affiliates as third-party revenue.

The consolidated financial statements include certain allocations from CMGI for certain general and administrative expenses, such as rent, legal services, insurance, and employee benefits. Allocations are based primarily on headcount. Management believes that the method used to allocate the costs and expenses is reasonable; however, such allocated amounts may or may not necessarily be indicative of what actual expenses would have been incurred had we operated independently of CMGI. As a result of CMGI's sale of its debt and equity interests in us, the agreement between NaviSite and CMGI whereby CMGI provided certain services for us automatically terminated. CMGI continued to provide certain services to us pursuant to a Transition Services Agreement we entered into with CMGI on November 25, 2002, as we transitioned to services agreements with ClearBlue and to other third-party suppliers. This transition agreement concluded during the second quarter of fiscal year 2003 and we have completely severed our administrative ties with CMGI; however, CMGI remains a third-party customer. During the second quarter of fiscal year 2003, we contracted with ClearBlue and third-party suppliers for these services. We currently rent administrative facilities from CMGI at 800 Federal Street, Andover, Massachusetts.

On December 31, 2002, CBTM was required to pay a \$6.1 million liability owed to the AppliedTheory Estate as a result of CBTM's acquisition of AppliedTheory. In order to fund the \$6.1 million payment, CBTM entered into a \$6.0 million line of credit with Unicorn Worldwide Holding Limited (Unicorn), a related party to NaviSite and CBTM. CBTM drew down \$4.6 million and together with cash on hand at December 31, 2002, paid the \$6.1 million liability due to the AppliedTheory Estate. In January 2003, CBTM paid \$2.6 million of the \$4.6 million due to Unicorn, leaving a liability to Unicorn of \$2.0 million at January 31, 2003. In January 2003, we entered into a Loan and Security Agreement with Atlantic and in February 2003, drew down on this facility to pay off the remaining \$2.0 million due Unicorn by CBTM. CBTM has a long-term liability of \$6.0 million (Estate Liability) due to the AppliedTheory Estate in June 10, 2006. The Estate Liability bears interest at 8% per annum, which is due and payable at the termination date of the Estate Liability.

Beginning January 1, 2003, we entered into an Outsourcing Agreement with ClearBlue whereby we provided certain management services as well as manage the day-to-day operations of ClearBlue's data centers. We charge ClearBlue actual costs incurred plus a 5% mark-up on labor costs only. In fiscal year 2003, we charged ClearBlue approximately \$270,000 under this agreement. This amount is included in other income in the Consolidated Statement of Operations. In connection with the Outsourcing Agreement, we entered into two loan arrangements, one whereby we will loan amounts to ClearBlue for

**Table of Contents****NAVISITE, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

working capital needs (NaviSite Loan) and one whereby ClearBlue will loan amounts to NaviSite for working capital needs (ClearBlue Loan). The two loans may be drawn down upon, at the sole discretion of the lender, up to a maximum aggregate amount of \$2.0 million per note. ClearBlue owed us approximately \$1.9 million at April 30, 2003 under the NaviSite Loan. In addition to the amount due under the NaviSite loan, ClearBlue owed certain amounts to CBTM at the time of CBTM's sale to NaviSite. On June 2, 2003, we amended the NaviSite Loan to increase the borrowing facility, on a temporary basis, to \$2.3 million and loaned an additional \$200,000 to ClearBlue. The additional \$200,000 funding to ClearBlue was repaid to us on June 6, 2003. On June 16, 2003, we used \$3.9 million of the amounts due to us by ClearBlue to pay down a portion of our \$45.0 million outstanding on the New Note.

On January 29, 2003, we entered into a \$10 million Loan and Security Agreement (Atlantic Loan) with Atlantic, a related party. The Atlantic Loan has a termination date of February 1, 2004 and bears an interest rate of 8% per annum. Interest is payable upon demand or, at Atlantic's option, interest may be added to the outstanding balance due to Atlantic by NaviSite. Atlantic may make demand for payment of amounts in excess of the minimum Atlantic Loan amount of \$2.0 million (Minimum Loan Amount), with 60 days notice, but not such that the payment would be required before February 1, 2003. Atlantic can demand payment of the Minimum Loan Amount with 90 days notice, but not such that payment would be required before August 1, 2003. Under the Atlantic Loan agreement, we can require Atlantic to loan us (1) up to \$2.0 million to repay an amount due from CBTM to Unicorn, a related party to NaviSite and Atlantic; (2) \$1.0 million for costs associated with our acquisition of Avasta; and (3) up to \$500,000 for the post-acquisition working capital needs of Avasta. Atlantic, at its sole and absolute discretion, may advance other amounts to us such that the aggregate amount borrowed by NaviSite does not exceed the maximum loan amount, defined as the lesser of \$10.0 million or 65% of our consolidated accounts receivables. At July 31, 2003, we had \$3.0 million outstanding under the Atlantic Loan and had approximately \$500,000 available to us. This amount is shown as Due to Affiliate on our Consolidated Balance Sheet. The Atlantic Loan is secured by all of our receivables. On May 30, 2003 we repaid \$2.0 million of the approximate \$3.0 million outstanding under the Atlantic Loan and on June 11, 2003, we borrowed \$2.0 million under the Atlantic Loan.

**(15) Selected Quarterly Financial Data (Unaudited)**

Financial information for interim periods was as follows:

	<b>Fiscal Year Ended July 31, 2003</b>			
	<b>Q1</b>	<b>Q2</b>	<b>Q3</b>	<b>Q4</b>
	<b>(In thousands)</b>			
Revenue	\$ 15,871	\$ 18,761	\$ 19,620	\$ 22,341
Gross profit (deficit)	(624)	1,747	2,308	2,381
Net loss	(10,005)	(20,231)	(11,304)	(32,085)
Net loss per share(a)	\$ (1.60)	\$ (2.07)	\$ (0.88)	\$ (1.80)

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**Table of Contents****NAVISITE, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Fiscal Year Ended July 31, 2002**

	<b>Q1</b>	<b>Q2</b>	<b>Q3</b>	<b>Q4</b>
	<b>(In thousands)</b>			
Revenue	\$ 19,279	\$ 15,674	\$ 14,717	\$ 9,751
Gross profit (deficit)	(29,457)	(11,859)	4,552	(39,132)
Net loss	(44,340)	(26,779)	(2,044)	(48,530)
Net loss per share(a)	\$ (10.72)	\$ (4.70)	\$ (0.35)	\$ (7.97)

- (a) Net loss per common share is computed independently for each of the quarters based on the weighted average number of shares outstanding during the quarter. Therefore, the aggregate per share amount for the quarters may not equal the amount calculated for the full year.

**(16) Subsequent Events**

On August 8, 2003, we completed the acquisition of certain assets and the assumption of certain liabilities of ClearBlue Technologies, Inc. pursuant to a Stock and Asset Acquisition Agreement (the CBT Agreement). Pursuant to the CBT Agreement, we acquired all outstanding shares of six (6) wholly-owned subsidiaries of ClearBlue Technologies, Inc. with data centers located in Chicago, Las Vegas, Los Angeles, Milwaukee, Oakbrook and Vienna.

In addition, we exercised effective control over and assumed the revenue and expenses, as of the date of the CBT Agreement, of four (4) additional wholly-owned subsidiaries of ClearBlue Technologies, Inc. with data centers located in Dallas, New York, San Francisco and Santa Clara. Ownership of these subsidiaries will automatically be transferred, under certain conditions, to us for no additional consideration in February 2004.

In exchange for these subsidiaries and certain assets and contracts relating to them, we: (i) issued 1.1 million shares of our common stock, to ClearBlue Technologies, Inc.; (ii) released ClearBlue Technologies, Inc. from certain inter-company advances in an amount up to \$300,000; (iii) assumed all of ClearBlue Technologies, Inc.'s obligations under certain assets and contracts relating to these subsidiaries; and (iv) released ClearBlue Technologies, Inc. from certain payment obligations owed to us pursuant to the Outsourcing Agreement in an amount not to exceed \$263,000. The financial statement impacts have been reflected in these restated financial statements to account for this business combination of entities under common control in a manner similar to a pooling-of-interest.

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM  
ON FINANCIAL STATEMENT SCHEDULE**

The Board of Directors and Stockholders

NaviSite, Inc. and Subsidiaries:

Under date of October 21, 2003, we reported on the consolidated balance sheets of NaviSite, Inc. as of July 31, 2003 and 2002 and the related consolidated statements of operations, changes in stockholders' equity (deficit), and cash flows for each of the fiscal years in the three-year period ended July 31, 2003, which are included in this Form S-2. In connection with our audits of the aforementioned consolidated financial statements, we also audited the related consolidated financial statement schedule of Valuation and Qualifying Accounts in this Form S-2. This financial statement schedule is the responsibility of the Company's management. Our responsibility is to express an opinion on this financial statement schedule based on our audits. In our opinion, such financial statement schedule when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

The audit report on the consolidated financial statements of NaviSite, Inc. referred to above contains an explanatory paragraph that states that the Company's recurring losses since inception and accumulated deficit, as well as other factors, raise substantial doubt about the entity's ability to continue as a going concern. The financial statement schedule does not include any adjustments that might result from the outcome of this uncertainty.

/s/ KPMG LLP

Boston, Massachusetts

October 21, 2003

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## NAVISITE, INC. AND SUBSIDIARIES

## VALUATION AND QUALIFYING ACCOUNTS

Years Ended July 31, 2003, 2002, and 2001

	Balance at Beginning of Year	Additions Charged to Expense	Other(1)	Deductions from Reserve	Balance at End of Year
(In thousands)					
Year ended July 31, 2001:					
Allowance for doubtful accounts	\$ 1,219	\$ 11,948	\$	\$ (6,308)	\$ 6,859
Year ended July 31, 2002:					
Allowance for doubtful accounts	\$ 6,859	\$ 3,490	\$	\$ (9,732)	\$ 617
Year ended July 31, 2003:					
Allowance for doubtful accounts	\$ 617	\$ 1,778	\$ 3,119	\$ (3,484)	\$ 2,030

- (1) Represents allowance for doubtful accounts of CBTM (acquired in fiscal year 2003) and CBT (acquired in fiscal year 2004) which were accounted for in a manner similar to a pooling-of-interest due to common control ownership.

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**Table of Contents****NAVISITE, INC. AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS**

	April 30, 2004	July 31, 2003
	(Unaudited) (In thousands, except par value)	
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 7,630	\$ 3,862
Accounts receivable, less allowance for doubtful accounts of \$2,307 and \$2,030 at April 30, 2004 and July 31, 2003, respectively	13,583	14,741
Due from related party	12	
Prepaid expenses and other current assets	4,224	4,011
	<hr/>	<hr/>
Total current assets	25,449	22,614
Property and equipment, net	15,388	22,165
Customer lists, less accumulated amortization of \$6,696 and \$3,724 at April 30, 2004 and July 31, 2003, respectively	10,279	12,052
Goodwill	3,206	3,206
Other assets	5,913	6,280
Restricted cash	1,253	3,054
	<hr/>	<hr/>
Total assets	\$ 61,488	\$ 69,371
	<hr/>	<hr/>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Accounts receivable financing line, net	\$ 15,786	\$ 6,358
Notes payable, current portion	1,048	1,211
Capital lease obligations, current portion	2,418	3,268
Note payable to related party, current portion	3,000	3,000
Accounts payable	3,856	4,371
Accrued expenses	13,628	17,580
Deferred revenue	2,196	2,993
Customer deposits	135	134
	<hr/>	<hr/>
Total current liabilities	42,067	38,915
Capital lease obligations, less current portion	830	1,907
Accrued lease abandonment, less current portion	1,782	3,476
Note to AppliedTheory Estate	6,000	6,000
Note payable	1,352	
Other long-term liabilities	737	2,194
	<hr/>	<hr/>
Total liabilities	52,768	52,492
	<hr/>	<hr/>
Commitments and contingencies (Note 10)		
Stockholders' equity:		
Preferred stock, \$0.01 par value; Authorized: 5,000 shares; Issued and outstanding: no shares at April 30, 2004 and July 31, 2003		
Common stock, \$0.01 par value; Authorized: 395,000 shares; Issued and outstanding: 24,829 and 23,412 at April 30, 2004 and July 31, 2003, respectively	249	235



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Deferred compensation	(1,699)	
Accumulated other comprehensive income (loss)	9	(16)
Additional paid-in capital	438,482	432,399
Accumulated deficit	(428,321)	(415,739)
	<u>          </u>	<u>          </u>
Total stockholders' equity	8,720	16,879
	<u>          </u>	<u>          </u>
Total liabilities and stockholders' equity	\$ 61,488	\$ 69,371
	<u>          </u>	<u>          </u>

See accompanying notes to interim consolidated financial statements.

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**Table of Contents****NAVISITE, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF OPERATIONS**

	<b>Three Months Ended April 30,</b>		<b>Nine Months Ended April 30,</b>	
	<b>2004</b>	<b>2003</b>	<b>2004</b>	<b>2003</b>
	<b>(Unaudited)</b>		<b>(Unaudited)</b>	
	<b>(In thousands, except per share data)</b>			
Revenue	\$ 20,173	\$ 19,620	\$ 65,975	\$ 52,942
Revenue, related parties	12		12	1,310
<b>Total revenue</b>	<b>20,185</b>	<b>19,620</b>	<b>65,987</b>	<b>54,252</b>
Cost of revenue	14,217	17,312	48,899	50,821
Impairment, restructuring and other			633	
<b>Total cost of revenue</b>	<b>14,217</b>	<b>17,312</b>	<b>49,532</b>	<b>50,821</b>
<b>Gross profit</b>	<b>5,968</b>	<b>2,308</b>	<b>16,455</b>	<b>3,431</b>
Operating expenses:				
Product development	230	121	890	624
Selling and marketing	1,848	1,429	5,724	3,759
General and administrative	6,097	5,023	16,342	13,718
Impairment, restructuring and other	206	3,819	1,608	6,274
<b>Total operating expenses</b>	<b>8,381</b>	<b>10,392</b>	<b>24,564</b>	<b>24,375</b>
Loss from operations	(2,413)	(8,084)	(8,109)	(20,944)
Other income (expense):				
Interest income	18	169	115	685
Interest expense	(656)	(2,470)	(1,935)	(20,170)
Other income (expense), net	25	(919)	111	(1,111)
Loss before income tax expense	(3,026)	(11,304)	(9,818)	(41,540)
Income tax expense				
<b>Net loss</b>	<b>\$ (3,026)</b>	<b>\$ (11,304)</b>	<b>\$ (9,818)</b>	<b>\$ (41,540)</b>
Basic and diluted net loss per common share	\$ (0.12)	\$ (0.88)	\$ (0.40)	\$ (4.33)
Basic and diluted weighted average number of common shares outstanding	24,809	12,845	24,685	9,587

See accompanying notes to interim consolidated financial statements.

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## NAVISITE, INC. AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CASH FLOWS

	Nine Months Ended April 30,	
	2004	2003
	(Unaudited) (In thousands)	
Cash flows from operating activities:		
Net loss	\$ (9,818)	\$ (41,540)
Adjustments to reconcile net loss to net cash used for operating activities:		
Depreciation and amortization	9,522	10,119
Amortization of beneficial conversion feature to interest expense		15,173
Interest on debt paid in stock		2,098
Amortization of warrants	304	
Non-cash stock compensation	287	
Impairment of leased facilities	1,941	
Impairment on long-lived assets	300	(71)
Impairment of assets held for sale		1,042
Impairment of goodwill and intangibles		6,127
Loss on disposal of assets	26	250
Provision for doubtful accounts	1,902	753
Changes in operating assets and liabilities, net of impact of acquisitions:		
Accounts receivable	(877)	521
Due from related parties	(12)	(3,533)
Prepaid expenses and other current assets, net	(220)	808
Other assets	796	791
Accounts payable	(515)	(1,211)
Customer deposits	1	(11)
Accrued expenses and deferred revenue	(4,920)	(635)
Other long-term liabilities	(1,456)	217
Net cash used for operating activities	(2,739)	(9,102)
Cash flows from investing activities:		
Purchase of property and equipment	(1,800)	(579)
Purchase of debt securities		(1,963)
Cash acquired, net of cash paid for businesses		3,759
Loans to related parties		(1,396)
Proceeds from the sale of equipment	67	395
Net cash (used for) provided by investing activities	(1,733)	216
Cash flows from financing activities:		
Decrease in restricted cash	1,677	594
Proceeds from exercise of stock options	350	
Proceeds from sale-leaseback	120	
Net proceeds from modified accounts receivable line	16,000	
Proceeds from note payable	450	
Repayment of note payable	(1,581)	

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Borrowing under note to affiliate		5,600
Net repayment under former accounts receivable line	(6,874)	
Payments under note to affiliates	(30)	(2,600)
Debt repayment to AppliedTheory Estate		(6,100)
Payment of capital lease obligations	(1,872)	(3,104)
	<u>8,240</u>	<u>(5,610)</u>
Net cash provided by (used for) financing activities		
Net increase (decrease) in cash	3,768	(14,496)
Cash and cash equivalents, beginning of period	3,862	21,842
	<u>3,862</u>	<u>21,842</u>
Cash and cash equivalents, end of period	\$ 7,630	\$ 7,346
	<u>\$ 7,630</u>	<u>\$ 7,346</u>
Supplemental disclosure of cash flow information:		
Cash paid during the period for:		
Interest	\$ 1,044	\$ 1,657
Acquisitions of businesses:		
Assets acquired		\$ 12,122
Liabilities assumed		(7,993)
Common stock issued		(370)
	<u>          </u>	<u>          </u>
Cash acquired, net of cash paid for businesses		\$ 3,759
	<u>          </u>	<u>\$ 3,759</u>

See accompanying notes to interim consolidated financial statements.

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**NAVISITE, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)**

**1. Description of Business**

NaviSite, Inc. provides a broad range of outsourced hosting and managed application services for middle-market organizations, which include mid-sized companies, divisions of large multi-national companies and government agencies. Our service offerings allow our customers to outsource the hosting and management of their information technology infrastructure and applications, such as commerce systems, enterprise software applications and email. Substantially all of our revenue is generated from customers in the United States.

**2. Significant Accounting Policies**

**(a) Basis of Presentation**

The accompanying interim consolidated financial statements have been prepared by NaviSite, Inc. (NaviSite, we, us or our) in accordance with accounting principles generally accepted in the United States of America and pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations. It is suggested that the interim consolidated financial statements be read in conjunction with the audited consolidated financial statements and the accompanying notes included in our Annual Report on Form 10-K filed with the Securities and Exchange Commission on October 22, 2003 and elsewhere in this Information Statement.

The information furnished reflects all adjustments, which, in the opinion of management, are of a normal recurring nature and are considered necessary for a fair presentation of results for the interim periods. Such adjustments consist only of normal recurring items. It should be noted that results for interim periods are not necessarily indicative of the results expected for the full year or any future period.

The preparation of these interim consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities on the date of the financial statements and the reported amounts of revenue and expenses during the reporting period.

**One-for-fifteen Reverse Stock Split**

On December 12, 2002, our board of directors, pursuant to authority previously granted by our stockholders at the annual meeting on December 19, 2001, approved a reverse stock split of our common stock at a ratio of one-for-fifteen (1:15) effective January 7, 2003. All per share amounts and number of shares outstanding have been restated to give effect to the reverse stock split.

**Impact of Acquisitions**

On August 8, 2003, we completed the acquisition of certain assets and the assumption of certain liabilities of ClearBlue Technologies, Inc. (CBT) pursuant to a Stock and Asset Acquisition Agreement (the CBT Agreement). We acquired all outstanding shares of six (6) wholly owned subsidiaries of CBT with data centers located in Chicago, Las Vegas, Los Angeles, Milwaukee, Oakbrook and Vienna. In addition, we assumed the revenue and expense, as of the date of acquisition, of four (4) additional wholly owned subsidiaries of CBT with data centers located in Dallas, New York, San Francisco and Santa Clara (collectively the Four Subsidiaries or the Deferred Entities). Ownership of these subsidiaries was to be automatically transferred, under certain conditions, to NaviSite for no additional consideration in February 2004 (the CBT Agreement was amended in February 2004, as described below). The operational

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**NAVISITE, INC. AND SUBSIDIARIES**

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

results of the Four Subsidiaries have been included herein since NaviSite exercised effective control over these subsidiaries as of August 8, 2003.

As Atlantic Investors, LLC had a controlling interest in both NaviSite and CBT at the time of the combination, the transaction was accounted for as a combination of entities under common control (i.e., as if pooling ) whereby the assets and liabilities of CBT and NaviSite were combined at their historical amounts. Accordingly, our consolidated financial statements have been restated for all periods prior to the business combination to include CBT's financial results beginning on September 11, 2002, the date on which CBT acquired the controlling interest in NaviSite, after the elimination of intercompany balances. See Note 6 for further discussion of our fiscal year 2003 and 2004 acquisitions.

On February 6, 2004, we entered into an amendment to the CBT Agreement (the Amendment ) by and among NaviSite, CBT and certain of CBT's wholly owned subsidiaries. The Amendment amended the CBT Agreement dated August 8, 2003 to extend the date by which we are able to cause the transfer to us of the Deferred Entities, from February 8, 2004 to anytime on or prior to August 8, 2005 (the Transfer Date ), under certain conditions and for no additional consideration. In consideration for such Amendment, we agreed to operate and manage the Deferred Entities in a manner consistent with the CBT Agreement.

On March 12, 2004, we had initially rejected the Santa Clara data center subsidiary, pursuant to our right under the acquisition agreement; however, on April 12, 2004, prior to the expiration of the thirty-day notification period, we revoked this rejection. On April 14, 2004, pursuant to the Amendment, NaviSite exercised its right to acquire from CBT all of the outstanding shares of the Deferred Entities, for no additional consideration. We will continue to consolidate, as part of our consolidated financial statements, the results of each of these four subsidiaries.

**(b) Principles of Consolidation**

The accompanying consolidated financial statements include the accounts of NaviSite, Inc. and our wholly owned subsidiaries, ClickHear, Inc., NaviSite Acquisition Corp., ClearBlue Technologies Management, Inc., Avasta, Inc., Conxion Corporation, Intrepid Acquisition Corp., ClearBlue Technologies/Chicago-Wells, Inc., ClearBlue Technologies/Las Vegas, Inc., ClearBlue Technologies/Los Angeles, Inc., ClearBlue Technologies/Milwaukee, Inc., ClearBlue Technologies/Oakbrook, Inc., and ClearBlue Technologies/Vienna, Inc., ClearBlue Technologies/New York, Inc., ClearBlue Technologies/ Dallas, Inc., ClearBlue Technologies/ Santa Clara, Inc. and ClearBlue Technologies/San Francisco, Inc. after elimination of all significant intercompany balances and transactions.

**(c) Use of Estimates**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect certain reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting periods. Actual results could differ from those estimates. Significant estimates made by management include the useful lives of fixed assets and intangible assets, recoverability of long-lived assets and the collectability of receivables.

**(d) Cash and Cash Equivalents and Restricted Cash**

Cash equivalents consist of a money market fund, which invests in high quality short-term debt obligations, including commercial paper, asset-backed commercial paper, corporate bonds, U.S. government agency obligations, taxable municipal securities, and repurchase agreements. The

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**NAVISITE, INC. AND SUBSIDIARIES**

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

Company had restricted cash of \$1.3 million and \$3.1 million at April 30, 2004 and July 31, 2003, respectively, which represents a cash collateral requirement for standby letters of credit associated with several of the Company's facility and equipment leases. Restricted cash declined by \$1.8 million during the nine months ended April 30, 2004, as the result of letters of credit that have expired, been drawn down or canceled due to lease modifications.

**(e) Revenue Recognition**

Revenue consists of monthly fees for Web site and Internet application management, application rentals, hosting, co-location, and professional services. Revenue (other than installation fees) is billed and recognized over the term of the contract, generally one to three years, based on actual usage. Payments received in advance of providing services are deferred until the period such services are provided. Revenue from professional services is recognized on a time-and-material basis as the services are performed or under the percentage of completion method for revenue relating to fixed-price contracts. We generally sell our professional services under contracts with terms ranging from one to five years. Revenue and profits on long-term Internet solutions contracts, which represent approximately 2% of total revenue for the three and nine-month periods ended April 30, 2004, performed over extended periods are recognized under the percentage-of-completion method of accounting, with adjustments recorded in the period in which the revisions are made. Any anticipated losses on contracts are charged to operations as soon as they are determinable.

**(f) Concentrations of Credit Risk**

Our financial instruments include cash, accounts receivable, obligations under capital leases, software agreements, accounts payable, and accrued expenses. As of April 30, 2004, the carrying cost of these instruments approximated their fair value. Financial instruments that potentially subject us to concentration of credit risk consist primarily of accounts receivable. Concentrations of credit risk with respect to trade receivables are limited due to the large number of customers across many industries that comprise our customer base. One third-party customer accounted for 13% and 24% of our total revenue for the nine months ended April 30, 2004 and 2003, respectively. Accounts receivable at April 30, 2004 include approximately \$1.7 million due from this third-party customer.

**(g) Comprehensive Income (Loss)**

Comprehensive income (loss) is defined as the change in equity from foreign currency translation adjustments.

**(h) Goodwill and Intangible Assets**

At April 30, 2004 and July 31, 2003, our intangible assets consisted of customer lists resulting from our acquisitions of Avasta, Inc. and certain assets and liabilities of Interliant and the as if poolings of CBTM and CBT. Our intangible assets were recorded at a gross carrying value of \$17.0 million and \$15.8 million, less accumulated amortization of \$6.7 million and \$3.7 million at April 30, 2004 and July 31, 2003, respectively. Amortization expense related to our intangible assets of \$2.6 million and \$1.8 million for the nine months ended April 30, 2004 and 2003, respectively, was recorded as a component of our cost of revenue. Goodwill, resulting from our acquisition of CBTM, is recorded at its gross carrying value of \$3.2 million. We perform our annual impairment analysis in our fiscal fourth quarter.

**Table of Contents****NAVISITE, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(i) Accounting for Impairment of Long-Lived Assets**

We assess the need to record impairment losses on long-lived assets used in operations when indicators of impairment are present. On an ongoing basis, management reviews the value and period of amortization or depreciation of long-lived assets. During this review, the significant assumptions used in determining the original cost of long-lived assets are reevaluated. Although the assumptions may vary from transaction to transaction, they generally include revenue growth, operating results, cash flows, and other indicators of value. Management then determines whether there has been a permanent impairment of the value of long-lived assets by comparing future undiscounted cash flows to the asset's carrying value. If the estimated future undiscounted cash flows are less than the carrying value of the asset, a loss is recorded based on the excess of the asset's carrying value over fair value.

**(j) Income Taxes**

We account for income taxes under the asset and liability method. 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 and tax credit 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. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

**(k) Net Loss Per Share**

Basic net loss per share is computed using the weighted average number of common shares outstanding during the period. Diluted net loss per share is computed using the weighted average number of common and dilutive common equivalent shares outstanding during the period using the treasury stock method for warrants and options, unless such amounts are anti-dilutive.

For the three and nine months ended April 30, 2004 and 2003, net loss per basic and diluted share is based on weighted average common shares and excludes any common stock equivalents, as they would be anti-dilutive due to the reported net loss. For the three and nine months ended April 30, 2004, 1,228,532 and 1,190,034, respectively, of dilutive shares related to warrants and employee stock options were excluded as they had an anti-dilutive effect due to the net loss. For the three and nine months ended April 30, 2003, 3,041 and 3,987, respectively, of dilutive shares related to employee stock options were excluded as they had an anti-dilutive effect due to the net loss. (See Note 11)

**(l) Stock-Based Compensation**

We account for our stock option plans under the recognition and measurement principles of Accounting Principles Board Opinion No. 25 (APB 25), Accounting for Stock Issued to Employees, and Related Interpretations. We recorded stock compensation expense of approximately \$69,000 and \$287,000 during the three and nine months ended April 30, 2004, respectively (see Note 11). The following table illustrates the effect on net loss and net loss per common share if we had applied the fair value recognition provisions of Financial Accounting Standards Board (FASB) Statement No. 123,



**Table of Contents****NAVISITE, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Accounting for Stock-Based Compensation, to stock-based compensation (in thousands, except per share data):

	Three Months Ended April 30,		Nine Months Ended April 30,	
	2004	2003	2004	2003
Net loss, as reported	\$ (3,026)	\$ (11,304)	\$ (9,818)	\$ (41,540)
Add: Stock-based employee compensation expense from the Amended and Restated 2003 Stock Incentive Plan included in reported net loss, net of related tax effects	69		287	
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(1,437)	(1,541)	(4,240)	(7,033)
Net loss, as adjusted	\$ (4,394)	\$ (12,845)	\$ (13,771)	\$ (48,573)
Net loss per common share:				
Basic and diluted, as reported	\$ (0.12)	\$ (0.88)	\$ (0.40)	\$ (4.33)
Basic and diluted, as adjusted	\$ (0.18)	\$ (1.00)	\$ (0.56)	\$ (5.07)

The fair value of each stock option is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions:

	Three Months Ended April 30,		Nine Months Ended April 30,	
	2004	2003	2004	2003
Risk-free interest rate	2.86%	2.06%	2.15%	2.06%
Expected dividend yield	0.00%	0.00%	0.00%	0.00%
Expected volatility	135.71%	140.69%	160.68%	161.24%
Expected life (years)	2.48	3.06	2.75	3.06
Weighted average fair value of options granted during the period	\$ 5.13	N/A	\$ 5.89	\$ 2.88

**(m) Segment Reporting**

We currently operate in one segment, outsourced hosting and application management services. The Company's chief operating decision maker reviews financial information at a consolidated level. The Company has determined that reporting revenue at a service offering level is impracticable.

**(n) New Accounting Pronouncements**

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In January 2003, FASB Interpretation No. ( FIN ) 46, Consolidation of Variable Interest Entities, was issued. FIN 46 requires certain variable interest entities ( VIE ) to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. FIN 46 is effective for all new VIEs created or acquired after January 31, 2003. During December 2003, the FASB issued a new revision to FIN 46 ( FIN 46R ). Under the revised provisions, public entities are required to apply the guidance if the entity has interests in VIEs commonly referred to as special-purpose entities for the periods ending after December 15, 2003. The adoption of FIN 46 and 46R did not have a material effect on our consolidated financial statements.

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**Table of Contents****NAVISITE, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

In May 2003, the FASB issued Statement of Financial Accounting Standards ( SFAS ) No. 150, Accounting For Certain Financial Instruments with Characteristics of Both Liabilities and Equity , which establishes standards for how an issuer of financial instruments classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances) if, at inception, the monetary value of the obligation is based solely or predominantly on a fixed monetary amount known at inception, variations in something other than the fair value of the issuer s equity shares or variations inversely related to changes in the fair value of the issuer s equity shares. This Statement is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. On November 7, 2003 the FASB deferred the classification and measurement provisions of SFAS No. 150 as they apply to certain mandatory redeemable non-controlling interests. This deferral is expected to remain in effect while these provisions are further evaluated by the FASB. We have not entered into or modified any financial instruments covered by this statement after May 31, 2003 and the application of this standard is not expected to have a material impact on our financial position or results of operations.

In December 2003, the Securities and Exchange Commission ( SEC ) issued Staff Accounting Bulletin ( SAB ) No. 104, Revenue Recognition, which supersedes SAB 101, Revenue Recognition in Financial Statements. SAB 104 s primary purpose is to rescind accounting guidance contained in SAB 101 related to multiple element revenue arrangements, superseded as a result of the issuance of Emerging Issues Task Force ( EITF ) 00-21, Accounting for Revenue Arrangements with Multiple Deliverables. The issuance of SAB 104 reflects the concepts contained in EITF 00-21; the other revenue recognition concepts contained in SAB 101 remain largely unchanged. The application of SAB 104 did not have a material impact on the Company s financial position or results of operations.

**(o) Reclassifications**

Certain fiscal year 2003 balances have been reclassified to conform to the fiscal year 2004 financial statement presentation.

**(p) Foreign Currency**

The functional currencies of our foreign wholly owned subsidiaries are the local currencies. The financial statements of the subsidiaries are translated into U.S. dollars using period end exchange rates for assets and liabilities and average exchange rates during corresponding periods for revenue, cost of revenue and expenses. Translation gains and losses are deferred and accumulated as a separate component of stockholders equity (accumulated other comprehensive income (loss)).

**3. Liquidity**

As of April 30, 2004, our principal sources of liquidity include cash and cash equivalents and our financing agreement with Silicon Valley Bank. We had a working capital deficit of \$16.6 million, including cash and cash equivalents of \$7.6 million at April 30, 2004, as compared to a working capital deficit of \$16.3 million, including cash and cash equivalents of \$3.9 million at July 31, 2003.

The total net change in cash and cash equivalents for the nine months ended April 30, 2004 was an increase of \$3.8 million. The primary uses of cash during this nine-month period included \$2.7 million of cash used for operating activities, \$1.8 million for purchases of property and equipment and \$10.4 million in repayments on notes payable, capital lease obligations and borrowings under our former accounts receivable financing line. Our primary sources of cash during this nine-month period were a \$1.7 million decrease in restricted cash, \$0.4 million in proceeds associated with the exercise of stock options under the employee stock option plans, \$16.0 million in net proceeds from our modified financing agreement and

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**NAVISITE, INC. AND SUBSIDIARIES**

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

\$0.6 million in proceeds from sale-leaseback and note payable transactions. Net cash used for operating activities of \$2.7 million for the nine months ended April 30, 2004, resulted primarily from our \$9.8 million net loss, partially offset by \$14.3 million in non-cash charges, and \$7.2 million used by net changes in operating assets and liabilities. At April 30, 2004, we had an accumulated deficit of \$428.3 million, and have reported losses from operations since incorporation. At July 31, 2003, we had an accumulated deficit of \$415.7 million.

Prior to May 2003, our primary sources of cash to fund our operations were sales of equity and convertible debt securities. Since May 2003, our primary source of cash to fund our operations and meet our contracted obligations and commitments has been our accounts receivable financing agreement with Silicon Valley Bank. On January 30, 2004, we amended this agreement to, among other things, allow for future borrowing to be based on monthly recurring revenue, increase the maximum borrowings level from \$10.0 million to \$12.8 million, and extend the term until January 29, 2006. On April 29, 2004, we amended this agreement, among other things, to increase the maximum borrowing level from \$12.8 million to \$20.4 million, and extend the term until April 29, 2006. Under the amended agreement, borrowings are based on monthly recurring revenue. We are required to prepare and deliver a written request for an advance of up to three times the value of total monthly recurring revenue, calculated to be monthly revenue (including revenue from New York State Department of Labor) less professional services revenue. The bank may then provide an advance of 85% of such value (or such other percentage as the bank may determine). The interest rate under the amended agreement is variable and is currently calculated at the bank's published prime rate plus four percent. Following the completion of certain equity and debt financings, and provided we continue to meet certain ratios under the amended agreement, the interest rate shall be reduced to the bank's prime rate plus one percent. In no event, however, will the bank's prime rate be less than 4.25%. On April 30, 2004, we had an outstanding balance under the amended agreement of \$16.0 million. On June 11, 2004, we borrowed approximately \$3.9 million under the Silicon Valley Bank amended agreement to repay a Surebridge loan with Silicon Valley Bank that we assumed as part of the Surebridge acquisition (see Note 13). Our outstanding balance under this amended agreement as of June 11, 2004, was \$15.2 million.

We anticipate incurring additional losses throughout our current fiscal year. We have taken several actions we believe will allow us to continue as a going concern through July 31, 2004, including the closing and integration of strategic acquisitions, the changes to our senior management and bringing costs more in line with projected revenue. On January 22, 2004, we filed with the Securities and Exchange Commission a registration statement on Form S-2 (amended Form S-2/A filed on June 29, 2004) to register shares of our common stock to issue and sell in a public offering to raise additional funds. We believe that this proposed offering will allow us to raise the necessary funds to meet our anticipated needs for working capital and capital equipment for at least 12 months following the proposed offering. However, there can be no assurance that we will complete the proposed offering. In the event we are unable to complete the proposed offering, we will need to find alternative sources of financing, in order to remain a going concern. Potential sources include our financing agreement with Silicon Valley Bank and public or private sales of equity or debt securities. We may also consider sales of assets to raise additional cash. If we use a significant portion of the net proceeds from an offering to acquire a company, technology or product, we will need to raise additional debt or equity capital.

During fiscal 2003, we acquired four companies, downsized our workforce and restructured our business and balance sheet to improve operating cash flow. Our operating forecast incorporates material trends, such as our acquisitions, reductions in workforce, loss of related party revenue and closings of facilities. Our forecast also incorporates the future cash flow benefits expected from our continued efforts to increase efficiencies and reduce redundancies. Nonetheless, our forecast includes the need to raise additional funds through the proposed offering or alternate sources of financing. Our cash flow estimates are based upon attaining certain levels of sales, maintaining budgeted levels of operating expenses,

**Table of Contents****NAVISITE, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

collections of accounts receivable and maintaining our current borrowing line with Silicon Valley Bank among other assumptions, including the improvement in the overall macroeconomic environment. However there can be no assurance that we will be able to meet such assumptions. Our sales estimate includes revenue from new and existing customers which may not be realized and we may be required to further reduce expenses if budgeted sales are not attained. We may be unsuccessful in reducing expenses in proportion to any shortfall in projected sales and our estimate of collections of accounts receivable may be hindered by our customers' ability to pay. In addition, we are currently involved in various pending and potential legal proceedings. While we believe that the allegations against us in each of these matters are without merit, and that we have meritorious defense in each, we are not able to predict the final outcomes of any of these matters and the effect, if any, on our financial condition. If we are ultimately unsuccessful in any of these matters, we could be required to pay substantial amounts of cash and/or shares of our common stock to the other parties. The amount and timing of any such payments could adversely affect our financial condition.

**4. Intangible Assets**

Intangible assets as of April 30, 2004 are as follows (in thousands):

	<b>Gross Carrying Amount</b>	<b>Accumulated Amortization</b>
	<hr/>	<hr/>
Customer Lists	\$ 16,975	\$ 6,696
	<hr/>	<hr/>

During the three months ended April 30, 2004, we finalized our purchase accounting for the valuation of identifiable intangible assets of Avasta, Inc., which resulted in a reclassification from leasehold improvements to an intangible asset allocated to customer list in the amount of approximately \$1.5 million. In addition, we reduced intangible assets during the third quarter of 2004 by \$325,000, as the result of the Interliant net worth adjustment, which was resolved during the quarter (see Note 9(d)). Intangible asset amortization expense for the three-month period ended April 30, 2004 and 2003 aggregated \$920,000 and \$677,000, respectively, and for the nine-month period ended April 30, 2004 and 2003 was \$2.6 million and \$1.8 million, respectively. The amount reflected in the table below for fiscal year 2004 includes year-to-date amortization. Amortization expense related to intangible assets for the next five years is as follows (in thousands):

	<b>Year Ending July 31,</b>
	<hr/>
2004	\$ 3,466
2005	\$ 3,276
2006	\$ 2,953
2007	\$ 2,003
2008	\$ 1,115

**5. Property and Equipment**

Property and equipment are stated at cost. Depreciation is computed using the straight-line method over the estimated useful lives of the assets. Leasehold improvements and assets acquired under capital leases are amortized using the straight-line method over the shorter of the lease term or estimated useful life of the asset. Assets acquired under capital leases in which title transfers to us at the end of the agreement are amortized over the useful life of the asset. Expenditures for maintenance and repairs are

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charged to expense as incurred. Property and equipment, net at April 30, 2004 and July 31, 2003 are summarized as follows (in thousands):

	April 30, 2004	July 31, 2003
Office furniture and equipment	\$ 2,367	\$ 2,613
Computer equipment	29,876	28,368
Software licenses	9,553	9,308
Leasehold improvements	10,820	12,549
	<u>52,616</u>	<u>52,838</u>
Less: Accumulated depreciation and amortization	(37,228)	(30,673)
Property and equipment, net	<u>\$ 15,388</u>	<u>\$ 22,165</u>

**6. Acquisitions**

*CBTM.* We acquired ClearBlue Technologies Management, Inc. (CBTM) in December 2002 in a transaction accounted for as a combination of entities under common control (i.e., as if pooling). In June 2002, prior to our acquisition of CBTM, CBTM acquired substantially all of the assets used or useful in the Web hosting and Internet solutions business and assumed certain associated liabilities from the bankruptcy estate of AppliedTheory Corporation (AppliedTheory), which had filed for bankruptcy on April 17, 2002. On June 13, 2002, the acquisition of AppliedTheory by CBTM was consummated, effective June 6, 2002. The results of operations of AppliedTheory have been included in the financial statements of CBTM since June 6, 2002.

The aggregate purchase price paid by CBTM for the AppliedTheory assets, excluding assumed liabilities, was \$16.0 million of which \$3.9 million was paid in cash and \$12.1 million was satisfied through the issuance of four notes payable to the AppliedTheory Estate: two unsecured promissory notes totaling \$6.0 million, bearing interest at 8% per annum and due June 10, 2006, a secured promissory note totaling \$700,000, bearing interest at 8% per annum and due December 10, 2002 and a \$5.4 million secured promissory note, non-interest bearing, due December 10, 2002. The two notes, due December 10, 2002, were paid in December 2002.

Of the \$6.2 million in identifiable intangible assets, \$5.8 million was assigned to customer lists, which are being amortized over eight years, except for the New York State Department of Labor customer contract, which is being amortized over five years, and represented the remaining life on the contract. The remaining \$440,000 of acquired intangible assets was allocated to proprietary software, which is being amortized over five years.

*Avasta, Inc.* On February 5, 2003, we acquired Avasta, a provider of remote hosting and managed service operations, in an all-stock transaction valued at approximately \$370,000. The acquisition was made to enhance our ability to be a full service provider of applications management services and technology to our customers. The purchase price consisted of 231,039 shares of common stock at a per share value of \$1.60 (representing a five-day average of the market value of our common stock at the time of the acquisition). The purchase price of \$442,000 consists of the issuance of common stock for approximately \$370,000 and approximately \$72,000 in acquisition costs. This acquisition was accounted for using the purchase method of accounting. The Agreement and Plan of Merger provided that up to an additional 1,004,518 shares of common stock could be issued in the event certain revenue targets were achieved through June 2003. As a result of the earnout calculation in September 2003, we adjusted our purchase accounting to reflect the issuance of 179,353 shares of our common stock at a per share value of \$4.14 (representing the market value of our common stock the day preceding the issuance of the additional

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shares for the attainment of certain revenue targets). During the third quarter of 2004, we finalized our purchase accounting for this acquisition, which resulted in the reclassification from leasehold improvements to an intangible asset allocated to customer lists in the amount of approximately \$1.5 million, which is being amortized over the remaining four years.

*Conxion Corporation.* On April 2, 2003, we completed the acquisition of Conxion, a provider of software distribution services and network/server security expertise for its customers, pursuant to an Agreement and Plan of Merger, dated as of March 26, 2003 (Conxion Agreement), by and between us, Union Acquisition Corp., a Delaware corporation and our wholly owned subsidiary, and Conxion. Pursuant to the Conxion Agreement, the shareholders of Conxion received an aggregate of \$1,925,000 in cash. The acquisition was made to enhance our ability to be a full service provider of applications management services and technology to our customers. The source of funds used for the acquisition of Conxion was our cash on hand. The acquisition price was based on the parties' determination of the fair value of Conxion and the terms of the Conxion Agreement were derived from arms-length negotiation among the parties. The purchase price of \$2,031,000 consisted of the \$1,925,000 paid to the Conxion shareholders and approximately \$106,000 in acquisition costs. The negative goodwill of approximately \$2.2 million reduced the recorded basis of property and equipment. This acquisition was accounted for using the purchase method of accounting.

*Interliant.* On May 16, 2003, we completed the acquisition of substantially all of the assets relating to the managed infrastructure solutions business, encompassing messaging and collaboration, managed hosting, bundled-in managed security, and integrated and related professional services in the United States and in Europe of Interliant, Inc., a Delaware corporation, and several of its subsidiaries (Debtors) in the bankruptcy proceedings of the Debtors under Chapter 11 of Title 11 of the United States Bankruptcy Code pending in the Southern District of New York (White Plains), pursuant to an Asset Purchase Agreement, dated as of May 15, 2003 (the Agreement), by and between our subsidiary, Intrepid Acquisition Corp. and the Debtors, approved by order of the Bankruptcy Court on May 15, 2003. Pursuant to the Agreement, the aggregate purchase price for the Interliant assets, excluding certain assumed liabilities, was approximately \$7,204,000 after adjustments, based upon the Debtors' adjusted net worth, comprised of approximately \$5,830,000 in cash, \$624,000 in the form of a credit of future distributions to be paid on the Interliant Notes, \$550,000 in principal amount of a non-interest bearing, 180-day promissory note, secured by the Interliant Notes and the accounts receivable acquired as part of the Interliant Assets and approximately \$200,000 in acquisition-related costs. On May 16, 2003, our subsidiary closed on the purchase of all of the Interliant Assets, other than the Debtors' accounts receivable. On June 6, 2003, our subsidiary closed on the purchase of the accounts receivable. The source of funds used for the initial closing was our cash on hand combined with the funds provided from and through financing of our accounts receivable with Silicon Valley Bank (SVB), as discussed below, cash acquired with the Interliant assets, and cash receipts from the purchased accounts receivable. The acquisition price was determined through arms-length negotiations and competitive bidding for the Interliant Assets at an auction conducted under the auspices of the Bankruptcy Court. On March 8, 2004, the court approved the \$325,000 net worth adjustment in favor of Intrepid and we adjusted our purchase accounting to reflect this resolution. In conjunction with this resolution, Intrepid's \$550,000 promissory note in favor of Interliant was satisfied out of the net worth adjustment and the remaining balance of \$225,000 was paid from funds Intrepid had placed in escrow (see Note 9).

*ClearBlue Technologies.* On August 8, 2003, we completed the acquisition of certain assets and the assumption of certain liabilities of CBT pursuant to a Stock and Asset Acquisition Agreement (the CBT Agreement). Pursuant to the CBT Agreement, we acquired all outstanding shares of six (6) wholly owned subsidiaries of CBT with data centers located in Chicago, Las Vegas, Los Angeles, Milwaukee, Oakbrook and Vienna.

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In addition, we assumed the revenue and expense, as of the date of the CBT Agreement, of four (4) additional wholly owned subsidiaries of CBT with data centers located in Dallas, New York, San Francisco and Santa Clara. Ownership of these subsidiaries was to be automatically transferred, under certain conditions, to us for no additional consideration in February 2004. On February 6, 2004, we entered into an amendment (as discussed in Note 2) to extend the date by which we are able to cause the transfer of these CBT wholly owned subsidiaries to us from February 8, 2004 to on or prior to August 8, 2005, under certain conditions and for no additional consideration. In consideration for such amendment, we agreed to operate and manage these entities in a manner consistent with the CBT Agreement.

In exchange for these subsidiaries and certain assets and contracts relating to them, we: (i) issued 1.1 million shares of our common stock, to CBT; (ii) released CBT from certain inter-company advances in an amount up to \$300,000; (iii) assumed all of CBT's obligations under certain assets and contracts relating to these subsidiaries; and (iv) released CBT from certain payment obligations owed to us pursuant to the Outsourcing Agreement in an amount not to exceed \$263,000.

As Atlantic Investors, LLC had a controlling interest in both NaviSite and CBT at the time of the CBT Agreement, the transaction was accounted for as a combination of entities under common control (i.e., as if pooling ) whereby the assets and liabilities of CBT and NaviSite were combined at their historical amounts. Accordingly, the Company's consolidated financial statements have been restated for all periods prior to the business combination to include CBT's financial results beginning on September 11, 2002, the date on which CBT acquired the controlling interest in the Company. CBT's balance sheet has been included in the Consolidated Balance Sheets of NaviSite at April 30, 2004 and July 31, 2003, and CBT's results of operations and cash flows for the nine months ended April 30, 2004 have been included in the Consolidated Statement of Operations and Consolidated Statement of Cash Flows of NaviSite for the nine-month period ended April 30, 2004, and CBT's results of operations and cash flows for the eight-month period ended April 30, 2003 have been included in our Consolidated Statement of Operations and Consolidated Statement of Cash Flows for the nine-month period ended April 30, 2003.

On March 12, 2004, we had initially rejected the Santa Clara data center subsidiary, pursuant to our right under the acquisition agreement; however, on April 12, 2004, prior to the expiration of the thirty-day notification period, we revoked this rejection. On April 14, 2004, pursuant to the Amendment, NaviSite exercised its right to acquire from CBT all of the outstanding shares of the Deferred Entities, for no additional consideration. We will continue to consolidate, as part of our consolidated financial statements, the results of each of these four subsidiaries.

The following unaudited pro forma results for the nine-month period ended April 30, 2003 give effect to our acquisitions of CBTM, Avasta, Conxion and the assets of Interliant and CBT as if they had taken place at the beginning of fiscal year 2003. The pro forma information does not necessarily reflect the results of operations that would have occurred had the acquisitions taken place at the beginning of the fiscal 2003 period and is not necessarily indicative of results that may be obtained in the future (in thousands, except per share data):

	<b>For the Nine Months Ended April 30, 2003</b>
	<b>Pro Forma</b>
Revenue	\$ 91,120
Net loss	\$(57,485)
Net loss per common share	\$ (6.00)



**Table of Contents****NAVISITE, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****7. Investment in Debt Securities**

In a privately negotiated transaction with Fir Tree Recovery Master Fund, LP and Fir Tree Value Partners, LDC pursuant to an Assignment Agreement dated October 11, 2002 and in a series of open market transactions from certain other third-party holders, we acquired an aggregate principal amount of approximately \$36.3 million face value, 10% convertible senior notes (Interliant Notes) due in 2006 of Interliant, Inc. (Interliant) for a total consideration of approximately \$2 million. Interliant is a provider of managed services, which filed a petition under Chapter 11 of the United States Bankruptcy Code in the Southern District of New York on August 5, 2002, and we made this investment with the intention of participating in the reorganization/sale of Interliant.

On May 16, 2003, the Southern District of New York (White Plains) confirmed us as the successful bidder for the purchase of the Interliant assets. The final value we will receive for the Interliant Notes has not been determined, however, we estimate the value to approximate the \$1.4 million carrying value, included in other assets on our Consolidated Balance Sheet. The Interliant Estate filed a plan of liquidation with the bankruptcy court, which has been approved by the creditors.

**8. Accrued Expenses**

Accrued expenses consist of the following at April 30, 2004 and July 31, 2003, respectively (in thousands):

	<b>April 30, 2004</b>	<b>July 31, 2003</b>
Accrued payroll, benefits and commissions	\$ 2,528	\$ 3,088
Accrued accounts payable	2,102	3,694
Accrued interest	899	351
Due to AppliedTheory Estate	1,464	1,461
Accrued contract termination fees	524	2,096
Accrued lease abandonment costs	2,285	2,536
Accrued taxes	782	708
Accrued other	3,044	3,646
	<b>\$ 13,628</b>	<b>\$ 17,580</b>

**9. Debt****(a) Silicon Valley Bank Financing Arrangements**

On May 27, 2003, we entered into an Accounts Receivable Financing Agreement (Financing Agreement), by and among Silicon Valley Bank (SVB), us and our wholly owned subsidiaries, ClearBlue Technologies Management, Inc., Avasta, Inc., Conxion Corporation and Intrepid Acquisition Corp., whereby we can finance up to a maximum of \$12.5 million of our eligible accounts receivables with an 80% advance rate. Under the Financing Agreement, we are required to repay advances upon the earlier of our receipt of payment on the financed accounts receivables from our customers, or the financed accounts receivable being aged greater than ninety days from date of service. The Financing Agreement has a one-year term and bears an annual interest rate of prime rate plus 4.0%, with a minimum \$10,000 monthly finance charge. The Financing Agreement also contains certain affirmative and negative covenants and is secured by substantially all of our assets, tangible and intangible. As part of the Financing Agreement, on May 27, 2003 we issued to SVB a warrant to purchase up to 165,000 shares of NaviSite common stock with an exercise price of \$2.50 per share, the closing price of our stock on the last business day before the



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**NAVISITE, INC. AND SUBSIDIARIES**

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

issuance of the warrant. We fair valued the warrants at \$370,000 using the Black-Scholes option-pricing model. The value of the warrants is being amortized into interest expense over the term of the Financing Agreement. Pursuant to the terms of the warrant, on May 19, 2004, SVB fully exercised its warrant, which resulted in a net issuance of 73,738 shares.

On January 30, 2004, we entered into a Loan Modification Agreement with SVB. The agreement amended our accounts receivable financing agreement with SVB, among other things, to: (i) base future borrowings on monthly recurring revenue; (ii) increase the maximum borrowing level from \$10.0 million to \$12.8 million; and (iii) extend the term until January 29, 2006. In connection with this amended agreement, on January 30, 2004, we issued a warrant to SVB for the purchase of 50,000 shares of common stock at an exercise price of \$5.75 per share. We fair valued the warrant at \$213,426 using the Black-Scholes option-pricing model. The value of the warrant is being amortized into interest expense over the term of the modified Financing Agreement. The warrant is exercisable at any time on or after September 1, 2004. Pursuant to the terms of a Registration Rights Agreement, dated as of January 30, 2004, we also granted certain registration rights to SVB with respect to the shares of common stock issuable upon exercise of the warrant.

On April 29, 2004, we entered into a Second Loan Modification Agreement with SVB. The agreement amended our account receivable financing agreement, with SVB to, among other things: (i) increase our maximum borrowing level from \$12.8 million to \$20.4 million; and (ii) extend the term until April 29, 2006. On April 30, 2004, we had an outstanding balance under the amended agreement of \$16.0 million and repaid \$7.0 million on May 3, 2004.

Under the amended agreement, borrowings are based on monthly recurring revenue. We are required to prepare and deliver a written request for an advance of up to three times the value of total recurring monthly revenue, calculated to be monthly revenue (including revenue from The New York State Department of Labor) less professional services revenue. SVB may then provide an advance of 85% of such value (or such other percentage as the bank may determine). The interest rate under the amended agreement is variable and is currently calculated at the bank's published prime rate plus 4.0%. Following the completion of certain equity or debt financings, and provided we continue to meet certain ratios under the amended agreement, the interest rate shall be reduced to the bank's prime rate plus 1.0%. In no event, however, will the bank's prime rate be less than 4.25%.

**(b) Note Payable to Atlantic Investors, LLC (Atlantic)**

On January 29, 2003, we entered into a \$10 million Loan and Security Agreement (Atlantic Loan) with Atlantic, a related party. The Atlantic Loan bears an interest rate of 8% per annum. Interest is payable upon demand or, at Atlantic's option, interest may be added to the outstanding balance due to Atlantic by NaviSite. Atlantic may make demand for payment of amounts in excess of the minimum Atlantic Loan amount of \$2.0 million (Minimum Loan Amount), with 60 days notice. Atlantic can demand payment of the Minimum Loan Amount with 90 days notice. Under the Atlantic Loan agreement, we can require Atlantic to loan us (1) up to \$2.0 million to repay an amount due from CBTM to Unicorn, a related party to NaviSite and Atlantic; (2) \$1.0 million for costs associated with our acquisition of Avasta; and (3) up to \$500,000 for the post-acquisition working capital needs of Avasta. Atlantic, at its sole and absolute discretion, may advance other amounts to us such that the aggregate amount borrowed by NaviSite does not exceed the maximum loan amount, defined as the lesser of \$10.0 million or 65% of our consolidated accounts receivables. On May 30, 2003, we repaid \$2.0 million of the approximate \$3.0 million outstanding under the Atlantic Loan and on June 11, 2003, we borrowed \$2.0 million under the Atlantic Loan. At April 30, 2004, we had \$3.0 million outstanding under the Atlantic Loan. This amount is shown as Current Note Payable to Related Party on our Consolidated

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**NAVISITE, INC. AND SUBSIDIARIES**

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

Balance Sheet. The Atlantic Loan is secured by all of our receivables and is subordinated to the borrowings from Silicon Valley Bank.

On January 16, 2004, the Atlantic Loan was amended to extend any and all Credit Advances under the Atlantic Loan made prior to or following, January 16, 2004, to be due on or before the earlier of (i) August 1, 2004 or (ii) five (5) business days following the closing of a financing transaction or disposition pursuant to which the Borrower receives gross proceeds of \$13 million.

**(c) Note Payable to AppliedTheory Estate**

As part of CBTM's acquisition of certain AppliedTheory assets, CBTM entered into two unsecured promissory notes totaling \$6.0 million (Estate Liability) due to the AppliedTheory Estate on June 10, 2006. The Estate Liability bears interest at 8% per annum, which is due and payable annually. At April 30, 2004, we had approximately \$440,000 in accrued interest related to this note, which is reflected within accrued expenses on our Consolidated Balance Sheet.

**(d) Notes Payable to the Interliant Estate**

As part of our acquisition of certain Interliant Assets, we entered into a promissory note with the Interliant Estate (Interliant Promissory Note) in the amount of \$550,000, payable without interest on the earlier of (i) the 180th day following the Second Closing Date or (ii) the date Interliant Estate makes distributions to their general unsecured creditors. The Interliant Promissory Note was secured by the Interliant Notes and the accounts receivable acquired as part of the Interliant Assets. Pursuant to the terms of the Asset Purchase Agreement between Intrepid and Interliant, each party placed \$300,000 in escrow as security for adjustments in the purchase price based upon changes in Interliant's net worth at the time of the closing. On March 8, 2004, the court approved the \$325,000 net worth adjustment in favor of Intrepid and we adjusted our purchase accounting to reflect this resolution by reducing intangible assets. In conjunction with this resolution, Intrepid's \$550,000 promissory note in favor of Interliant was satisfied out of the net worth adjustment and the remaining balance of \$225,000 was paid from funds Intrepid had placed in escrow and Interliant's security interest securing Intrepid's obligations under the Interliant Promissory Note was released.

**(e) Notes Payable to Landlord**

As part of an amendment to our 400 Minuteman Road lease, \$2.2 million of our future payments to the landlord of our 400 Minuteman Road facility were transferred into a note payable (Landlord Note). The Landlord Note bears interest at an annual rate of 11% and calls for 36 equal monthly payments of principal and interest, with the final payment due on November 1, 2006. The \$2.2 million represents leasehold improvements made by the landlord, on our behalf, to the 400 Minuteman location in order to facilitate the leasing of a portion of the facility (First Lease Amendment), as well as common area maintenance and property taxes associated with the space.

In addition, during the three months ended January 31, 2004, we paid \$120,000 and we entered into a separate \$150,000 note (Second Landlord Note) with the landlord for additional leasehold improvements to facilitate a subleasing transaction involving a specific section of the 400 Minuteman location. The Second Landlord Note bears interest at an annual rate of 11% and calls for 36 equal monthly payments of principal and interest, with the final payment due on March 1, 2007.

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**NAVISITE, INC. AND SUBSIDIARIES**

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

**10. Commitments and Contingencies**

*(a) Leases*

*Abandoned Leased Facilities*

On January 31, 2003, we abandoned our administrative space on the second floor of our 400 Minuteman Road, Andover, MA leased location. We continue to maintain and operate our Data Center on the first floor of the building. While we remain obligated under the terms of the lease for the rent and other costs associated with the second floor of the building, we ceased to use the space on January 31, 2003. Therefore, in accordance with SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities, issued in July 2002, we recorded a charge to our earnings in fiscal year 2003 of approximately \$5.4 million to recognize the costs of exiting the space. The liability is equal to the total amount of rent and other direct costs for the period of time the second floor of the building was expected to remain unoccupied plus the present value of the amount by which the rent paid by us to the landlord exceeds any rent paid to us by a tenant under a sublease over the remainder of the lease term, which is May 2011. During the second quarter of fiscal 2004, \$2.2 million of our future payments to the landlord of our 400 Minuteman Road facility were transferred into a note payable (see Note 9(e)).

Near the end of our fiscal year 2002, we abandoned our sales office space in La Jolla, CA. At that time we were able to sublet the space to a third party. During the second quarter of fiscal year 2003, the sublease tenant stopped making payments under the sublease and has abandoned the space. The facility is currently empty and we remain obligated under the terms of the lease for the rent and other costs associated with the building. We have no foreseeable plans to occupy the space; therefore, under SFAS No. 146, we recorded a charge to our earnings of approximately \$1.4 million during fiscal year 2003 to recognize the costs of exiting the building.

In conjunction with the Conxion acquisition in April 2003, we impaired data center and office leases in Chicago, IL, Herndon, VA, and Amsterdam, as these leases provided no economic benefit to the combined company.

In October 2003, we abandoned administrative office space at 55 Francisco St., San Francisco, CA and data center space and office space located at Westwood Center, Vienna, VA. While we remain obligated under the terms of these leases for the rent and other costs associated with these leases, we made the decision to cease using these spaces on October 31, 2003 and have no foreseeable plans to occupy them in the future. Therefore, in accordance with SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities, issued in July 2002, we recorded a charge to our current earnings in the first quarter of fiscal year 2004 of approximately \$1.1 million to recognize the costs of exiting the space. The amount is included in the caption Impairment, restructuring and other in the accompanying Consolidated Statements of Operations. The liability is equal to the total amount of rent and other direct costs for the period of time space is expected to remain unoccupied plus the present value of the amount by which the rent paid by us to the landlord exceeds any rent paid to us by a tenant under a sublease over the remainder of the lease terms, which expire in January 2006 for San Francisco, CA and July 2005 for Vienna, VA, respectively.

The \$206,000 net impairment charge recorded during the three months ended April 30, 2004 resulted from the write-off of \$300,000 in property and equipment, net of \$94,000 in recovery of impairment charges, triggered by the termination and settlement of the abandoned lease at 55 Francisco, San Francisco, CA. Additional net adjustments of \$69,000 were recorded during the three months ended April 30, 2004, in conjunction with the final purchase accounting for Conxion.

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Details of activity in the lease exit accrual for the three months ended April 30, 2004 were as follows (in thousands):

	Balance at January 31, 2004	Payments, less Accretion of Interest	Adjustments	Balance at April 30, 2004
400 Minuteman lease abandonment costs	\$ 1,267	\$(124)	\$	\$ 1,143
La Jolla lease abandonment costs	1,060	(175)		885
Chicago & Virginia lease abandonment costs	1,407	(220)	(73)	1,114
Amsterdam lease abandonment costs	100	4	142	246
Vienna lease abandonment costs	551	(175)		376
55 Francisco lease abandonment costs	457	(60)	(94)	303
	<u>\$4,842</u>	<u>\$(750)</u>	<u>\$(25)</u>	<u>\$4,067</u>

We are obligated under various capital and operating leases for facilities and equipment.

Minimum annual rental commitments under operating leases and other commitments are as follows as of April 30, 2004 (in thousands):

Description	Total	Less than 1 Year	Year 2	Year 3	Year 4	Year 5	After 5 Years
Short/Long-term debt	\$27,400	\$20,048	\$ 815	\$ 6,537	\$	\$	\$
Interest on debt	1,819	859	480	480			
Capital leases	3,248	2,418	830				
Operating leases	535	523	12				
Bandwidth commitments	7,981	3,095	2,768	1,875	243		
Maintenance for hardware/ software	1,019	1,019					
Property leases	57,808	12,599	11,184	8,804	8,655	7,014	9,552
	<u>\$99,810</u>	<u>\$40,561</u>	<u>\$16,089</u>	<u>\$17,696</u>	<u>\$8,898</u>	<u>\$7,014</u>	<u>\$9,552</u>

On June 10, 2004, we completed the acquisition of substantially all of the assets and liabilities of Surebridge. Under the terms of the Asset Purchase Agreement, we issued two promissory notes in the aggregate principal amount of approximately \$39.3 million to Surebridge. The Notes accrue interest on the unpaid balance at an annual rate of 10%, however no interest shall accrue on any principal paid within nine months of the closing. The Notes shall be paid in full no later than the second anniversary of the closing. In the event that we realize net proceeds in excess of \$1 million from certain equity or debt financings or sales of assets, we are obligated to use a significant portion of the proceeds to make payments on the Notes. The outstanding principal and accrued interest of the Notes shall be convertible into shares of NaviSite common stock (the "Conversion Shares") at the election of the holder (i) at any time following the first anniversary of the closing if the aggregate principal outstanding under the Notes at such time is greater than or equal to \$20 million, (ii) at any time following the 18-month anniversary of the closing if the aggregate principal outstanding under the Notes at such time is greater than or equal to \$10 million, (iii) at any time following the second anniversary of the closing, and (iv) at any time following an event of default thereunder. The conversion price of each of the Notes is \$4.642, which is the average closing price of NaviSite's common stock for the ten-day period ending one day prior to closing.

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**NAVISITE, INC. AND SUBSIDIARIES**

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

**(b) Legal Matters**

*IPO Securities Litigation*

On or about June 13, 2001, Stuart Werman and Lynn McFarlane filed a lawsuit against us, BancBoston Robertson Stephens, an underwriter of our initial public offering in October 1999, Joel B. Rosen, our then chief executive officer, and Kenneth W. Hale, our then chief financial officer. The suit was filed in the United States District Court for the Southern District of New York. The suit generally alleges that the defendants violated federal securities laws by not disclosing certain actions allegedly taken by Robertson Stephens in connection with our initial public offering. The suit alleges specifically that Robertson Stephens, in exchange for the allocation to its customers of shares of our common stock sold in our initial public offering, solicited and received from its customers agreements to purchase additional shares of our common stock in the aftermarket at pre-determined prices. The suit seeks unspecified monetary damages and certification of a plaintiff class consisting of all persons who acquired shares of our common stock between October 22, 1999 and December 6, 2000. Three other substantially similar lawsuits were filed between June 15, 2001 and July 10, 2001 by Moses Mayer (filed June 15, 2001), Barry Feldman (filed June 19, 2001), and Binh Nguyen (filed July 10, 2001). Robert E. Eisenberg, our president at the time of the initial public offering in 1999, also was named as a defendant in the Nguyen lawsuit.

On or about June 21, 2001, David Federico filed in the United States District Court for the Southern District of New York a lawsuit against us, Mr. Rosen, Mr. Hale, Robertson Stephens and other underwriter defendants including J.P. Morgan Chase, First Albany Companies, Inc., Bank of America Securities, LLC, Bear Stearns & Co., Inc., B.T. Alex. Brown, Inc., Chase Securities, Inc., CIBC World Markets, Credit Suisse First Boston Corp., Dain Rauscher, Inc., Deutsche Bank Securities, Inc., The Goldman Sachs Group, Inc., J.P. Morgan & Co., J.P. Morgan Securities, Lehman Brothers, Inc., Merrill Lynch, Pierce, Fenner & Smith, Inc., Morgan Stanley Dean Witter & Co., Robert Fleming, Inc. and Salomon Smith Barney, Inc. The suit generally alleges that the defendants violated the anti-trust laws and the federal securities laws by conspiring and agreeing to raise and increase the compensation received by the underwriter defendants by requiring those who received allocation of initial public offering stock to agree to purchase shares of manipulated securities in the after-market of the initial public offering at escalating price levels designed to inflate the price of the manipulated stock, thus artificially creating an appearance of demand and high prices for that stock, and initial public offering stock in general, leading to further stock offerings. The suit also alleges that the defendants arranged for the underwriter defendants to receive undisclosed and excessive brokerage commissions and that, as a consequence, the underwriter defendants successfully increased investor interest in the manipulated initial public offering of securities and increased the underwriter defendants individual and collective underwritings, compensation, and revenue. The suit further alleges that the defendants violated the federal securities laws by issuing and selling securities pursuant to the initial public offering without disclosing to investors that the underwriter defendants in the offering, including the lead underwriters, had solicited and received excessive and undisclosed commissions from certain investors. The suit seeks unspecified monetary damages and certification of a plaintiff class consisting of all persons who acquired shares of our common stock between October 22, 1999 and June 12, 2001.

Those five cases, along with lawsuits naming more than 300 other issuers and over 50 investment banks, which have been sued in substantially similar lawsuits, have been assigned to the Honorable Shira A. Scheindlin (the Court) for all pretrial purposes (the IPO Securities Litigation). On September 6, 2001, the Court entered an order consolidating the five individual cases involving us and designating Werman v. NaviSite, Inc., et al., Civil Action No. 01-CV-5374 as the lead case. A consolidated, amended complaint was filed thereafter on April 19, 2002 (the Class Action Litigation) on behalf of plaintiffs Arvid Brandstrom and Tony Tse against underwriter defendants Robertson Stephens (as

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**NAVISITE, INC. AND SUBSIDIARIES**

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

successor-in-interest to BancBoston), BancBoston, J.P. Morgan (as successor-in-interest to Hambrecht & Quist), Hambrecht & Quist and First Albany and against us and Messrs. Rosen, Hale and Eisenberg (collectively, the NaviSite Defendants ). Plaintiffs uniformly allege that all defendants, including the NaviSite Defendants, violated the federal securities laws (i.e., Sections 11 and 15 of the Securities Act, Sections 10(b) and 20(a) of the Exchange Act and Rule 10b-5) by issuing and selling our common stock pursuant to the October 22, 1999, initial public offering, without disclosing to investors that some of the underwriters of the offering, including the lead underwriters, had solicited and received extensive and undisclosed agreements from certain investors to purchase aftermarket shares at pre-arranged, escalating prices and also to receive additional commissions and/or other compensation from those investors. At this time, plaintiffs have not specified the amount of damages they are seeking in the Class Action Litigation.

Between July and September 2002, the parties to the IPO Securities Litigation briefed motions to dismiss filed by the underwriter defendants and the issuer defendants, including NaviSite. On November 1, 2002, the Court held oral argument on the motions to dismiss. The plaintiffs have since agreed to dismiss the claims against Messrs. Rosen, Hale and Eisenberg without prejudice, in return for their agreement to toll any statute of limitations applicable to those claims. By stipulation entered by the Court on November 18, 2002, Messrs. Rosen, Hale and Eisenberg were dismissed without prejudice from the Class Action Litigation. On February 19, 2003, an opinion and order was issued on defendants' motion to dismiss the IPO Securities Litigation, essentially denying the motions to dismiss of all 55 underwriter defendants and of 185 of the 301 issuer defendants, including NaviSite.

On June 30, 2003, our Board of Directors considered and authorized us to negotiate a settlement of the pending Class Action Litigation substantially consistent with a memorandum of understanding negotiated among class plaintiffs, the issuer defendants and the insurers for such issuer defendants. On June 14, 2004, a Stipulation and Agreement of Settlement with Defendant Issuers and Individuals was submitted to the Court. The Court ordered plaintiffs to file a motion for preliminary approval on or before June 25, 2004, and the motion is expected to be fully briefed by July 21, 2004. If completed and then given final approval by the Court, the settlement is expected to be covered by our existing insurance policies and is not expected to have a material effect on our business or financial results.

We believe that the allegations against us are without merit and, if the settlement is not finalized, we intend to vigorously defend against the plaintiffs' claims. Due to the inherent uncertainty of litigation, we are not able to predict the possible outcome of the suits and their ultimate effect, if any, on our financial condition.

*Goldman Sachs Payment Demand*

In March 2001, we engaged Goldman Sachs & Co. to serve as our financial advisor in connection with the possible sale of all or a portion of NaviSite. On September 17, 2002, Goldman made a written demand for payment of a \$3.0 million success fee in connection with the September 2002 acquisition by CBT of the stock and convertible debt of NaviSite from CMGI and Hewlett-Packard Financial Services Company. We have rejected Goldman's demands, as we believe they are without merit. No legal actions have been filed concerning the Goldman claim. As this matter is in the initial stage, we are not able to predict the possible outcome of this matter and the effect, if any, on our financial condition.

*Joseph Cloonan*

On or about September 27, 2002, we received a demand for a wage payment of \$850,000 from our former Procurement Director, Joseph Cloonan. We rejected the demand, alleging that Mr. Cloonan's claim is based, among other things, on a potentially fraudulent contract. Mr. Cloonan also claimed \$40,300 for allegedly unpaid accrued vacation and bonuses and that he may be statutorily entitled to treble damages and legal fees. On October 11, 2002, NaviSite filed a civil complaint with the Massachusetts Superior



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**NAVISITE, INC. AND SUBSIDIARIES**

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

Court, Essex County, seeking a declaratory judgment and asserting claims against Mr. Cloonan for civil fraud, misrepresentation, unjust enrichment and breach of duty of loyalty. Mr. Cloonan asserted counter claims against NaviSite seeking the payments set forth in his September 2002 demand. We believe Mr. Cloonan's allegations are without merit and intend to vigorously defend against them. As the litigation is in the discovery stage, we are not able to predict the possible outcome of this matter and the effect, if any, on our financial condition.

*Lighthouse International*

On October 28, 2002, CBTM, one of our subsidiaries, filed a complaint in United States District Court for the Southern District of New York against Lighthouse International, alleging six causes of action for copyright infringement, breach of contract, account stated, unjust enrichment, unfair competition, and misappropriation and/or conversion. The total claimed damages are in the amount of \$1.9 million. On or about January 16, 2003, Lighthouse filed and served its answer and counterclaimed against CBTM claiming \$3.1 million in damages and \$5.0 million in punitive relief.

On June 17, 2003, the U.S. Bankruptcy Court for the Southern District of New York heard oral argument on Lighthouse's Motion for an Order Compelling the Debtor (AppliedTheory) to Assume or Reject an Agreement, filed in response to CBTM's complaint, and the objections to Lighthouse's motion filed by CBTM and AppliedTheory. Lighthouse made this motion on the basis that it never received notice of CBTM assuming the AppliedTheory contract for the LighthouseLink Web site. The Bankruptcy Court declined to grant Lighthouse's motion, and instead ordered that an evidentiary hearing be conducted to determine whether Lighthouse received appropriate notice of the proposed assignment of the contract by AppliedTheory to CBTM. The Bankruptcy Court ordered that the parties first conduct discovery, and upon completion of discovery, the Bankruptcy Court would schedule an evidentiary hearing on the issues of due process and notice.

As to the U.S. District Court matter, the exchange of written discovery has been completed. Further, the majority of depositions of witnesses have been completed. Factual discovery has been completed, with expert discovery to be exchanged by the end of August 2004. On June 15, 2004, District Court Judge Pauley determined that both parties could proceed with their respective summary judgment motions. All motion papers shall be finally submitted by September 20, 2004, with oral argument scheduled for October 15, 2004. In the interim, expert discovery shall be completed by the parties. A final pre-trial conference is scheduled for October 15, 2004. Because of the pending motion requests, the future expert discovery to be completed, and the uncertain outcome of the evidentiary hearing before the Bankruptcy Court, we are not able to predict the possible outcome of this matter, if any, on our financial condition.

*Avasta Earnout*

On October 14, 2003, we received a letter purportedly on behalf of the former stockholders of Avasta relating to the issuance of additional shares of common stock pursuant to the earnout calculations pursuant to the Agreement and Plan of Merger and Reorganization dated as of January 29, 2003 among Avasta Corp., Avasta, Inc. and NaviSite. On December 11, 2003, a demand for arbitration before JAMS (formerly known as Judicial Arbitration and Mediation Services) was filed claiming among other things breach of contract, tortious conduct, fraud and other wrongful conduct. Damages sought include in excess of 782,790 shares of NaviSite common stock. We believe the allegations are without merit and intend to vigorously defend against them. As the arbitration is in the initial discovery stage, we are not able to predict the possible outcome of this matter and the effect, if any, on our financial condition.

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**NAVISITE, INC. AND SUBSIDIARIES**

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

*La Jolla Landlord*

On November 24, 2003, U.S. Property Fund GmbH & Co, the landlord for space leased by NaviSite in La Jolla, California, filed a breach of lease action against NaviSite. The landlord claims damages in excess of \$2.0 million. On February 23, 2004, the landlord agreed to stay the litigation in exchange for NaviSite agreeing to make future rent payments in a timely manner and replenishing the letter of credit within 12 months.

**11. Stockholders Equity**

On December 12, 2002, CBT cancelled warrants to purchase 346,883 shares of our common stock at exercise prices ranging from \$86.55 to \$103.80 per share.

We have accounted for the 567,978 shares, issued to CBT on December 31, 2002 in connection with the acquisition of CBTM, as a dividend distribution to CBT because CBT and its affiliates were considered to have controlling interest over both CBTM and NaviSite. As a result, we reported an increase to accumulated deficit of \$1,277,950, which represents the number of common shares issued at the then current market value of \$2.25 per share.

On February 5, 2003, we issued 231,039 shares of our common stock at a per share value of \$1.60 in connection with the acquisition of Avasta (see Note 6). In September 2003, we issued 179,353 shares of our common stock at a per share value of \$4.14 (representing the market value of our common stock the day preceding the issuance of the addition shares) for the attainment of certain revenue targets in conjunction with the Avasta acquisition.

On August 8, 2003, we issued 1,100,000 shares of our common stock to CBT at a per share value of \$2.55 in connection with the acquisition of certain assets of CBT (see Note 6). The issuance of these shares has been accounted for as a dividend distribution because Atlantic Investors, LLC and its affiliates are considered to have controlling interest in both CBT and NaviSite. As a result, we reported a reduction of retained earnings of \$2,805,000, which represents the number of common shares issued at the then current market value of \$2.55 per share.

In connection with our Silicon Valley Bank financing arrangement, on May 27, 2003 we issued SVB a warrant to purchase up to 165,000 shares of NaviSite common stock with an exercise price of \$2.50 per share. We fair valued the warrant at \$370,000 using the Black-Scholes option-pricing model. Pursuant to the terms of the warrant, on May 19, 2004, SVB fully exercised its warrant, which resulted in a net issuance of 73,738 shares. On January 30, 2004, in connection with a loan modification agreement with SVB, we issued a warrant to SVB for the purchase of 50,000 shares of common stock at an exercise price of \$5.75 per share. We fair valued the warrant at \$213,426 using the Black-Scholes option-pricing model. The warrant is exercisable at any time on or after September 1, 2004. The value of both warrants is being amortized into interest expense over the term of the financing agreement. (See Note 9)

During 2003, we had an insufficient number of stock options remaining within our existing shareholder approved stock option plans for grants to our independent Board of Directors and members of management. At our 2003 annual meeting of stockholders, held on December 9, 2003, our stockholders approved our Amended and Restated 2003 Stock Incentive Plan and we granted stock options to members of our independent Board of Directors and certain members of management at that time. These stock options were granted to the independent members of our Board of Directors and management at strike prices similar to the period that the stock options would have been granted had sufficient shareholder approved stock options been available for grant at that time. Because the strike price of these stock options represented a discount from the market value of our stock on the date of grant, we recorded approximately \$2.0 million of deferred compensation expense, which will be amortized into compensation expense over the vesting period of the stock options. During the three and nine months ended April 30, 2004, the

**Table of Contents****NAVISITE, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Company reported compensation expense of approximately \$69,000 and \$287,000, respectively, for options, which had vested during that period. The remaining unamortized compensation charge of \$1.7 million is recorded as deferred compensation, which is a component of stockholders' equity.

**12. Related Party Transactions**

For the period August 1, 2002 through September 11, 2002, we classified revenue from CMGI and CMGI affiliates as revenue from related parties. For all periods subsequent to September 12, 2002, we classified revenue from CMGI and CMGI affiliates as third-party revenue.

The consolidated financial statements for the three and nine-month period ended April 30, 2003 include certain allocations from CMGI for certain general and administrative expenses, such as rent, legal services, insurance, and employee benefits. Allocations are based primarily on headcount. Management believes that the method used to allocate the costs and expenses is reasonable; however, such allocated amounts may or may not necessarily be indicative of what actual expenses would have been incurred had we operated independently of CMGI. As a result of CMGI's sale of its debt and equity interests in us to CBT, the agreement between NaviSite and CMGI whereby CMGI provided certain services to us automatically terminated. CMGI continued to provide certain services to us pursuant to a Transition Services Agreement we entered into with CMGI on November 25, 2002, as we transitioned to service offerings from CBT and other third-party suppliers. This transition agreement concluded during the second quarter of fiscal year 2003 and we have completely severed our administrative ties with CMGI; however, CMGI remains a third-party customer. During the second quarter of fiscal year 2003, we contracted with CBT and other third-party suppliers for these services. We currently rent administrative facilities from CMGI at 800 Federal Street, Andover, Massachusetts.

On December 31, 2002, CBTM was required to pay a \$6.1 million liability owed to the AppliedTheory Estate as a result of CBTM's acquisition of AppliedTheory. In order to fund the \$6.1 million payment, CBTM entered into a \$6.0 million line of credit with Unicorn Worldwide Holding Limited (Unicorn), a related party to NaviSite and CBTM. CBTM drew down \$4.6 million and together with cash on hand at December 31, 2002, paid the \$6.1 million liability due to the AppliedTheory Estate. In January 2003, CBTM paid \$2.6 million of the \$4.6 million due to Unicorn, leaving a liability to Unicorn of \$2.0 million at January 31, 2003. In January 2003, we entered into a Loan and Security Agreement with Atlantic and in February 2003, drew down on this facility to pay off the remaining \$2.0 million due Unicorn by CBTM.

On January 29, 2003, we entered into a \$10 million Loan and Security Agreement (Atlantic Loan) with Atlantic, a related party. The Atlantic Loan bears an interest rate of 8% per annum. Interest is payable upon demand or, at Atlantic's option, interest may be added to the outstanding balance due to Atlantic by NaviSite. Atlantic may make demand for payment of amounts in excess of the minimum Atlantic Loan amount of \$2.0 million (Minimum Loan Amount), with 60 days notice. Atlantic can demand payment of the Minimum Loan Amount with 90 days notice. Under the Atlantic Loan agreement, we can require Atlantic to loan us (1) up to \$2.0 million to repay an amount due from CBTM to Unicorn, a related party to NaviSite and Atlantic; (2) \$1.0 million for costs associated with our acquisition of Avasta; and (3) up to \$500,000 for the post-acquisition working capital needs of Avasta. Atlantic, at its sole and absolute discretion, may advance other amounts to us such that the aggregate amount borrowed by NaviSite does not exceed the maximum loan amount, defined as the lesser of \$10.0 million or 65% of our consolidated accounts receivables. At April 30, 2004 and July 31, 2003, we had \$3.0 million outstanding under the Atlantic Loan and had approximately \$500,000 available to us. This amount is shown as a current note payable to related party on our Consolidated Balance Sheet. The Atlantic Loan is secured by all of our receivables. On May 30, 2003 we repaid \$2.0 million of the approximate \$3.0 million outstanding under the Atlantic Loan and on June 11, 2003, we borrowed

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**NAVISITE, INC. AND SUBSIDIARIES**

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

\$2.0 million under the Atlantic Loan (see Note 9). On January 16, 2004, the Atlantic Loan was amended to extend any and all Credit Advances under the Atlantic Loan made prior to, or following January 16, 2004 to be due on or before the earlier of (i) August 1, 2004 or (ii) five (5) business days following the closing of a financing transaction or disposition pursuant to which the Borrower receives gross proceeds of \$13 million.

*ClearBlue Technologies (UK) Limited Outsourcing Agreement*

Beginning April 1, 2004, we entered into an Outsourcing Agreement with ClearBlue Technologies (UK) Limited ( ClearBlue ) whereby, the Company will provide certain management services as well as manage the day-to-day operations as required by ClearBlue s customers contracts. The Company charges ClearBlue a monthly fee of £4,700, plus 20% of gross profit (gross profit is revenue collected from ClearBlue customers, less the monthly fee), but in the event such calculation is less than \$0, 100% of the gross profit shall remain with ClearBlue. During the three months ended April 30, 2004, the Company charged ClearBlue approximately \$12,000 under this agreement. This amount is included in Due from related party on the consolidated balance sheet at April 30, 2004 and in Revenue, related parties in the Consolidated Statements of Operations.

**13. Subsequent Event**

*Surebridge Acquisition.*

On June 10, 2004, we completed the acquisition of substantially all of the assets and liabilities of Surebridge, Inc. ( Surebridge ), a privately held provider of managed application services for mid-market companies, pursuant to the terms of an asset purchase agreement (as amended, the Asset Purchase Agreement ). Under the terms of the Asset Purchase Agreement, we acquired substantially all of the assets of Surebridge in exchange for two promissory notes in the aggregate principal amount of approximately \$39.3 million, three million shares of NaviSite common stock (the Fixed Shares ) and the assumption of certain liabilities of Surebridge at closing.

The promissory notes issued by the Company to Surebridge consist of a Primary Note and an Escrow Note (collectively, the Notes ). The Primary Note is in the principal amount of approximately \$32.5 million. The Escrow Note is in the principal amount of approximately \$6.8 million and has been deposited into escrow for the purpose of satisfying indemnification claims by the Company pursuant to the Asset Purchase Agreement. The Notes accrue interest on the unpaid balance at an annual rate of 10%, however no interest shall accrue on any principal paid within nine months of the closing. The Notes shall be paid in full no later than the second anniversary of the closing. In the event that we realize net proceeds in excess of \$1 million from certain equity or debt financings or sales of assets, we are obligated to use a significant portion of the proceeds to make payments on the Notes.

The outstanding principal and accrued interest of the Notes shall be convertible into the Conversion Shares at the election of the holder (i) at any time following the first anniversary of the closing if the aggregate principal outstanding under the Notes at such time is greater than or equal to \$20 million, (ii) at any time following the 18-month anniversary of the closing if the aggregate principal outstanding under the Notes at such time is greater than or equal to \$10 million, (iii) at any time following the second anniversary of the closing, and (iv) at any time following an event of default thereunder. The conversion price of each of the Notes is \$4.642, which is the average closing price of NaviSite s common stock for the ten-day period ending one day prior to closing.

For a period of one year following the closing of the acquisition, Surebridge shall not sell, transfer, assign, convey, encumber, gift, distribute or otherwise dispose of the Fixed Shares, the Conversion Shares or the Notes; provided, however, if NaviSite does not make certain payments under the Notes or otherwise

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**NAVISITE, INC. AND SUBSIDIARIES**

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

suffers an event of default thereunder, Surebridge may sell the Fixed Shares and the Conversion Shares at any time thereafter. The Fixed Shares and the Conversion Shares shall have certain demand and piggyback registration rights pursuant to a Registration Rights Agreement entered into by and between the Company and Surebridge.

*Amendment to Amended and Restated 2003 Stock Incentive Plan*

On May 6, 2004, our Board of Directors approved, subject to stockholder approval, an amendment to our Amended and Restated 2003 Stock Incentive Plan to increase the maximum number of shares of Common Stock pursuant to which we may grant stock options and restricted stock awards thereunder from 3,800,000 to 6,800,000. Also on May 6, 2004, Atlantic Investors, LLC, our majority stockholder, delivered to us an executed written consent approving the amendment to our Amended and Restated 2003 Stock Incentive Plan. Under federal securities laws governing the taking of stockholder action by written consent, such approval will be deemed effective 20 days after the mailing of an Information Statement to stockholders of NaviSite.

Since May 6, 2004, and subject to effective stockholder approval of the amendment to our Amended and Restated 2003 Stock Incentive Plan, we have granted an aggregate of 1,516,000 options to purchase shares of Common Stock under the plan, as amended.

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**NAVISITE, INC. AND SUBSIDIARIES**

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

**INDEPENDENT AUDITORS REPORT**

The Board of Directors  
NaviSite, Inc.

We have audited the accompanying consolidated balance sheet of Surebridge, Inc. and subsidiaries (the Company) as of December 31, 2003, and the related consolidated statements of operations, stockholders' deficit, and cash flows for the year then ended. 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 audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. 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 audit provides 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 Surebridge, Inc. and subsidiaries as of December 31, 2003, and the results of their operations and their cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 1, it was announced on May 6, 2004 that the Company had signed a definitive asset purchase agreement pursuant to which substantially all of the assets of the Company would be acquired by NaviSite, Inc. for two promissory notes in the aggregate principal amount of approximately \$39.3 million, three million shares of NaviSite common stock and the assumption of certain liabilities of the Company at closing. This transaction was consummated on June 10, 2004. These consolidated financial statements do not reflect the impact of this transaction.

/s/ KPMG LLP

Providence, Rhode Island

June 10, 2004

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**Table of Contents****SUREBRIDGE, INC. AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS****March 31, 2004 (Unaudited) and December 31, 2003**

	<b>March 31, 2004</b>	<b>December 31, 2003</b>
	<u>                    </u>	<u>                    </u>
	<b>(Unaudited)</b>	
<b>ASSETS (NOTE 8)</b>		
Current assets:		
Cash and cash equivalents	\$ 1,725,222	\$ 2,520,410
Accounts receivable, net of allowance for doubtful accounts of \$210,454 at March 31, 2004 and \$224,837 at December 31, 2003	4,564,021	4,340,217
Costs and estimated earnings in excess of billings	970,941	279,116
Due from related party	42,770	87,076
Deferred tax asset	70,448	70,448
Prepaid expenses and other current assets	419,262	335,850
	<u>                    </u>	<u>                    </u>
Total current assets	7,792,664	7,633,117
Restricted cash	475,122	520,122
Property and equipment, net	7,782,227	8,302,041
Goodwill	6,326,955	6,290,573
Other intangible assets, net	4,319,175	4,638,185
Other long-term assets	161,923	189,638
	<u>                    </u>	<u>                    </u>
Total assets	\$ 26,858,066	\$ 27,573,676
	<u>                    </u>	<u>                    </u>
<b>LIABILITIES, REDEEMABLE CONVERTIBLE PREFERRED STOCK AND STOCKHOLDERS DEFICIT</b>		
Current liabilities:		
Accounts payable	\$ 4,777,734	\$ 4,440,302
Accrued expenses and other current liabilities	1,943,324	3,006,547
Deferred revenue	936,355	947,634
Customer deposits	249,912	163,370
Current portion of long-term debt	3,617,960	2,575,539
Current portion of obligations under capital lease	138,934	308,596
	<u>                    </u>	<u>                    </u>
Total current liabilities	11,664,219	11,441,988
Deferred tax liability	70,448	70,448
Obligations under capital lease	24,152	5,000
Long-term debt	1,019,426	1,560,659
	<u>                    </u>	<u>                    </u>
Total liabilities	12,778,245	13,078,095
Commitments and contingencies (Note 7)		
Redeemable convertible preferred stock, \$0.01 par value; 45,801,302 shares authorized, 37,061,321 shares issued and outstanding at March 31, 2004; and 45,801,302 shares authorized, 37,061,321 shares issued and outstanding at December 31, 2003	62,144,214	61,705,252
Stockholders' deficit:		
Common stock, \$0.01 par value; 75,000,000 shares authorized, 10,861,056 shares issued, and 9,977,444 shares outstanding at March 31, 2004; 75,000,000 shares authorized, 10,855,206 shares issued, and 9,971,594 shares outstanding at December 31, 2003	108,611	108,553

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Additional paid-in capital	9,486,602	9,922,697
Accumulated deficit	(57,194,508)	(56,775,823)
Treasury stock, at cost, 883,612 shares	(465,098)	(465,098)
	<u>                    </u>	<u>                    </u>
Total stockholders' deficit	(48,064,393)	(47,209,671)
	<u>                    </u>	<u>                    </u>
Total liabilities, redeemable convertible preferred stock and stockholders' deficit	\$ 26,858,066	\$ 27,573,676
	<u>                    </u>	<u>                    </u>

See accompanying notes to the consolidated financial statements

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**Table of Contents****SUREBRIDGE, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF OPERATIONS**

**For the Three Months Ended March 31, 2004 and 2003 (Unaudited)  
and for the Year Ended December 31, 2003**

	Three Months Ended March 31,		Year Ended December 31,
	2004	2003	2003
	(Unaudited)		
Revenue:			
Revenue	\$ 11,712,790	\$ 9,528,068	\$ 41,673,247
Revenue, related parties	226,716	310,709	1,078,278
Total revenue	11,939,506	9,838,777	42,751,525
Cost of revenue	7,776,818	6,709,620	29,632,382
Gross profit	4,162,688	3,129,157	13,119,143
Operating expenses:			
Sales and marketing	1,960,544	1,682,684	8,499,369
General and administrative	2,533,866	2,406,989	11,114,461
Total operating expenses	4,494,410	4,089,673	19,613,830
Loss from operations	(331,722)	(960,516)	(6,494,687)
Other income (expense):			
Interest income	2,186	42,070	64,534
Interest expense	(89,149)	(52,177)	(297,293)
Other expenses, net	(86,963)	(10,107)	(232,759)
Net loss	\$ (418,685)	\$ (970,623)	\$ (6,727,446)
Accrued dividends on preferred stock (including accretion to redemption value of \$412,338, \$223,392 and \$1,636,214 for the three months ended March 31, 2004 and 2003, and for the year ended December 31, 2003, respectively)	(438,962)	(225,684)	(1,734,172)
Net loss to common stockholders	\$ (857,647)	\$ (1,196,307)	\$ (8,461,618)

See accompanying notes to the consolidated financial statements

**Table of Contents****SUREBRIDGE, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF STOCKHOLDERS DEFICIT****Three Months Ended March 31, 2004 (Unaudited) and Year Ended December 31, 2003**

	Common Stock		Additional Paid-in Capital	Accumulated Deficit	Deferred Comp- ensation	Treasury Stock		Total Stockholders Deficit
	Shares Issued	Par Value				Shares in Treasury	Amount	
Balance, December 31, 2002	10,842,164	\$ 108,422	\$ 11,650,476	\$(50,048,377)	\$(5,603)	883,612	\$(465,098)	\$(38,760,180)
Issuance of common stock pursuant to the exercise of stock options	13,042	131	6,393					6,524
Accretion of dividend on Series A preferred stock			(97,958)					(97,958)
Accretion of Series E preferred stock to redemption value			(459,554)					(459,554)
Accretion of Series C preferred stock to redemption value			(1,176,660)					(1,176,660)
Amortization of deferred compensation					5,603			5,603
Net loss				(6,727,446)				(6,727,446)
Balance, December 31, 2003	10,855,206	108,553	9,922,697	\$(56,775,823)		883,612	(465,098)	(47,209,671)
Issuance of common stock pursuant to the exercise of stock options (unaudited)	5,850	58	2,867					2,925
Accretion of dividend on Series A preferred stock (unaudited)			(26,624)					(26,624)
Accretion of Series E preferred stock to redemption value (unaudited)			(118,173)					(118,173)
Accretion of Series C preferred stock to redemption value (unaudited)			(294,165)					(294,165)
				(418,685)				(418,685)

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Net loss  
(unaudited)

Balance, March 31, 2004 (unaudited)	10,861,056	\$108,611	\$ 9,486,602	\$(57,194,508)	\$	883,612	\$(465,098)	\$(48,064,393)
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See accompanying notes to the consolidated financial statements

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**Table of Contents****SUREBRIDGE, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS**

**For the Three Months Ended March 31, 2004 and 2003 (Unaudited)  
and for the Year Ended December 31, 2003**

	Three Months Ended March 31,		Year Ended December 31,
	2004	2003	2003
(Unaudited)			
Cash flows from operating activities:			
Net loss	\$ (418,685)	\$ (970,623)	\$ (6,727,446)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation and amortization	1,332,397	1,227,781	6,055,588
Stock-based compensation		5,603	5,603
Provision for losses on accounts receivable	(14,383)		(169,504)
Issuance of preferred stock to settle compensation from earn-out arrangement, net of issuance costs		249,874	533,171
Changes in assets and liabilities, net of effects of acquisition:			
(Increase) decrease in assets:			
Accounts receivable	(165,115)	400,122	171,732
Costs and estimated earnings in excess of billings	(691,825)	(208,181)	42,502
Prepaid expenses and other current assets	(83,412)	136,154	380,169
Increase (decrease) in liabilities:			
Accounts payable	337,432	(989,055)	1,545,923
Accrued expenses and other current liabilities	(1,019,570)	(147,451)	(2,413,434)
Deferred revenue and customer deposits	(4,772)	(841,807)	(396,967)
Net cash used in operating activities	(727,933)	(1,137,583)	(972,663)
Cash flows from investing activities:			
Purchase of property and equipment	(493,573)	(551,368)	(3,943,926)
Decrease (increase) in other long-term assets	27,715	775,655	864,405
Cash expended in acquisition, net of cash acquired		(111,893)	(111,893)
Net cash (used in) provided by investing activities	(465,858)	112,394	(3,191,414)
Cash flows from financing activities:			
Decrease (increase) in restricted cash	45,000	(298,234)	109,878
Proceeds from exercise of stock options	2,925		6,524
Proceeds from long-term debt	1,247,752	97,688	2,867,373
Principal payments on long-term debt	(746,564)	(490,900)	(2,278,068)
Principal payments on capital lease obligations	(150,510)	(287,129)	(1,092,990)
Net cash provided by (used in) financing activities	398,603	(978,575)	(387,283)
Net (decrease) increase in cash and cash equivalents	(795,188)	(2,003,764)	(4,551,360)
Cash and cash equivalents, beginning of period	2,520,410	7,071,770	7,071,770
Cash and cash equivalents, end of period	\$ 1,725,222	\$ 5,068,006	\$ 2,520,410
Supplemental disclosure of cash flow information:			
Cash paid during the year for:			
Interest	\$ 89,149	\$ 52,177	\$ 297,293

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### Noncash investing and financing activities:

Acquisition of equipment under capital leases	\$	\$	\$ 1,141,851
Net assets acquired in the acquisition		4,224,074	4,224,074
Preferred stock accretion	438,962	225,684	1,734,172

See accompanying notes to the consolidated financial statements

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**SUREBRIDGE, INC. AND SUBSIDIARIES**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

**(1) Organization, Acquisition and Basis of Presentation**

Surebridge, Inc. (the Company), formerly known as Panoptic Business Networks, Inc., was incorporated in the State of Delaware to leverage the Internet to meet the needs of middle market companies seeking advanced business applications. The Company provides packaged application selection, implementation, application management and hosting, and continuous business improvement services.

On May 6, 2004, it was announced that the Company had signed a definitive asset purchase agreement pursuant to which substantially all of the assets of the Company would be acquired by NaviSite, Inc. (NaviSite) for two promissory notes in the aggregate principal amount of approximately \$39.3 million, three million shares of NaviSite common stock and the assumption of certain liabilities of Company at closing. This transaction was consummated on June 10, 2004. These consolidated financial statements do not reflect the impact of this transaction.

The consolidated financial statements and notes thereto as of March 31, 2004 and for the three months ended March 31, 2004 and 2003 and the related notes are unaudited; however, in the opinion of management, all adjustments (consisting of normal recurring adjustments necessary for a fair presentation of the financial statements for the interim period) have been included. Results of operations for the interim periods presented are not necessarily indicative of the results that may be expected for a full fiscal year or any future period.

**(2) Summary of Significant Accounting Policies**

**(a) Basis of Consolidation**

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries, Surebridge Services, Inc. (formerly known as Panoptic Technology Services, Inc.) and Surebridge Acquisition Corp. which was formed to consummate the acquisition of ManagedOps.com, Inc. in March 2003 as discussed in Note 3. All intercompany accounts and transactions have been eliminated.

**(b) Use of Estimates**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**(c) Cash and Cash Equivalents and Restricted Cash**

Cash and cash equivalents consist of cash and highly liquid investments with original or remaining maturities of three months or less at the date of purchase and whose carrying amounts approximate market value due to the short maturity of the investments. Cash equivalents at March 31, 2004 and December 31, 2003 consist of money market instruments. The Company had restricted cash of approximately \$475,000 and \$520,000 as of March 31, 2004 and December 31, 2003, respectively, which related to security deposits on facility leases.

**(d) Financial Instruments and Concentration of Credit Risk**

Financial instruments that subject the Company to credit risk consist principally of cash and cash equivalents, accounts receivable and costs and estimated earnings in excess of billings. The Company places its cash in highly rated financial institutions. The Company periodically assesses the financial strength of its customers and, as a consequence, believes that its accounts receivable credit risk exposure is limited. The Company does not require collateral and establishes reserves for doubtful accounts as



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**SUREBRIDGE, INC. AND SUBSIDIARIES**

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

warranted. Bad debts are provided on the allowance method based on historical experience and management evaluation of outstanding accounts receivable. There were no single customers that accounted for over 10% of total accounts receivable or revenue as of and for the year ended December 31, 2003.

**(e) Property and Equipment**

Property and equipment are stated at cost less accumulated depreciation. Repair and maintenance costs are charged to operations when incurred, while additions and betterments are capitalized. Depreciation is computed using the straight-line method over the estimated useful lives of the assets which range from 1 to 7 years. Leasehold improvements are depreciated over the shorter of the estimated useful life of the asset or the lease term. Property and equipment under capital leases are stated at the lower of the present value of the minimum lease payments at the beginning of the lease term or the fair value at the inception of the lease. Amortization expense is recorded over the life of the related asset or lease term, if shorter. Upon retirement or sale, the cost of the assets disposed of and the related accumulated depreciation are removed from the accounts and any resulting gain or loss is included in the determination of net income or loss from operations.

**(f) Impairment of Long-Lived Assets**

The Company assesses the need to record impairment losses on long-lived assets used in operations when indicators of impairment are present. Although the assumptions may vary in these assessments, they generally include revenue growth, operating results, cash flows, and other indicators of value. Management then determines whether there has been a permanent impairment of the value of long-lived assets by comparing future undiscounted cash flows to the asset's carrying value. If the estimated future undiscounted cash flows are less than the carrying value of the asset, a loss is recorded based on the excess of the asset's carrying value over fair value.

**(g) Goodwill and Other Intangible Assets**

Goodwill represents the excess of the purchase price over the fair value of net tangible and identifiable intangible assets the Company has acquired and has accounted for under the purchase method in accordance with Statement of Financial Accounting Standards No. 141 ( SFAS No. 141 ), Business Combinations. The Company adopted the provisions of Statement of Financial Accounting Standards No. 142 ( SFAS No. 142 ), Goodwill and Other Intangible Assets, on January 1, 2002. Accordingly, the Company ceased the ratable amortization of goodwill on that date. SFAS No. 142 also requires the Company to perform an annual impairment test of its goodwill. The Company performs its annual impairment test of goodwill in the fourth quarter of its calendar year.

Other intangible assets consist primarily of customer base and covenants not to compete. Such assets are being amortized on a straight-line basis over periods ranging from one to seven years.

**(h) Revenue Recognition**

The Company derives its revenue primarily from information technology consulting, software implementation services and application management and hosting services. The Company also derives revenue from the sale of software and related maintenance contracts. Reimbursable expenses charged to clients are included in revenue and costs of revenue.

*Information Technology Consulting and Software Implementation Services*

The Company enters into two types of contracts for information technology and software implementation services. Revenue from time and materials contracts is recognized as services are



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**SUREBRIDGE, INC. AND SUBSIDIARIES**

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

performed. The Company recognizes revenue on fixed price contracts on an efforts expended method when it can demonstrate the ability to perform under the contract. Under this method revenue is recognized based on the ratio of labor hours expended compared with the total estimated hours to complete the contract.

When current contract estimates indicate that a loss is probable, provision is made for the total anticipated loss in the current period. Contract losses are determined to be the amount by which the estimated service costs of the contract exceed the estimated revenues that will be generated by the contract. Unbilled revenues represent revenues for services performed that have not been billed. Billings in excess of revenue recognized are recorded as deferred revenue until the applicable revenue recognition criteria are met.

Amounts received or billed in advance of the services being provided are recorded as deferred revenue. Cost and estimated earnings in excess of billings represent amounts recognized based on services performed in advance of billings, in accordance with the contract term.

*Application Management and Hosting Services*

Application management and hosting fees are for the management of application software and for access to the Company's data center and technical infrastructure. These fees are recognized ratably over the contract term. Set-up fees related to application management and hosting services are recognized ratably over the expected customer relationship period.

*Software Revenue*

The Company primarily sells or licenses software in combination with software implementation services. Revenue from the sale of software is recognized when the software is delivered to the customer. In instances where the Company also provides application management and hosting services, software revenue is recognized ratably over the expected customer relationship period.

*Maintenance Contracts*

The Company sells maintenance contracts on behalf of third-party software vendors. The Company is not a party to the maintenance contracts and therefore has no continuing obligations under the contracts. Revenue from these contracts is recognized on a net basis, when the Company's customers enter into the contracts. In addition, the Company sells phone support for software. Phone support contracts typically have one-year terms, and customers are required to prepay the contract amount, which is recorded as deferred revenue and recognized ratably over the contract term.

**(i) Income Taxes**

The Company uses the asset and liability method of accounting for income taxes. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to the differences between the financial statement and tax bases of assets and liabilities and operating loss and tax credit carryforwards using enacted tax rates expected to apply to the year in which the differences are expected to affect taxable income. The effect on deferred tax assets and liabilities of a change in tax rate is recognized in operations in the period that includes the enactment date. Valuation allowances are established when necessary to reduce deferred tax assets to the amounts expected to be recovered.

**(j) Stock-Based Compensation**

The Company accounts for stock-based compensation granted to employees and directors using the intrinsic value method prescribed in Accounting Principles Board Opinion No. 25 ( APB No. 25 ),

**Table of Contents****SUREBRIDGE, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Accounting for Stock Issued to Employees, and related interpretations. Statement of Financial Accounting Standards No. 123 ( SFAS No. 123 ), Accounting for Stock-Based Compensation, and Statement of Financial Accounting Standards No. 148 ( SFAS No. 148 ), Accounting for Stock-Based Compensation Transition and Disclosure, require that companies either recognize compensation expense for grants of stock, stock options, and other equity instruments based on fair value, or provide pro forma disclosures of net income (loss) in the notes to the consolidated financial statements. Accordingly, compensation cost for stock options granted to employees and directors is measured as the excess, if any, of the fair value of the Company's stock at the date of the grant over the amount that must be paid to acquire the stock. All stock-based awards to nonemployees are accounted for at their fair value in accordance with SFAS No. 123, SFAS No. 148, and related interpretations. For all stock-based awards to employees and directors, the Company has elected the pro forma disclosure provisions of SFAS No. 123 and SFAS No. 148.

For purposes of pro forma disclosure, the fair value of each employee option grant was estimated on the date of grant using the minimum value method with the following assumptions for grants in 2003:

Expected life	5 years
Dividend yield	None
Volatility	0%
Weighted average risk-free interest rate	3.22%

The weighted-average fair value of stock options granted by the Company during 2003 was zero.

The following table illustrates the effect on net loss if the Company had applied the fair value recognition provisions of SFAS No. 123 and SFAS No. 148 to stock-based employee compensation:

	<b>Three Months Ended March 31, 2004</b>	<b>Year Ended December 31, 2003</b>
Net loss, as reported	\$(418,685)	\$(6,727,446)
Add (deduct): Stock-based employee compensation included in net loss, net of related taxes		5,603
Add (deduct): Total stock-based employee compensation expense determined under the fair value based method for all awards, net of related tax effects	(11,500)	(174,795)
Pro forma net loss	<u>\$(430,185)</u>	<u>\$(6,896,638)</u>

**(k) Guarantees and Indemnification Obligations**

In November 2002, the FASB issued FIN No. 45, Guarantor's Accounting and Disclosure Requirements for Guarantees Including Indirect Guarantee of Indebtedness of Others, an interpretation of FASB Statements No. 5, 57 and 107 and rescission of FASB Interpretation No. 34. The interpretation requires that a guarantor recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken by issuing the guarantee. The interpretation also requires additional disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under certain guarantees it has issued. The accounting requirements for the initial recognition of guarantees are applicable on a prospective basis for guarantees issued or modified after December 31, 2002. The disclosure requirements are effective for all guarantees outstanding, regardless of when they were issued or modified, during the first quarter of fiscal 2003. The adoption of FIN No. 45 did not have a material effect on the Company's consolidated financial statements. The following is a summary of agreements that the Company has determined are within the scope of FIN No. 45.



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**SUREBRIDGE, INC. AND SUBSIDIARIES**

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

As permitted by Delaware law, the Company has agreements whereby it indemnifies its officers and directors for certain events or occurrences while the officer or director is, or was serving, at the Company's request in such capacity. The term of the indemnification period is for the officer's or director's lifetime. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited; however, the Company has a Directors and Officers insurance policy that limits its exposure and enables the Company to recover a portion of any future amounts paid. As a result of the insurance policy coverage, the Company believes the estimated fair value of these indemnification agreements is minimal. All of these indemnification agreements were grandfathered under the provisions of FIN No. 45 as they were in effect prior to December 31, 2002. Accordingly, the Company has no liabilities recorded for these agreements as of December 31, 2003.

The Company enters into standard indemnification agreements in the ordinary course of business. Pursuant to these agreements, the Company indemnifies, holds harmless, and agrees to reimburse the indemnified party for losses suffered or incurred by the indemnified party, generally its business partners or customers, in connection with any U.S. patent, or copyright or other intellectual property infringement claim by any third party with respect to its products. The term of these indemnification agreements is generally perpetual after execution of the agreement. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited. The Company has never incurred costs to defend lawsuits or settle claims related to these indemnification agreements. As a result, the Company believes the estimated fair value of these agreements is minimal. Accordingly, the Company has no liabilities recorded for these agreements as of December 31, 2003.

The Company enters into arrangements with its business partners, whereby the business partner(s) agrees to sublicense the Company's services to its customers. The Company enters into standard indemnification agreements with those business partners, whereby it indemnifies them for its acts or omissions in providing the services that result in a claim against its business partner. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited; however, the Company has general and umbrella insurance policies that enable it to recover a portion of any amounts paid. The Company has never incurred costs to defend lawsuits or settle claims related to these indemnification agreements. As a result, the Company believes the estimated fair value of these agreements is minimal. Accordingly, the Company has no liabilities recorded for these agreements as of December 31, 2003.

When as part of an acquisition the Company acquires all of the stock or all of the assets and liabilities of a company, it assumes the liability for certain events or occurrences that took place prior to the date of acquisition. All of these obligations were grandfathered under the provisions of FIN No. 45 as they were in effect prior to December 31, 2002. However, as a result of the Company's acquisition of ManagedOps.com, Inc. on March 5, 2003 (see Note 3), the Company granted a \$500,000 maximum guarantee related to a mortgage loan on a facility that the Company now leases and that the principals of ManagedOps.com, Inc. had personally guaranteed. Due to the fact that the Company has the option to purchase the number of its own preferred shares at nominal value in exchange for the aggregate amount it contingently may need to pay under the guarantee, the net present value of the probable weighted future cash flows to the Company is zero. Accordingly, the Company has no liabilities recorded for these guarantees as of December 31, 2003.

**(I) Recent Accounting Pronouncements**

In June 2002, the FASB issued Statement of Financial Accounting Standards No. 146 (SFAS No. 146), Accounting for Costs Associated with Exit or Disposal Activities. SFAS No. 146 addresses financial accounting and reporting for costs associated with exit or disposal activities and nullifies Emerging Issues Task Force Issue No. 94-3, Liability Recognition for Certain Employee Termination

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**SUREBRIDGE, INC. AND SUBSIDIARIES**

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

Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring). SFAS No. 146 requires that a liability be recognized when it is incurred and should initially be measured and recorded at fair value. This statement is effective for exit or disposal activities that are initiated after December 31, 2002. The adoption of SFAS No. 146 did not materially affect the consolidated financial statements.

In November 2002, the FASB issued Interpretation No. 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness to Others, an interpretation of FASB Statements No. 5, 57, and 107 and a rescission of FASB Interpretation No. 34. This Interpretation elaborates on the disclosure to be made by a guarantor in its interim and annual financial statements about its obligations under guarantees issued. The Interpretation also clarifies that a guarantor is required to recognize, at inception of a guarantee, a liability for the fair value of obligation undertaken. The disclosure requirements are effective for financial statements of interim or annual periods ending after December 15, 2002. The initial recognition and measurement provisions of the Interpretation are applicable to guarantees issued or modified after December 31, 2002. See Note 2 (k) for Company disclosures related to this pronouncement.

In November 2002, the Emerging Issues Task Force (EITF) of the FASB issued a consensus on issue No. 00-21, Accounting for Revenue Arrangements with Multiple Deliverables. EITF No. 00-21 addresses certain aspects of the accounting by a vendor for arrangements under which it will perform multiple revenue generating activities. EITF No. 00-21 establishes three principles: revenue should be recognized only when the arrangement consideration is reliably measurable, the earnings process is substantially complete, and consideration should be allocated among the separate units of accounting in an arrangement based on their fair values. EITF No. 00-21 is effective for all revenue arrangements entered into in fiscal periods beginning after June 15, 2003, with early adoption permitted. The adoption of this pronouncement did not have a material impact on the Company's consolidated financial statements.

In December 2002, the FASB issued Statement of Financial Accounting Standards No. 148 (SFAS No. 148), Accounting for Stock-Based Compensation Transition and Disclosure which is effective for financial statements for fiscal years ending after December 15, 2002, with early adoption permitted. SFAS No. 148 enables companies that choose to adopt the preferable fair value method to report the full effect of employee stock options in their financial statements immediately upon adoption. The Company will continue to apply the disclosure only provisions of both SFAS No. 123 and SFAS No. 148.

In January 2003, the FASB issued FIN No. 46, Consolidation of Variable Interest Entities and, in December 2003, issued a revision to that interpretation. FIN No. 46R replaces FIN No. 46 and addresses consolidation by business enterprises of variable interest entities that possess certain characteristics. A variable interest entity (VIE) is defined as (a) an ownership, contractual or monetary interest in an entity where the ability to influence financial decisions is not proportional to the investment interest, or (b) an entity lacking the invested capital sufficient to fund future activities without a third party. FIN No. 46R establishes standards for determining under what circumstances VIEs should be consolidated with their primary beneficiary, including those to which the usual conditions for consolidation do not apply. The Company will adopt FIN No. 46 and FIN No. 46R as of January 1, 2005. The Company does not expect a material effect from adoption of FIN No. 46 or FIN No. 46R. In May 2003, the FASB issued Statement of Financial Accounting Standards No. 150 (SFAS No. 150), Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity. SFAS No. 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances). SFAS No. 150 is effective for financial instruments

**Table of Contents****SUREBRIDGE, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

entered into or modified after May 31, 2003. The adoption of SFAS 150 is not expected to have a material impact on the Company's financial position or results of operations.

**(3) Acquisitions****Transchannel, Inc.**

On October 27, 2002, the Company acquired all of the outstanding stock of Transchannel, Inc. (Transchannel), and merged Transchannel into the Company, with the Company continuing as the surviving corporation. Transchannel, a Georgia corporation, provided sales, deployment, and application support and management of Peoplesoft software throughout the United States. The Company acquired Transchannel to increase their overall market share and increase their application management and hosting customer base. The purchase consideration, aggregating \$7,272,825, consisted of \$1,400,000 in cash, 7,262,411 shares of the Company's Series E Preferred Stock (Series E) valued at \$0.58 per share, 1,815,603 shares of the Company's Series F Preferred Stock (Series F) valued at \$0.83 per share, 200,578 stock options to purchase the Company's common stock, valued at \$10,430 using the Black Scholes method, and acquisition costs of \$162,395. The fair value of the Series E and Series F was determined with the assistance of a valuation specialist. The results of operations of Transchannel are included in the operating results of the Company from the date of acquisition.

The acquisition was accounted for using the purchase method of accounting. Accordingly, the total purchase consideration was allocated to the assets acquired and the liabilities assumed based on their fair values at the date of acquisition. The fair value of the net assets acquired exceeded the purchase consideration by \$156,579, which was allocated as a pro-rata reduction of the fair values of the noncurrent assets that were acquired (property and equipment, and identifiable intangible assets). The total purchase consideration and the allocation to the acquired assets and assumed liabilities were as follows:

Purchase consideration:	
Cash paid	\$ 1,400,000
Fair value of company stock and stock options issued (excludes issuance costs of \$3,546)	5,710,430
Acquisition costs	162,395
	<hr/>
Total purchase consideration	\$ 7,272,825
	<hr/>
Allocation of purchase consideration:	
Cash acquired	\$ 2,039,130
Other current assets	1,143,706
Property and equipment	1,928,000
Identifiable intangible assets	3,746,621
Goodwill	<hr/>
Total assets acquired	8,857,457
Current liabilities assumed	(1,184,632)
Liability related to an acquisition contingency	(400,000)
	<hr/>
Net assets acquired	\$ 7,272,825
	<hr/>

Current assets acquired relate primarily to accounts receivable, and current liabilities assumed primarily relate to accounts payable and accrued expenses.

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The Company was required to restrict and escrow \$400,000 of cash on the date of the acquisition, which was to be paid to the former stockholders of Transchannel, after deducting the amount of acquired receivables that the Company was unable to collect within the 120 days immediately following the date of

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**Table of Contents****SUREBRIDGE, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

acquisition. The Company recorded the \$400,000 of contingent consideration as a liability as of December 31, 2002. The amount was paid in 2003.

The terms of the acquisition also included an additional payment to the former stockholders of Transchannel, if the former stockholders were able to meet certain performance goals during the six month period following the date of acquisition. The maximum earn-out was \$1.8 million payable in one third cash, one third preferred stock and one third common stock. In July 2003, the Company settled the earn-out consideration for 679,082 shares of Series E Preferred Stock and 169,995 shares of Series F Preferred Stock, with a fair value of \$533,171. Payment of the earn-out was contingent upon continued employment with the Company during the six-month earn-out period. The Company had accrued \$200,000 through general and administrative expense as of December 31, 2002 and recorded the remaining amount of the charge totaling \$333,171 in 2003.

The following are the identifiable intangible assets acquired and the respective periods over which the assets will be amortized on a straight-line basis:

	<b>Weighted Average Useful Life (Years)</b>	<b>Amount</b>
	<u>        </u>	<u>        </u>
Customer base	6	\$3,406,019
Noncompete agreements	2	262,750
Other intangibles	2	77,852
		<u>        </u>
		\$3,746,621
		<u>        </u>

**ManagedOps.com, Inc.**

On March 5, 2003, the Company acquired all of the shares of ManagedOps.com, Inc. ( ManagedOps ), a Delaware company with its principal place of business in New Hampshire. ManagedOps provided sales, deployment, implementation and application support of Microsoft Software throughout the United States. The consideration consisted of 6,039,909 shares of preferred stock (150,135 shares of Series A, 240,216 shares of Series B, 1,287,681 shares of Series C, 2,544,636 shares of Series D, 1,453,793 shares of Series E and 363,448 shares of Series F). The results of operations of ManagedOps are included in the operating results of the Company from the date of acquisition.

The shares issued to the seller as consideration are subject to a repurchase agreement by the Company. In the event that the Company needs to pay cash under certain personal guarantee agreements (see Note 2(k)) and certain bonus agreements, the Company has the right to repurchase the shares at par value. The number of shares subject to repurchase is determined by the fair value of the shares at the time of the repurchase. The fair value is based on the fair value of the Company taking into account the liquidation preferences. The aggregate value of the repurchased shares cannot exceed the cash consideration paid by the Company with respect to the aforementioned obligations.

ManagedOps had issued a warrant to a vendor to purchase 530,519 shares of its common shares at a price of \$0.37 per share. Pursuant to the terms of the warrant agreement, upon the acquisition of ManagedOps, the warrants became exercisable for shares of common stock of the Company.

The acquisition was accounted for using the purchase method of accounting. Accordingly, the total purchase consideration was allocated to the assets acquired and the liabilities assumed based on their fair



**Table of Contents****SUREBRIDGE, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

values at the date of acquisition. The total purchase consideration and the allocation to the acquired assets and assumed liabilities were as follows:

Purchase consideration:	
Fair value of company stock	\$ 6,305,679
Acquisition costs	136,622
Total purchase consideration	\$ 6,442,301
Allocation of purchase consideration:	
Cash acquired	\$ 24,729
Other current assets	1,523,668
Other assets	195,239
Property and equipment	3,650,100
Identifiable intangible assets	2,330,000
Goodwill	1,894,075
Total assets acquired	9,617,811
Current liabilities assumed	(2,954,729)
Long-term liabilities assumed	(220,781)
Net assets acquired	\$ 6,442,301

The following are the identifiable intangible assets acquired and the respective periods over which the assets will be amortized on a straight-line basis:

	Weighted Average Useful Life (Years)	Amount
	<u>          </u>	<u>          </u>
Customer base	5	\$ 1,820,000
Noncompete agreements	2	50,000
Other intangibles	5	460,000
		\$ 2,330,000

The following unaudited pro forma results of operations for the year ended December 31, 2003 give effect to the Company's acquisition of ManagedOps as if the transaction had occurred at the beginning of 2003. The pro forma information does not necessarily reflect the results of operations that would have occurred had the acquisitions taken place at the beginning of 2003 and is not necessarily indicative of results that may be obtained in the future.

Revenue	\$ 44,665,170
Net loss	(6,956,171)



**Table of Contents****SUREBRIDGE, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(4) Property and Equipment**

Property and equipment summarized by major category consisted of the following at:

	Estimated Useful Life (Years)	March 31, 2004	December 31, 2003
		(Unaudited)	
Computer equipment	2 to 5	\$ 14,050,083	\$ 13,742,555
Computer software	1 to 4	2,741,022	2,554,976
Furniture and fixtures	3 to 7	1,493,788	1,493,788
Leasehold improvements	3 to 7	785,776	785,776
		19,070,669	18,577,095
Less: accumulated depreciation		(11,288,442)	(10,275,054)
Property and equipment, net		\$ 7,782,227	\$ 8,302,041

The cost of equipment under capital lease and the related accumulated depreciation totaled approximately \$2.5 million and \$1.8 million, respectively, at March 31, 2004, and approximately \$2.5 million and \$1.7 million, respectively, at December 31, 2003. Depreciation expense was approximately \$1.0 million for the three months ended March 31, 2004 and approximately \$4.8 million for the year ended December 31, 2003.

**(5) Goodwill and Other Intangible Assets**

The Company acquired goodwill and other intangible assets through acquisitions in the years ended December 31, 2003, 2002, 2000 and 1999 (see Note 3). Under SFAS No. 142, the Company was required to complete a transitional impairment test on all goodwill effective as of January 1, 2002 on a reporting unit basis. A reporting unit is defined as an operating segment or one level below an operating segment referred to as a component. A component of an operating segment is a reporting unit if the component constitutes a business and discrete financial information is prepared and regularly reviewed by management. The Company determined that it operates in one reporting unit and, therefore, has completed the transitional goodwill impairment test on an enterprise-wide basis.

The fair value of the reporting unit was determined with the assistance of an independent valuation specialist as of January 1, 2002. As the fair value of the reporting unit as of January 1, 2002 was in excess of the carrying amount of the net assets, the Company concluded that its goodwill was not impaired, and no impairment charge was recorded. The Company performed its annual assessment for 2002 as of September 30, 2002 and its annual assessment of 2003 as of December 31, 2003, and the fair value of the reporting unit was determined to be in excess of the carrying amount of the net assets. Therefore, no further analysis was required under SFAS No. 142.

**Table of Contents****SUREBRIDGE, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Other intangible assets summarized by major category consisted of the following at:

	Estimated Useful Life (Years)	March 31, 2004	December 31, 2003
		(Unaudited)	
Acquired customer base	1 to 7	\$ 6,989,864	\$ 6,989,864
Noncompete agreements	1 to 2	585,925	585,925
Other intangibles	2 to 5	743,852	743,852
		8,319,641	8,319,641
Less: accumulated amortization		(4,000,466)	(3,681,456)
Other intangibles, net		\$ 4,319,175	\$ 4,638,185

Amortization expense was approximately \$0.3 million for the three months ended March 31, 2004 and approximately \$1.4 million for the year ended December 31, 2003.

The estimated future amortization of other intangible assets is as follows:

2004	\$ 1,206,720
2005	1,021,391
2006	1,017,007
2007	718,068
2008	490,245
Thereafter	184,754
	\$4,638,185

**(6) Accrued Expenses and Other Current Liabilities**

Accrued expenses and other current liabilities consisted of the following at:

	March 31, 2004	December 31, 2003
	(Unaudited)	
Compensation and benefits	\$ 1,032,755	\$ 1,817,713
Professional fees	265,183	180,325
Consultant fees	172,716	394,425
Software costs		32,500
Accruals related to acquisition	91,388	146,222
Legal settlement costs	146,125	146,125
Other	235,157	289,237

<u>                    </u> \$1,943,324 <u>                    </u>	<u>                    </u> \$3,006,547 <u>                    </u>
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**(7) Commitments & Contingencies**

**Leases**

The Company leases its facilities and certain computer equipment under operating and capital leases. The leases expire at various dates through December 2006. Total rent expense under these operating leases was approximately \$0.6 million for the three months ended March 31, 2004 and \$2.7 million for the year

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**Table of Contents****SUREBRIDGE, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

ended December 31, 2003. Obligations under capital lease have been recorded in the accompanying financial statements at the present value of future minimum lease payments. Future commitments as of December 31, 2003 are as follows:

	Total	Less Than 1 Year	Year 2	Year 3	Year 4	Year 5	After 5 Years
Operating leases	\$3,987,224	\$2,582,296	\$1,056,527	\$348,401	\$	\$	\$
Capital lease obligations	448,036	360,936	87,100				
	<b>\$4,435,260</b>	<b>\$2,943,232</b>	<b>\$1,143,627</b>	<b>\$348,401</b>	<b>\$</b>	<b>\$</b>	<b>\$</b>

**Legal Proceedings**

During 2002, a software vendor asserted claims against the Company for software licensing infringements and filed a complaint in federal court seeking relief for monetary damages and unspecified punitive damages. The Company settled these claims during 2002 for \$375,000, of which \$300,000 was paid during 2002, and the remaining \$75,000 which was paid in 2003.

During 2002, the Company began settlement discussions with another software vendor, regarding software-licensing infringements. On March 24, 2003, the Company reached a final settlement with this software vendor in the amount of \$302,000. The Company accrued for this amount as of December 31, 2002 and paid the amount during 2003. In addition, in 2002 and 2003, the Company identified additional areas where it was not in compliance with software licenses. The Company purchased additional licenses in the amount of \$143,432 for these software products and accrued an additional \$60,000 at December 31, 2003 pursuant to an agreement with a third party software vendor to settle additional software license issues.

During 2003, the Company settled a customer claim which requires the Company to pay the customer \$65,000 in exchange for mutual contract releases. This sum was paid in 2004.

The Company is subject to a number of other claims and legal proceedings which, in the opinion of the Company's management, are incidental to the Company's normal business operations. In the opinion of the Company, although final settlement of these claims and legal proceedings may impact the Company's financial statements in a particular period, they will not, in the aggregate, have a material adverse effect on the Company's financial position, results of operations or cash flows.

**(8) Long-Term Debt**

On February 21, 2002, the Company entered into a loan and security agreement with a commercial bank for the purpose of refinancing an existing loan. The agreement includes a term loan that replaced the existing loan and two equipment credit lines, whereby the Company could borrow up to a total of \$2,500,000 under the equipment credit lines to finance certain equipment purchases through December 31, 2002. The agreement also includes certain financial covenants related to, among other things, quick-ratio and earnings. Borrowings under these loan facilities are collateralized by substantially all of the assets of the Company.

On April 2, 2003, the Company entered into a loan modification agreement, amending certain terms of the existing loan and security agreement. The modification agreement added four additional equipment credit lines, allowing the Company to finance certain equipment purchases through March 31, 2004; the agreement did not change any of the terms related to the borrowings that were outstanding under the already existing term loan and equipment credit lines. The modification agreement also includes certain financial covenants related to quick-ratio and profitability.



**Table of Contents****SUREBRIDGE, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The Company had the ability to borrow \$1,000,000 under the third equipment line, which was available through June 30, 2003, \$1,000,000 under the fourth equipment line, which was available through September 30, 2003, \$750,000 under the fifth equipment line, which was available through December 31, 2003, and \$750,000 under the sixth equipment line, which was available through March 31, 2004. Borrowings under these equipment lines accrue interest at the rate of prime plus 2%, and are repayable in 33 monthly installments. Borrowings under these equipment credit lines are collateralized by substantially all of the assets of the Company.

The following summarizes the Company's total availability and borrowings on its loan facilities during the year ended December 31, 2003. Interest on these facilities was 6.00% at December 31, 2003.

	Availability	Borrowings	Interest Rate	Payment Term
Four equipment loans	\$3,500,000	\$2,484,123	Prime + 2%	33 mos

The Company had no remaining borrowing availability as of December 31, 2003.

Aggregate amounts outstanding under these borrowing arrangements totaled \$4,136,198 at December 31, 2003, and future annual principal payments are as follows:

	Year Ending December 31,
2004	\$ 2,551,987
2005	1,237,728
2006	346,483
Total principal payments	4,136,198
Less: current portion	(2,575,539)
Total long-term principal obligation	\$ 1,560,659

In conjunction with the loan and security agreement dated February 21, 2002, the Company issued a warrant to the bank pursuant to which the bank can purchase up to 90,000 shares of the Company's common stock at a price of \$0.50 per share. At the date of issuance, the fair value of the warrant was estimated to be \$36,636, using the Black Scholes method. The fair value was recorded as a discount on the term loan, and is being accreted to interest expense over the term of the loan (28 months). The unamortized portion of this discount was \$7,848 at December 31, 2003.

**(9) Related Parties**

Included in revenue for the year ended December 31, 2003 was approximately \$1.1 million of sales to three companies that are affiliated with a director of the Company and partially or wholly owned by Berkshire Companies Limited Partnership (BCLP), a shareholder of the Company. Accounts receivable balances related to these customers totaled \$87,076 at December 31, 2003, which is stated at fair value. The Company believes that these arrangements are priced at rates consistent with sales arrangements with unrelated customers.

The Company sublets certain office space from BCLP to house its data center. Rent expense related to this lease was \$37,203 for the year ended December 31, 2003. The Company believes the rental rate approximates the fair market rate.



**(10) Redeemable Convertible Preferred Stock**

On October 25, 2002, the Company completed a Fourth Amended and Restated Certificate of Incorporation reflecting the issuance of the Series E and Series F Preferred Stock in the acquisition of

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**Table of Contents****SUREBRIDGE, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Transchannel (see Note 3), and amending certain preferences and rights of each of the other classes of shares.

The Company had 45,801,302 shares of \$0.01 par value preferred stock authorized at December 31, 2003, of which 900,135 shares are designated as Series A Preferred Stock ( Series A ), 1,440,216 shares are designated as Series B Preferred Stock ( Series B ), 7,720,284 shares are designated as Series C Preferred Stock ( Series C ), 23,994,179 shares are designated as Series D Preferred Stock ( Series D ), 9,397,190 shares are designated as Series E Preferred Stock ( Series E ), and 2,349,298 shares are designated as Series F Preferred Stock ( Series F ).

The following is a rollforward of redeemable convertible preferred stock for the three months ended March 31, 2004 (unaudited) and the year ended December 31, 2003:

	<u>Shares</u>	<u>Amount</u>
Balance, December 31, 2002	30,172,335	\$ 53,132,230
Issuance of Series A, B, C, D, E and F preferred stock in connection with the ManagedOps acquisition	6,039,909	6,305,679
Accretion of dividend on Series A preferred stock		97,958
Accretion of Series E preferred stock to redemption value		459,554
Accretion of Series C preferred stock to redemption value		1,176,660
Series E and F earnout consideration	849,077	533,171
	<u>                    </u>	<u>                    </u>
Balance, December 31, 2003	37,061,321	61,705,252
Accretion of dividend on Series A preferred stock (unaudited)		26,624
Accretion of Series E preferred stock to redemption value (unaudited)		118,173
Accretion of Series C preferred stock to redemption value (unaudited)		294,165
	<u>                    </u>	<u>                    </u>
Balance, March 31, 2004 (unaudited)	<u>37,061,321</u>	<u>\$ 62,144,214</u>

Redeemable convertible preferred stock consisted of the following at December 31, 2003:

	<u>Carrying Value</u>	<u>Redemption Value</u>
Series A: 900,135 issued and outstanding at December 31, 2003	\$ 1,331,208	\$ 1,331,208
Series B: 1,440,216 shares issued and outstanding at December 31, 2003	1,440,216	1,440,216
Series C: 7,720,284 shares issued and outstanding at December 31, 2003	40,841,008	44,421,078
Series D: 15,256,355 shares issued and outstanding at December 31, 2003	10,193,427	10,193,427
Series E: 9,395,285 shares issued and outstanding at December 31, 2003	5,958,677	6,623,703
Series F: 2,349,046 shares issued and outstanding at December 31, 2003	1,940,716	1,940,716
	<u>                    </u>	<u>                    </u>
	<u>\$ 61,705,252</u>	<u>\$ 65,950,348</u>

The Company's various series of preferred stock have the following characteristics:

**Dividends**

Holders of Series A are entitled to receive dividends equal to the greater of 8% per annum of the Series A base amount, or an amount per share equal to the dividends payable on the shares of common stock into which such shares are then convertible. Dividends on Series A accrue whether declared or not, and are cumulative. Dividends on Series A are payable quarterly and, if unpaid, increase the base amount of Series A, which was initially \$1.00. At December 31, 2003, Series A had a base amount of approximately \$1.47 per share, including accrued and unpaid dividends. Unpaid dividends shall be paid

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**SUREBRIDGE, INC. AND SUBSIDIARIES**

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

upon the merger, sale or change of control of the Company (as defined) or in the event of a firmly underwritten public offering in which the price per share of common stock is such that the equity valuation of the Company immediately prior to the public offering is at least \$173,324,000, and the net proceeds to the Company are at least \$15 million. Holders of Series B, Series C, Series D, Series E and Series F are entitled to receive dividends equal to the amount that the holder would have received if the shares were converted to common stock. Unpaid dividends, whether declared or not, on Series A, and declared but unpaid dividends on Series B, Series C, Series D, Series E and Series F are also paid upon liquidation or redemption.

**Liquidation**

Holders of Series D and Series F have preference in liquidation to holders of common stock and holders of Series A, Series B, Series C and Series E in the amount of \$0.64599 per share and \$0.70486 per share, respectively, (adjusted for any stock dividends, combinations, splits, recapitalizations and the like with respect to such shares) plus all unpaid dividends declared on the Series D and Series F.

Holders of Series C and Series E have preference in liquidation to holders of common stock and holders of Series A and Series B in the amount of \$0.70486 per share and \$5.753814 per share, respectively, (adjusted for any stock dividends, combinations, splits, recapitalizations and the like with respect to such shares) plus all unpaid dividends declared on the Series C and Series E.

Holders of Series A and B have preference to holders of common stock in the amount of \$1.00 per share (as adjusted for any stock dividends, combinations, splits, recapitalizations and the like with respect to such shares), plus any unpaid dividends declared on the Series B and any unpaid dividends, whether or not declared, on the Series A.

Holders of Series C, Series D, Series E and Series F, along with the holders of common stock, participate in any remaining distribution upon liquidation, on an as-if-converted basis, immediately prior to any such liquidation.

If the payment to the holders of Series C (assuming conversion of all Preferred Stock to common stock and no payment of the Series A, Series B, Series C, Series D, Series E and Series F liquidation amounts) equals or exceeds \$17.2624 per share (adjusted for any stock dividends, combinations, splits, recapitalizations and the like with respect to such shares), the liquidation protection terminates and the holders of the Series C, Series D and Series E shall participate pro rata along with the holders of common stock on an as-if-converted basis without payment of the Series C, Series D and Series E liquidation amounts. If the payment to the holders of Series A and Series B, assuming conversion to common stock, exceeds the Series A and Series B liquidation amount, respectively, then in addition to the accrued dividends (whether or not declared in the case of the Series A) the holders of Series A and Series B shall participate pro rata along with the holders of common stock, and depending on whether there is any pro rata participation of the holders of Series C, Series D, Series E and Series F, in the remaining distribution in all liquidation proceeds as if the Series A and the Series B had been converted into common stock. A sale of the Company or a merger with or into another entity is considered a deemed liquidation.

**Conversion**

Holders of Series E and Series F have the right to convert their shares into common stock at a conversion ratio of one common share for each Series E or Series F share (as adjusted for any stock dividends, combinations, splits, recapitalizations and the like with respect to such shares).

Holders of Series D have the right to convert their shares into common stock at a conversion ratio of 0.916479 common shares for each Series D share (adjusted for any stock dividends, combinations, splits, recapitalizations and the like with respect to such shares). Holders of Series C have the right to convert

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**SUREBRIDGE, INC. AND SUBSIDIARIES**

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

their shares into common stock at a conversion ratio of 2.511935 common shares for each Series C share (as adjusted for any stock dividends, combinations, splits, recapitalizations and the like with respect to such shares).

Holders of Series A and Series B also have the right to convert their shares into common stock at a conversion ratio of 2.002962 common shares for each Series A or Series B share (as adjusted for any stock dividends, combinations, splits, recapitalizations and the like with respect to such shares).

Each share of preferred stock automatically converts into common stock at any time upon the election of 66 2/3% of the outstanding Series C shares or immediately upon a firmly underwritten public offering in which the price per share of common stock is such that the equity valuation of the Company immediately prior to the public offering is at least \$173,324,000, and the net proceeds to the Company are at least \$15 million.

If the Company issues additional common shares below the conversion price of the Series A, Series B, Series C, Series D, Series E and Series F (\$0.4992605, \$0.4992605, \$2.29059, \$0.64599, \$0.70486 and \$0.70486, respectively, at December 31, 2003), other than as a dividend or other distribution on the Company's common stock (as defined), then the existing Series A, Series B, Series C, Series D, Series E and Series F conversion price shall be reduced accordingly. This may result in the recording of a beneficial conversion feature in future periods.

**Voting**

Preferred stockholders are entitled to vote, together with the holders of common stock, on all matters submitted to stockholders for a vote. Each preferred stockholder is entitled to the number of votes equal to the number of shares of common stock into which each preferred share is convertible at the time of such vote. Directors appointed by the Series D shareholders have certain special voting rights related to matters such as changes in the certificate of incorporation, incurring indebtedness, sale of the corporation, acquisition of assets and liabilities other than in the normal course of business and authorization or issuance of any additional class or series of capital stock.

**Redemption**

Between February 11, 2007 and February 11, 2009, the holders of at least fifty percent of the outstanding shares of any series of preferred stock have the right to require the Company to redeem the shares of preferred stock owned by such holders. The redemption price is equal to the greater of \$0.70486 per share for the Series F and Series E, \$0.64599 per share for the Series D, \$5.753814 per share for the Series C and \$1.00 per share for the Series A and B, plus all unpaid dividends accrued on such shares (whether or not earned or declared in the case of the Series A), or the then current fair market value per share.

The holders of Series D and Series F have redemption preference over all other classes of shares and the holders of Series C and Series E have redemption preference over all other classes of shares, with the exception of Series D and Series F.

**(11) Stockholders Deficit  
Common Stock**

The Company had 75,000,000 shares of \$0.01 par value common stock authorized, of which 9,971,594 shares were outstanding as of December 31, 2003. Each share of common stock is entitled to one vote. The holders of common stock are entitled to receive dividends whenever funds are legally available, and when and if declared by the Board of Directors, subject to the prior rights of holders of all

**Table of Contents****SUREBRIDGE, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

classes of stock outstanding. Upon the liquidation, dissolution or winding up of the Company, holders of common stock will be entitled to receive all available assets, subject to any preferential rights of any then outstanding preferred stock. The Company has never declared or paid dividends on its common stock.

As of December 31, 2003, the Company has reserved 1,502,222, 2,403,554, 16,158,281, 11,650,023, 7,262,411 and 1,815,603 shares of common stock for the conversion of the Series A, Series B, Series C, Series D, Series E and Series F preferred stock, respectively. Additionally, the Company has reserved 6,618,940 shares of common stock for issuance pursuant to the Company's 1998 Stock Plan (see Note 12), and 90,000 shares of common stock for the outstanding warrants, as of December 31, 2003.

**Warrants**

In connection with the loan and security agreement that the Company entered into during 2002 (see Note 8), the Company granted a warrant to purchase 90,000 shares of common stock at an exercise price of \$0.50. The warrant may be exercised at any time before February 21, 2009, at which time it expires.

**(12) Stock Option Plan**

In May 1998, the Company adopted the 1998 Stock Incentive Plan (the "Stock Plan") that provides for the issuance of restricted common stock, and incentive and nonstatutory common stock options to employees, directors and consultants of the Company. The Board of Directors determines the term of each option, option price, number of shares for which each option is granted, whether restrictions will be imposed on the shares subject to options and the rate at which each option is exercisable. The exercise price for incentive stock options may not be less than the fair market value per share of the underlying common stock on the date granted (110% of fair market value in the case of holders of more than 10% of the voting stock of the Company) and the term of incentive stock options may not exceed ten years (five years in the case of holders of more than 10% of the voting stock of the Company). The Board of Directors reserved 6,714,000 shares of common stock to be issued in conjunction with the Stock Plan. There were 6,618,940 shares available for issuance under the Stock Plan as of December 31, 2003.

Consistent with the provisions of APB No. 25, the Company recognizes compensation expense for the excess of the fair value of the shares optioned over the exercise price, determined as of the grant date. The Company recognizes compensation cost on an accelerated basis over the periods in which the services being compensated are performed, generally the vesting period (three years).

The following table summarizes the activity of the Company's stock option plan for the year ended December 31, 2003:

	Number of Options	Weighted Average Exercise Price	Range of Exercise Prices
Balances beginning of year	4,945,513	\$ 0.64	\$ 0.125 - \$4.50
Granted	1,500,400	\$ 0.50	\$ 0.50
Exercised	(13,042)	\$ 0.50	\$ 0.50
Canceled/forfeited	(742,452)	\$ 1.03	\$ 0.50 - \$4.50
Balances end of year	5,690,419	\$ 0.55	\$ 0.125 - \$2.87

**Table of Contents****SUREBRIDGE, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The following table summarizes information about stock options outstanding at December 31, 2003:

Exercise Price	Options Outstanding			Options Exercisable	
	Shares	Weighted Average Contractual Life (Years)	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
\$0.12	48,000	4.59	\$0.125	48,000	\$0.125
\$0.50	5,492,134	8.30	\$ 0.50	2,978,280	\$ 0.50
\$0.65	24,350	7.05	\$ 0.65	23,292	\$ 0.65
\$2.25	2,000	5.80	\$ 2.25	2,000	\$ 2.25
\$2.87	123,935	6.63	\$ 2.87	116,435	\$ 2.87
	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>
\$0.125 - \$2.87	5,690,419	8.22	\$ 0.55	3,168,007	\$ 0.58
	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>

**(13) Income Taxes**

The Company had no income tax expense for the year ended December 31, 2003.

Income tax benefit for the year ended December 31, 2003 differed from the amount computed by applying the U.S. Federal income tax rate of 34% to pretax income as a result of the following:

Computed expected income tax benefit	\$(2,536,211)
Increase (decrease) in income taxes resulting from:	
State income taxes, net of federal benefit	(467,707)
Change in valuation allowance	3,068,590
Other	(64,672)
	<hr/>
	\$ <hr/>

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities at December 31, 2003 are presented below:

<b>Deferred Tax Assets:</b>	
Bad debts	\$ 65,172
Accruals and reserves	580,416
Amortization	1,553,705
Depreciation	280,125
Net operating loss and tax credit carryforwards	19,154,031
Others	13,389
	<hr/>
Total gross deferred tax assets	21,646,838

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Less valuation allowance	(19,284,673)
Net deferred tax assets	\$ 2,362,165
<b>Deferred Tax Liabilities:</b>	
Intangible assets	2,362,165
Total gross deferred tax liabilities	2,362,165
Net deferred tax asset	\$

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**Table of Contents****SUREBRIDGE, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

At December 31, 2003, the Company had federal and state net operating loss carryforwards available to offset future taxable income of approximately \$47,290,000. The federal and state net operating loss carryforwards will begin to expire in years 2020 and 2005, respectively. The Company also had certain research tax credit carryforwards available to reduce future regular income taxes of approximately \$276,000 which expire in year 2020. Utilization of the net operating losses and tax credits may be subject to an annual limitation imposed by change in ownership provisions of Section 382 of the Internal Revenue Code and similar state provisions. 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 periods in which those temporary differences become deductible. The Company has recorded a valuation allowance against its deferred tax assets because management believes that, after considering all of the available objective evidence, historical and prospective, with greater weight given to historical evidence, it is more likely than not that the asset will not be realized.

The total valuation allowance for deferred tax assets as of December 31, 2003 was \$19,284,673 of which \$14,415,802 was charged against income tax expense while \$4,868,871 was charged against acquisition goodwill and/or intangible assets. If the valuation allowance is fully realized, \$4,868,871 will reduce goodwill and noncurrent acquisition-related intangible assets and the balance of \$14,415,802 will reduce income tax expense.

**(14) Employee Benefit Plan**

In 1998, the Company established a savings plan (the Plan) which was designed to be qualified under Section 401(k) of the Internal Revenue Code, covering substantially all of its employees. Eligible employees are permitted to contribute to the Plan through payroll deductions, within statutory and plan limits. The Plan provides for a discretionary employer matching contribution. The Company authorized matching contributions of approximately \$372,000 for the year ended December 31, 2003.

**(15) Subsequent Events****Loan Facility**

On March 4, 2004, the Company entered into a second loan modification agreement and loan and security agreement, amending certain terms of the modified loan agreements, which the Company entered into on April 2, 2003. The second modification agreements establish an additional loan facility, which allows the Company to borrow a maximum of \$2,500,000 through March 3, 2005. Borrowings under this loan facility accrue interest at the rate of prime plus 2%, interest is payable monthly, and any unpaid principal balance is due on March 3, 2005. Borrowings are collateralized by substantially all of the assets of the Company, although the agreements also require the Company to pledge three certificates of deposit totaling \$750,000. The second modification agreements also include certain financial covenants related to profitability and capital expenditures. As of March 31, 2004, the Company was in default of its debt covenants under this loan facility. However, the Company received a waiver for the debt covenants in default from the lending institution that was dated May 13, 2004. The Company expects to be in compliance with its debt covenants in the future.

At April 30, 2004, the Company had approximately \$4.0 million outstanding and \$0.2 million available under its loan facilities.

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**SUREBRIDGE, INC. AND SUBSIDIARIES**

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

**Acquisition**

As discussed in Note 1, it was announced on May 6, 2004 that the Company had signed a definitive asset purchase agreement pursuant to which substantially all of the assets of the Company would be acquired by NaviSite, Inc. for two promissory notes in the aggregate principal amount of approximately \$39.3 million, three million shares of NaviSite common stock and the assumption of certain liabilities of Company at closing. This transaction was consummated on June 10, 2004.

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**REPORT OF INDEPENDENT AUDITORS**

To the Board of Directors and Stockholders of

Surebridge, Inc.

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations, stockholders' deficit and cash flows, present fairly, in all material respects, the financial position of Surebridge, Inc. and its subsidiaries at December 31, 2002 and 2001, and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America, which 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, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Notes 2 and 5 to the consolidated financial statements, the Company changed its method of accounting for goodwill and other intangible assets upon adoption of Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets, on January 1, 2002.

/s/ PRICEWATERHOUSECOOPERS LLP

Boston, Massachusetts

May 6, 2004

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**Table of Contents****SUREBRIDGE, INC.****CONSOLIDATED BALANCE SHEETS****December 31, 2002 and 2001**

	<u>2002</u>	<u>2001</u>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 7,071,770	\$ 6,361,796
Restricted cash	400,000	2,410,000
Accounts receivable, net of allowance for doubtful accounts of \$269,130 and \$444,059 at December 31, 2002 and 2001, respectively	3,176,255	2,933,600
Unbilled receivables	314,394	200,476
Prepaid expenses and other current assets	452,842	368,417
	<u>11,415,261</u>	<u>12,274,289</u>
Total current assets	11,415,261	12,274,289
Restricted cash	230,000	230,000
Property and equipment, net	5,345,149	3,913,778
Goodwill	4,396,498	3,663,184
Other intangible assets, net	3,726,639	1,719,930
Other long-term assets	692,397	563,523
	<u>25,805,944</u>	<u>22,364,704</u>
Total assets	\$ 25,805,944	\$ 22,364,704
<b>LIABILITIES, REDEEMABLE CONVERTIBLE PREFERRED STOCK AND STOCKHOLDERS DEFICIT</b>		
Current liabilities:		
Accounts payable	\$ 2,204,871	\$ 1,153,279
Accrued expenses	2,877,306	1,885,778
Other current liabilities	1,519,563	994,927
Deferred revenue	1,020,526	1,024,663
Current portion of long-term debt	1,920,950	938,263
Current portion of obligations under capital lease	246,236	339,901
	<u>9,789,452</u>	<u>6,336,811</u>
Total current liabilities	9,789,452	6,336,811
Obligations under capital lease	18,499	133,567
Long-term debt	1,625,943	1,397,258
Commitments and contingencies (Notes 8 and 15)		
Redeemable convertible preferred stock, \$0.01 par value; 42,306,030 and 32,376,782 shares authorized, 30,172,335 and 21,094,321 shares issued and outstanding at December 31, 2002 and 2001, respectively	53,132,230	47,290,965
Stockholders' deficit		
Common stock, \$0.01 par value; 65,000,000 shares authorized; 10,842,164 and 10,059,668 shares issued; 9,958,552 and 9,901,056 shares outstanding at December 31, 2002 and 2001, respectively	108,422	100,597
Additional paid-in capital	11,650,476	11,415,094
Accumulated deficit	(50,048,377)	(44,175,857)
Treasury stock, at cost, 883,612 and 158,612 shares at December 31, 2002 and 2001, respectively	(465,098)	(103,098)
Deferred compensation	(5,603)	(30,633)

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Total stockholders' deficit	<u>(38,760,180)</u>	<u>(32,793,897)</u>
Total liabilities, redeemable convertible preferred stock and stockholders' deficit	<u>\$ 25,805,944</u>	<u>\$ 22,364,704</u>

The accompanying notes are an integral part of the consolidated financial statements.

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**Table of Contents****SUREBRIDGE, INC.****CONSOLIDATED STATEMENTS OF OPERATIONS****For the Years Ended December 31, 2002 and 2001**

	<u>2002</u>	<u>2001</u>
Revenue	\$ 23,893,128	\$ 25,258,332
Operating expenses:		
Cost of revenue	14,736,506	16,450,942
Selling and marketing	5,923,012	13,326,967
General and administrative	7,933,025	11,053,557
Amortization of intangible assets	531,301	3,424,345
Impairment charge		4,168,306
	<u>29,123,844</u>	<u>48,424,117</u>
Loss from operations	(5,230,716)	(23,165,785)
Other income(expense):		
Interest income	109,604	430,785
Interest expense	(276,111)	(234,961)
	<u>(166,507)</u>	<u>(91,176)</u>
Loss before income taxes	(5,397,223)	(22,969,961)
Income tax provision	475,297	
	<u>(4,921,926)</u>	<u>(22,969,961)</u>
Net loss	\$ (5,872,520)	\$ (22,969,961)
Accrued dividends on preferred stock (including accretion to redemption value of \$65,642 for the year ended December 31, 2002)	(141,265)	(69,865)
	<u>(5,993,785)</u>	<u>(23,039,826)</u>
Net loss to common shareholders	\$ (6,013,785)	\$ (23,039,826)

The accompanying notes are an integral part of the consolidated financial statements.

**Table of Contents****SUREBRIDGE, INC.****CONSOLIDATED STATEMENTS OF STOCKHOLDERS DEFICIT****For the Years Ended December 31, 2002 and 2001**

	Common Stock		Additional Paid-in Capital	Note Receivable From Stockholder		Accumulated Deficit	Treasury Stock Shares in Treasury	Amount	Deferred Compensation	Total Stockholders Deficit
	Shares Issued	Par Value		Treasury Stock Shares in Treasury						
Balance, December 3, 2000	9,454,898	\$ 94,549	\$ 13,737,850	\$	\$ (21,205,896)			\$	\$ (3,953,690)	\$ (11,327,187)
Issuance of Series D preferred stock			(884,137)							(884,137)
Issuance of common stock to employees	585,254	5,853	374,563							380,416
Issuance of common stock pursuant to the exercise of stock options	19,516	195	30,699							30,894
Accretion of dividend on Series A preferred stock			(69,865)							(69,865)
Acquisition of shares of common stock for treasury							(158,612)	(103,098)		(103,098)
Amortization and reversal of deferred compensation			(1,784,314)						3,923,057	2,138,743
Stock options granted to nonemployees			10,298							10,298
Net loss					(22,969,961)					(22,969,961)
Balance, December 31, 2001	10,059,668	100,597	11,415,094		(44,175,857)	(158,612)	(103,098)	(30,633)		(32,793,897)
Issuance of Series E and Series F preferred stock in conjunction with the acquisition of Transchannel			(3,546)							(3,546)
Issuance of stock options in the acquisition			10,430							10,430
Sale of restricted stock	725,000	7,250	354,750	(362,000)						
Issuance of common stock pursuant to the exercise of stock options	57,496	575	14,877							15,452
Accretion of dividend on Series A preferred stock			(75,623)							(75,623)
Accretion of Series E preferred stock to redemption value			(65,642)							(65,642)
Issuance of warrants			36,636							36,636
Purchase of restricted stock				362,000			(725,000)	(362,000)		

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Amortization and reversal of deferred compensation			(36,500)					25,030	(11,470)
Net loss					(5,872,520)				(5,872,520)
Balance, December 31, 2002	10,842,164	\$ 108,422	\$ 11,650,476	\$	\$ (50,048,377)	(883,612)	\$ (465,098)	\$ (5,603)	\$ (38,760,180)

The accompanying notes are an integral part of the consolidated financial statements.

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**Table of Contents****SUREBRIDGE, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS****For the Years Ended December 31, 2002 and 2001**

	<u>2002</u>	<u>2001</u>
Cash flows from operating activities:		
Net loss	\$(5,872,520)	\$(22,969,961)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	2,934,880	5,422,469
Stock-based compensation	(11,470)	2,529,457
Provision for losses on accounts receivable	10,300	683,912
Accretion of interest on long-term debt	13,084	
Impairment charge		4,168,306
Provision for deferred income taxes	475,297	
Changes in assets and liabilities, net of effects of acquisition:		
Decrease in accounts receivable	759,088	195,674
(Increase) decrease in unbilled receivables	(72,487)	273,420
(Increase) decrease in prepaid expenses and other current assets	(34,284)	112,254
(Increase) decrease in other long-term assets	(88,783)	85,118
Increase in accounts payable	653,785	368,183
Increase (decrease) in accrued expenses	248,121	(2,617,032)
Increase in other current liabilities	124,636	622,783
Decrease in deferred revenue	(4,137)	(109,694)
	<u>                    </u>	<u>                    </u>
Net cash used in operating activities	(864,490)	(11,235,111)
	<u>                    </u>	<u>                    </u>
Cash flows from investing activities:		
Purchases of property and equipment	(1,906,950)	(1,813,698)
Increase in restricted cash related to the acquisition	(400,000)	
Net cash acquired in acquisition	639,130	
	<u>                    </u>	<u>                    </u>
Net cash used in investing activities	(1,667,820)	(1,813,698)
	<u>                    </u>	<u>                    </u>
Cash flows from financing activities:		
(Increase) decrease in restricted cash	2,410,000	(2,640,000)
Proceeds from issuance of preferred stock, net of issuance costs		7,327,505
Payment of issuance costs for preferred stock issued in the acquisition	(3,546)	
Proceeds from exercise of employee stock options	15,452	30,894
Proceeds from long-term debt	4,663,057	2,674,228
Principal payments on long-term debt	(3,428,133)	(338,707)
Principal payments on notes payable		(2,145,814)
Principal payments on capital lease obligations	(414,546)	(395,832)
	<u>                    </u>	<u>                    </u>
Net cash provided by financing activities	3,242,284	4,512,274
	<u>                    </u>	<u>                    </u>
Net increase (decrease) in cash and cash equivalents	709,974	(8,536,535)
Cash and cash equivalents, beginning of year	6,361,796	14,898,331
	<u>                    </u>	<u>                    </u>
Cash and cash equivalents, end of year	\$ 7,071,770	\$ 6,361,796

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Supplemental disclosure of cash flow information:

Cash paid during the year for:		
Interest	\$ 263,027	\$ 374,960
Noncash investing and financing activities:		
Acquisition of equipment under capital leases	\$	\$ 104,320
Issuance of restricted stock in exchange for a note	\$ 362,000	\$
Acquisition of treasury stock	\$ 362,000	\$ 103,098
Net assets acquired in the acquisition	\$ 7,272,825	\$
Issuance of preferred stock in conjunction with the acquisition	\$ 5,700,000	\$
Accrual for minimum purchase commitment included in property and equipment	\$	\$ 246,927

The accompanying notes are an integral part of the consolidated financial statements.

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**SUREBRIDGE, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**1. Nature of Business**

Surebridge, Inc. (the Company), formerly known as Panoptic Business Networks, Inc., was incorporated in the State of Delaware to leverage the Internet to meet the needs of middle market companies seeking advanced business applications. The Company provides packaged application selection, implementation, application management and hosting, and continuous business improvement services.

The Company is subject to a number of risks similar to other companies in the industry, including rapid technological change, competition from other companies, and dependence on key individuals. The Company incurred net losses in 2002 and 2001 of \$5,872,520 and \$22,969,961, respectively, as it expanded its operations. The Company has an accumulated deficit of \$50,048,377 at December 31, 2002.

The Company's future beyond 2003 is dependent upon its ability to achieve break-even or positive operating cash flow, or raise additional financing. There can be no assurances that the Company will be able to do so.

**2. Summary of Significant Accounting Policies**

The following is a summary of significant accounting policies followed in the preparation of these financial statements.

**Basis of Consolidation**

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries, Surebridge Services, Inc. (formerly known as Panoptic Technology Services, Inc.) and Surebridge Acquisition Corp. All intercompany accounts and transactions have been eliminated.

**Use of Estimates**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**Cash and Cash Equivalents**

Cash and cash equivalents consist of cash and highly liquid investments with original or remaining maturities of three months or less at the date of purchase and whose carrying amounts approximate market value due to the short maturity of the investments. Cash equivalents at December 31, 2002 and 2001 consist of money market instruments.

The Company had restricted cash of \$630,000 and \$2,640,000 as of December 31, 2002 and 2001, respectively. As of December 31, 2002, restricted cash consisted of an acquisition contingency totaling \$400,000 related to the 2002 acquisition of Transchannel, Inc. (see Note 3), and \$230,000 related to a security deposit on a facilities lease. \$2,350,000 of the restricted cash as of December 31, 2001 related to a bank financing that the Company refinanced on February 21, 2002 (see Note 7), at which time the restriction was lifted.

**Financial Instruments and Concentration of Credit Risk**

Financial instruments that subject the Company to credit risk consist principally of cash and cash equivalents and accounts receivable. The Company places its cash in highly rated financial institutions. The Company periodically assesses the financial strength of its customers and, as a consequence, believes



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**SUREBRIDGE, INC.**

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

that its accounts receivable credit risk exposure is limited. The Company does not require collateral and establishes reserves for doubtful accounts as warranted. There were no single customers that accounted for over 10% of total accounts receivable at December 31, 2002, and one customer accounted for 11% of total accounts receivable at December 31, 2001.

**Property and Equipment**

Property and equipment are stated at cost less accumulated depreciation. Repair and maintenance costs are charged to operations when incurred, while additions and betterments are capitalized. Depreciation is computed using the straight-line method over the estimated useful lives of the assets. Leasehold improvements are depreciated over the shorter of the estimated useful life of the asset or the lease term. Upon retirement or sale, the cost of the assets disposed of and the related accumulated depreciation are removed from the accounts and any resulting gain or loss is included in the determination of net income or loss.

The Company periodically evaluates the recoverability of long-lived assets whenever events and changes in circumstances indicate that the carrying value of an asset or class of assets may not be fully recoverable and exceeds its fair value. For long-lived assets the Company intends to hold and use, if the carrying amount of the asset exceeds the sum of undiscounted cash flows expected to result from the use of the asset over its useful life, an impairment loss is recorded. The amount of the impairment loss is measured as the amount by which the carrying amount of the long-lived asset exceeds its fair value.

**Goodwill and Other Intangible Assets**

Goodwill represents the excess of the purchase price over the fair value of net tangible and identifiable intangible assets the Company has acquired and has accounted for under the purchase method in accordance with Statement of Financial Accounting Standards No. 141 ( SFAS No. 141 ), Business Combinations. The Company adopted the provisions of Statement of Financial Accounting Standards No. 142 ( SFAS No. 142 ), Goodwill and Other Intangible Assets, on January 1, 2002. Accordingly, the Company ceased the ratable amortization of goodwill on that date. SFAS No. 142 also requires the Company to perform an annual impairment test of its goodwill.

Other intangible assets consist primarily of customer base and covenants not to compete. Such assets are being amortized on a straight-line basis over periods ranging from two months to seven years.

**Revenue Recognition**

The Company derives its revenue primarily from information technology consulting, software implementation services and application management and hosting services. The Company also derives revenue from the sale of software and related maintenance contracts. Reimbursable expenses charged to clients are included in revenue and costs of revenue. To conform to the current year presentation, the Company has adjusted its 2001 revenue and costs of revenue to include \$743,873 of reimbursable expenses.

*Information Technology Consulting and Software Implementation Services*

The Company enters into two types of contracts for information technology and software implementation services. Revenue from time and materials contracts is recognized as services are performed. The Company recognizes revenue on fixed price contracts on an efforts expended method when it can demonstrate the ability to perform under the contract. Under this method, revenue is recognized based on the ratio of labour hours expended compared with the total estimated hours to complete the contract. When current contract estimates indicate that a loss is probable, provision is made for the total

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**SUREBRIDGE, INC.**

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

anticipated loss in the current period. Contract losses are determined to be the amount by which the estimated service costs of the contract exceed the estimated revenues that will be generated by the contract. Unbilled revenues represent revenues for services performed that have not been billed. Billings in excess of revenue recognized are recorded as deferred revenue until the applicable revenue recognition criteria are met.

Amounts received or billed in advance of the services being provided are recorded as deferred revenue. Unbilled receivables represent amounts recognized based on services performed in advance of billings, in accordance with the contract term.

*Application Management and Hosting Services*

Application management and hosting fees are for the management of application software and for access to the Company's data center and technical infrastructure. These fees are recognized ratably over the contract term. Set-up fees related to application management and hosting services are recognized ratably over the expected customer relationship period.

*Software Revenue*

The Company primarily sells or licenses software in combination with software implementation services. Revenue from the sale of software is recognized when the software is delivered to the customer. In instances where the Company also provides application management and hosting services, software revenue is recognized ratably over the expected customer relationship period.

*Maintenance Contracts*

The Company sells maintenance contracts on behalf of third-party software vendors. The Company is not a party to the maintenance contracts and therefore has no continuing obligations under the contracts. Revenue from these contracts is recognized on a net basis, when the Company's customers enter into the contracts.

In addition, the Company sells phone support for software. Phone support contracts typically have one-year terms, and customers are required to prepay the contract amount, which is recorded as deferred revenue and recognized ratably over the contract term.

**Income Taxes**

Deferred tax assets and liabilities are recognized based on temporary differences between the financial statement and tax bases of assets and liabilities using current enacted tax rates in effect for the year in which the difference is expected to reverse. Valuation allowances are provided if, based on the weight of available evidence, it is more likely than not that some or all of the deferred tax assets will not be realized.

**Advertising**

Advertising costs are expensed as incurred and are charged to selling and marketing expenses.

**Accounting for Stock-Based Compensation**

The Company accounts for stock-based compensation granted to employees and directors using the intrinsic value method prescribed in Accounting Principles Board Opinion No. 25 ( APB No. 25 ), Accounting for Stock Issued to Employees, and related interpretations. Statement of Financial Accounting Standards No. 123 ( SFAS No. 123 ), Accounting for Stock-Based Compensation, and Statement of Financial Accounting Standards No. 148 ( SFAS No. 148 ), Accounting for Stock-Based

**Table of Contents****SUREBRIDGE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Compensation Transition and Disclosure, require that companies either recognize compensation expense for grants of stock, stock options, and other equity instruments based on fair value, or provide pro forma disclosures of net income (loss) in the notes to the consolidated financial statements. Accordingly, compensation cost for stock options granted to employees and directors is measured as the excess, if any, of the fair value of the Company's stock at the date of the grant over the amount that must be paid to acquire the stock. All stock-based awards to nonemployees are accounted for at their fair value in accordance with SFAS No. 123, SFAS No. 148, and related interpretations. For all stock-based awards to employees and directors, the Company has elected the pro forma disclosure provisions of SFAS No. 123 and SFAS No. 148.

The following table illustrates the effect on net loss if the Company had applied the fair value recognition provisions of SFAS No. 123 and SFAS No. 148 to stock-based employee compensation.

	Year Ended December 31,	
	2002	2001
Net loss, as reported	\$(5,872,520)	\$(22,969,961)
Stock-based employee compensation included in net loss, net of related tax effects	(11,470)	2,474,723
Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	152,931	(2,100,808)
Pro forma net loss	\$(5,731,059)	\$(22,596,046)

Because options vest over several years and additional option grants are expected to be made in future years, the above pro forma results are not representative of pro forma results for future years.

**Guarantees and Indemnification Obligations**

In November 2002, the FASB issued FIN No. 45, Guarantor's Accounting and Disclosure Requirements for Guarantees Including Indirect Guarantee of Indebtedness of Others, an interpretation of FASB Statements No. 5, 57 and 107 and rescission of FASB Interpretation No. 34. The interpretation requires that a guarantor recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken by issuing the guarantee. The interpretation also requires additional disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under certain guarantees it has issued. The accounting requirements for the initial recognition of guarantees are applicable on a prospective basis for guarantees issued or modified after December 31, 2002. The disclosure requirements are effective for all guarantees outstanding, regardless of when they were issued or modified, during the first quarter of fiscal 2003. The adoption of FIN No. 45 did not have a material effect on our consolidated financial statements. The following is a summary of our agreements that we have determined are within the scope of FIN No. 45.

As permitted by Delaware law, the Company has agreements whereby it indemnifies its officers and directors for certain events or occurrences while the officer or director is, or was serving, at the Company's request in such capacity. The term of the indemnification period is for the officer's or director's lifetime. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited; however, the Company has a Directors and Officers insurance policy that limits its exposure and enables the Company to recover a portion of any future amounts paid. As a result of our insurance policy coverage, we believe the estimated fair value of these indemnification agreements is minimal. All of these indemnification agreements were grandfathered under the provisions of FIN No. 45 as they were in effect prior to December 31, 2002. Accordingly, we have no liabilities recorded for these agreements as of December 31, 2002.





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**SUREBRIDGE, INC.**

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

We enter into standard indemnification agreements in the ordinary course of business. Pursuant to these agreements, we indemnify, hold harmless, and agree to reimburse the indemnified party for losses suffered or incurred by the indemnified party, generally our business partners or customers, in connection with any patent, or any copyright or other intellectual property infringement claim by any third party with respect to our products. The term of these indemnification agreements is generally perpetual anytime after execution of the agreement. The maximum potential amount of future payments we could be required to make under these indemnification agreements is unlimited. We have never incurred costs to defend lawsuits or settle claims related to these indemnification agreements. As a result, we believe the estimated fair value of these agreements is minimal. Accordingly, we have no liabilities recorded for these agreements as of December 31, 2002.

We enter into arrangements with our business partners, whereby the business partner agrees to sublicense our services to its customers. We enter into standard indemnification agreements with those business partners, whereby we indemnify them for our acts or omissions in providing the services that result in a claim against our business partner. The maximum potential amount of future payments we could be required to make under these indemnification agreements is unlimited; however, we have general and umbrella insurance policies that enable us to recover a portion of any amounts paid. We have never incurred costs to defend lawsuits or settle claims related to these indemnification agreements. As a result, we believe the estimated fair value of these agreements is minimal. Accordingly, we have no liabilities recorded for these agreements as of December 31, 2002.

When as part of an acquisition we acquire all of the stock or all of the assets and liabilities of a company, we assume the liability for certain events or occurrences that took place prior to the date of acquisition. The maximum potential amount of future payments we could be required to make for such obligations is undeterminable at this time. Accordingly, we have no liabilities recorded for these liabilities as of December 31, 2002.

**New Accounting Pronouncements**

In July 2001, the Financial Accounting Standards Board ( FASB ) issued SFAS No. 141 and SFAS No. 142. SFAS No. 141 replaces Accounting Principles Board Opinion No. 16, Business Combinations, and eliminates pooling-of-interests accounting prospectively. It also provides guidance on purchase accounting related to the recognition of intangible assets and accounting for negative goodwill. SFAS No. 142 changes the accounting for goodwill from an amortization method to an impairment-only approach. Under SFAS No. 142, goodwill is required to be tested annually and whenever events or circumstances occur indicating that goodwill might be impaired. SFAS No. 142 was adopted by the Company on January 1, 2002. Upon adoption of SFAS No. 142, amortization of goodwill recorded for business combinations ceased. In addition, acquired workforce assets were reclassified to goodwill as they did not meet the criteria set forth in SFAS No. 141 for recognition apart from goodwill. In connection with the adoption of SFAS No. 142, the Company performed transitional and annual goodwill impairment assessments and determined that the fair value exceeded net assets (see Note 5).

In August 2001, the FASB issued Statement of Financial Accounting Standards No. 143 ( SFAS No. 143 ), Accounting for Asset Retirement Obligations, which provides the accounting requirements for retirement obligations associated with tangible long-lived assets. This Statement requires entities to record the fair value of a liability for an asset retirement obligation in the period in which it is incurred. This Statement is effective for the Company's 2003 fiscal year, and early adoption is permitted. The Company is evaluating the impact, if any, that this pronouncement will have on the consolidated financial statements.

In October 2001, the FASB issued Statement of Financial Accounting Standards No. 144 ( SFAS No. 144 ), Accounting for the Impairment or Disposal of Long-Lived Assets, which excludes

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**SUREBRIDGE, INC.**

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

from the definition of long-lived assets, goodwill and other intangibles that are not amortized in accordance with SFAS No. 142. SFAS No. 144 requires that long-lived assets to be disposed of by sale be measured at the lower of carrying amount or fair value less cost to sell. SFAS No. 144 is effective for financial statements issued for fiscal years beginning after December 15, 2001, and generally its provisions are to be applied prospectively. The Company adopted this standard effective January 1, 2002.

In June 2002, the FASB issued Statement of Financial Accounting Standards No. 146 ( SFAS No. 146 ), Accounting for Costs Associated with Exit or Disposal Activities. SFAS No. 146 addresses financial accounting and reporting for costs associated with exit or disposal activities and nullifies Emerging Issues Task Force Issue No. 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring). SFAS No. 146 requires that a liability be recognized when it is incurred and should initially be measured and recorded at fair value. This statement is effective for exit or disposal activities that are initiated after December 31, 2002.

In December 2002, the FASB issued Statement of Financial Accounting Standards No. 148 ( SFAS No. 148 ), Accounting for Stock-Based Compensation Transition and Disclosure which is effective for financial statements for fiscal years ending after December 15, 2002, with early adoption permitted. SFAS No. 148 enables companies that choose to adopt the preferable fair value method to report the full effect of employee stock options in their financial statements immediately upon adoption. The Company will continue to apply the disclosure only provisions of both SFAS No. 123 and SFAS No. 148.

In May 2003, the FASB issued Statement of Financial Accounting Standards No. 150 ( SFAS No. 150 ), Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity. SFAS No. 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances). SFAS No. 150 is effective for financial instruments entered into or modified after May 31, 2003. The Company is evaluating the impact, if any, that this pronouncement will have on the consolidated financial statements.

In November 2002, the Emerging Issues Task Force ( EITF ) of the FASB issued a consensus on Issue No. 00-21, Accounting for Revenue Arrangements with Multiple Deliverables. EITF No. 00-21 addresses certain aspects of the accounting by a vendor for arrangements under which it will perform multiple revenue-generating activities. EITF No. 00-21 establishes three principles: revenue should be recognized only when the arrangement consideration is reliably measurable, the earnings process is substantially complete, and consideration should be allocated among the separate units of accounting in an arrangement based on their fair values. EITF No. 00-21 is effective for all revenue arrangements entered into in fiscal periods beginning after June 15, 2003, with early adoption permitted. The Company is evaluating the impact, if any, that this issue will have on the consolidated financial statements.

In January 2003, the FASB issued FIN No. 46, Consolidation of Variable Interest Entities and, in December 2003, issued a revision to that interpretation. FIN No. 46R replaces FIN No. 46 and addresses consolidation by business enterprises of variable interest entities that possess certain characteristics. A variable interest entity (VIE) is defined as (a) an ownership, contractual or monetary interest in an entity where the ability to influence financial decisions is not proportional to the investment interest, or (b) an entity lacking the invested capital sufficient to fund future activities without the support of a third party. FIN No. 46R establishes standards for determining under what circumstances VIEs should be consolidated with their primary beneficiary, including those to which the usual conditions for consolidation do not apply. The Company will adopt FIN No. 46 and FIN No. 46R as of January 1, 2005. The Company does not expect a material effect from the adoption of FIN No. 46 or FIN No. 46R.

**Table of Contents****SUREBRIDGE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Reclassifications**

Certain reclassifications have been made to prior year statements to conform to the current year presentation.

**3. Acquisition**

On October 27, 2002, the Company acquired all of the outstanding stock of Transchannel, Inc. ( Transchannel ), and merged Transchannel into the Company, with the Company continuing as the surviving corporation. Transchannel, a Georgia corporation, provided sales, deployment, and application support and management of Peoplesoft software throughout the United States. The Company acquired Transchannel to increase their overall market share and increase their application management and hosting customer base. The purchase consideration, aggregating \$7,272,825, consisted of \$1,400,000 in cash, 7,262,411 shares of the Company's Series E Preferred Stock ( Series E ) valued at \$0.58 per share, 1,815,603 shares of the Company's Series F Preferred Stock ( Series F ) valued at \$0.83 per share, 200,578 stock options to purchase the Company's common stock, valued at \$10,430 using the Black Scholes method, and acquisition costs of \$162,395. The fair value of the Series E and Series F was determined with the assistance of a valuation specialist. The results of operations of Transchannel is included in the operating results of the Company from the date of acquisition.

The acquisition was accounted for using the purchase method of accounting. Accordingly, the total purchase consideration was allocated to the assets acquired and the liabilities assumed based on their fair values at the date of acquisition. The fair value of the net assets acquired exceeded the purchase consideration by \$156,579, which was allocated as a pro-rata reduction of the fair values of the noncurrent assets that were acquired (property and equipment, and identifiable intangible assets). The total purchase consideration and the allocation to the acquired assets and assumed liabilities was as follows:

Purchase consideration:	
Cash paid	\$ 1,400,000
Company stock and stock options issued	5,710,430
Acquisition costs	162,395
Total purchase consideration	\$ 7,272,825
Allocation of purchase consideration:	
Cash acquired	\$ 2,039,130
Other current assets	1,143,706
Property and equipment	1,928,000
Identifiable intangible assets	3,746,621
Goodwill	
Total assets acquired	8,857,457
Current liabilities assumed	(1,184,632)
Liability related to an acquisition contingency	(400,000)
Net assets acquired	\$ 7,272,825

Current assets acquired relate primarily to accounts receivable, and current liabilities assumed primarily relate to accounts payable and accrued expenses.

The Company was required to restrict and escrow \$400,000 of cash on the date of the acquisition, which was to be paid to the former stockholders of Transchannel, after deducting the amount of acquired



**Table of Contents****SUREBRIDGE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

receivables that the Company was unable to collect within the 120 days immediately following the date of acquisition. The Company recorded the \$400,000 of contingent consideration as a liability as of December 31, 2002. The amount was paid in 2003.

The terms of the acquisition also included an additional payment to the former stockholders of Transchannel, if the former stockholders were able to meet certain performance goals during the six month period following the date of acquisition. The maximum earnout was \$1.8 million payable in one third cash, one third preferred stock and one third common stock. In July 2003, the Company settled the earnout consideration for 679,083 shares of Series E Preferred Stock and 169,996 shares of Series F Preferred Stock, with an estimated fair value of \$600,000. Payment of the earnout was contingent upon continued employment with the Company during the six-month earnout period. The Company accrued \$200,000 through general and administrative expense as of December 31, 2002.

The following are the identifiable intangible assets acquired and the respective periods over which the assets will be amortized on a straight-line basis:

	<b>Weighted Average Useful Life (Months)</b>	<b>Amount</b>
	<u>                    </u>	<u>                    </u>
Customer base	75	\$3,406,019
Noncompete agreements	24	262,750
Other intangibles	24	77,852
		<u>                    </u>
		<b>\$3,746,621</b>
		<u>                    </u>

The weighted average useful life of all identifiable intangible assets acquired is 71 months.

The following unaudited pro forma results of operations for the years ended December 31, 2002 and 2001 give effect to the Company's acquisition of Transchannel as if the transaction had occurred at the beginning of 2001. The pro forma information does not necessarily reflect the results of operations that would have occurred had the acquisitions taken place at the beginning of 2001 and is not necessarily indicative of results that may be obtained in the future.

	<b>2002</b>	<b>2001</b>
	<u>                    </u>	<u>                    </u>
Revenue	\$32,439,172	\$ 34,742,164
Net loss	(6,503,831)	(24,883,056)

**4. Property and Equipment**

Property and equipment consist of the following:

	<b>Estimated Useful Life (Years)</b>	<b>December 31,</b>	
	<u>                    </u>	<u>                    </u>	<u>                    </u>
		<b>2002</b>	<b>2001</b>
		<u>                    </u>	<u>                    </u>
Computer equipment	2 to 5	\$ 8,169,602	\$ 5,526,321
Computer software	1 to 4	1,322,096	695,635

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Furniture and fixtures	3 to 7	978,487	723,971
Leasehold improvements	3 to 7	512,885	202,193
		<u>10,983,070</u>	<u>7,148,120</u>
Less: accumulated depreciation		(5,637,921)	(3,234,342)
Property and equipment, net		<u>\$ 5,345,149</u>	<u>\$ 3,913,778</u>

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**Table of Contents****SUREBRIDGE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The cost of equipment under capital lease and the related accumulated depreciation totaled \$1,670,304 and \$1,206,228, respectively, at December 31, 2002 and \$1,244,298 and \$835,457, respectively, at December 31, 2001.

Depreciation expense was \$2,403,579 and \$1,998,124 in 2002 and 2001, respectively.

**5. Goodwill and Other Intangible Assets**

The Company acquired goodwill and other intangible assets through acquisitions in the years ended December 31, 2002, 2000 and 1999.

In June 2001, the FASB issued SFAS No. 142. SFAS 142 addresses financial accounting and reporting for acquired goodwill and other intangible assets, including how goodwill and other intangible assets should be accounted for after they have been initially recognized. SFAS No. 142 provides that goodwill and intangible assets that have indefinite useful lives not be amortized but rather be tested at least annually for impairment; intangible assets with finite useful lives continue to be amortized over their useful lives.

The Company adopted SFAS No. 142 on January 1, 2002 and discontinued the amortization of goodwill (including acquired workforce) of \$4,396,498. Upon adoption, the Company reclassified \$1,208,611 of previously amortizable acquired workforce to goodwill, with an offsetting reversal associated with the deferred tax liability of \$475,297. Goodwill and acquired workforce amortization were \$2,231,303 and \$694,643, respectively, for the year ended December 31, 2001. The Company estimates that goodwill and acquired workforce amortization expense would have been approximately \$1,430,405 and \$411,310, respectively for the year ended December 31, 2002. The following table presents a reconciliation of net loss for the exclusion of goodwill and acquired workforce amortization for the years ended December 31, 2002 and 2001, as if SFAS No. 142 had been adopted by the Company as of the beginning of each year:

	Year Ended December 31,	
	2002	2001
Net loss, as reported	\$(5,872,520)	\$(22,969,961)
Goodwill amortization		2,231,303
Acquired workforce amortization		694,643
Pro forma net loss	\$(5,872,520)	\$(20,044,015)

Under SFAS No. 142, the Company was required to complete a transitional impairment test on all goodwill effective as of January 1, 2002 on a reporting unit basis. A reporting unit is defined as an operating segment or one level below an operating segment referred to as a component. A component of an operating segment is a reporting unit if the component constitutes a business and discrete financial information is prepared and regularly reviewed by management. The Company determined that it operates in one reporting unit and, therefore, has completed the transitional goodwill impairment test on an enterprise-wide basis.

The fair value of the reporting unit was determined with the assistance of an independent valuation specialist as of January 1, 2002. As the fair value of the reporting unit as of January 1, 2002 was in excess of the carrying amount of the net assets, the Company concluded that its goodwill was not impaired, and no impairment charge was recorded. The Company performed its annual assessment for 2002 as of September 30, 2002, and the fair value of the reporting unit was determined to be in excess of the carrying amount of the net assets. Therefore, no further analysis was required under SFAS No. 142.

Other intangible assets are amortized on a straight-line basis over their estimated useful lives of two months to seven years. As required, upon the adoption of SFAS No. 142, the Company reassessed the





**Table of Contents****SUREBRIDGE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

useful lives of its intangible assets and determined that no adjustments were required. The following tables summarize other intangible assets by major intangible asset class as of December 31, 2002 and 2001, respectively:

	Estimated Useful Life (Months)	Gross	Accumulated Amortization	Net
<b>December 31, 2002</b>				
Acquired customer base	2 to 84	\$5,169,863	\$(1,761,902)	\$3,407,961
Noncompete agreements	18 to 24	535,925	(295,071)	240,854
Other intangibles	24 to 36	283,852	(206,028)	77,824
		<u>\$5,989,640</u>	<u>\$(2,263,001)</u>	<u>\$3,726,639</u>
<b>December 31, 2001</b>				
Acquired customer base	3 to 54	\$1,763,844	\$(1,386,900)	\$ 376,944
Acquired workforce	48 to 72	2,255,357	(1,046,746)	1,208,611
Noncompete agreements	18 to 24	273,175	(203,196)	69,979
Other intangibles	24 to 36	206,000	(141,604)	64,396
		<u>\$4,498,376</u>	<u>\$(2,778,446)</u>	<u>\$1,719,930</u>

The estimated future amortization of other intangible assets is as follows:

2003	\$ 876,273
2004	656,425
2005	514,507
2006	514,507
2007 and thereafter	1,164,927
	<u>\$3,726,639</u>

The Company recorded an impairment charge of \$4,068,306 during 2001, to adjust the carrying amount of goodwill and other intangible assets to their fair value as of December 31, 2001.

**6. Accrued Expenses and Other Current Liabilities**

Accrued expenses consist of the following:

December 31,	
2002	2001
<u>                    </u>	<u>                    </u>

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Compensation and benefits	\$ 1,561,495	\$ 1,390,280
Professional fees	813,289	97,058
Consultant fees	253,378	20,618
Software costs	115,756	229,085
Other	133,388	148,737
	<u>\$2,877,306</u>	<u>\$1,885,778</u>

As of December 31, 2002, other current liabilities consisted of \$600,000 of payments related to the acquisition (see Note 3) that were paid in 2003, \$467,099 of various legal settlement costs (see Note 15), \$246,927 related to a minimum purchase commitment with a hardware supplier, and \$205,537 for internal-

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**Table of Contents****SUREBRIDGE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

use software licenses. As of December 31, 2001, other current liabilities consisted of \$748,000 of various legal settlement costs, the majority of which were paid during 2002 and 2003, and \$246,927 related to a minimum purchase commitment with a hardware supplier.

**7. Long-Term Debt**

On February 21, 2002, the Company entered into a loan and security agreement with a commercial bank for the purpose of refinancing an existing loan. The agreement includes a term loan that replaced the existing loan and two equipment credit lines, whereby the Company could borrow up to a total of \$2,500,000 under the equipment credit lines to finance certain equipment purchases through December 31, 2002. The agreement also includes certain financial covenants related to, among other things, quick-ratio and earnings. Borrowings under these loan facilities are collateralized by substantially all of the assets of the Company.

The Company borrowed \$2,500,000 under the term loan, repayable in 28 monthly installments, which began on March 1, 2002. Interest on this loan is prime plus 2% (5.25% as of December 31, 2002).

During 2002, the Company borrowed \$1,198,523 on the first equipment line. This credit line is repayable in 30 monthly installments, which began on August 1, 2002. Interest on this credit line is prime plus 2% (5.25% as of December 31, 2002).

During 2002, the Company borrowed \$964,534 on the second equipment line. This credit line is repayable in 30 monthly installments, which begin on January 1, 2003. Interest on this credit line is prime plus 2% (5.25% as of December 31, 2002).

Amounts outstanding under these borrowing arrangements totaled \$3,570,446 at December 31, 2002 and future annual principal payments are as follows:

Year Ending December 31,	
2003	\$ 1,936,651
2004	1,400,937
2005	232,858
	<hr/>
Total principal payments	3,570,446
Less: current portion	(1,936,651)
	<hr/>
Total long-term principal obligation	\$ 1,633,795
	<hr/>

In conjunction with the loan and security agreement, the Company issued a warrant to the bank pursuant to which the bank can purchase up to 90,000 shares of the Company's common stock at a price of \$0.50 per share. At the date of issuance, the fair value of the warrant was estimated to be \$36,636, using the Black Scholes method. The fair value was recorded as a discount on the term loan, and is being accreted to interest expense over the term of the loan (28 months). The unamortized portion of this discount was \$23,553 at December 31, 2002.

**8. Commitments****Leases**

The Company leases its facilities and certain computer equipment under operating and capital leases. The leases expire at various dates through December 1, 2006. Total rent expense under these operating leases was \$1,883,815 and \$1,476,841 for the years ended December 31, 2002 and 2001, respectively.



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Future minimum lease payments under noncancelable leases are as follows:

Year Ending December 31,	Operating Leases	Capital Leases
2003	\$2,535,916	\$ 269,456
2004	1,910,761	14,849
2005	566,401	5,500
2006	215,193	
<b>Total payments</b>	<b>\$5,228,271</b>	<b>289,805</b>
Less: portion representing interest		(25,070)
<b>Total principal obligation</b>		<b>264,735</b>
Less: current portion		(246,236)
<b>Total long-term principal obligation</b>		<b>\$ 18,499</b>

**9. Redeemable Convertible Preferred Stock**

On October 25, 2002, the Company completed a Fourth Amended and Restated Certificate of Incorporation reflecting the issuance of the Series E and Series F Preferred Stock in the acquisition of Transchannel (see Note 3), and amending certain preferences and rights of each of the other classes of shares.

The Company has 42,306,030 shares of \$0.01 par value preferred stock authorized, of which 750,000 shares are designated as Series A Preferred Stock ( Series A ), 1,200,000 shares are designated as Series B Preferred Stock ( Series B ), 6,432,603 shares are designated as Series C Preferred Stock ( Series C ), 23,994,179 shares are designated as Series D Preferred Stock ( Series D ), 7,943,398 shares are designated as Series E, and 1,985,850 shares are designated as Series F.

The following is a rollforward of Redeemable Convertible Preferred Stock for the years ended December 31, 2002 and 2001:

	Shares	Amount
Balance, December 31, 2000	8,382,603	\$39,009,458
Issuance of Series D preferred stock	12,711,718	8,211,642
Accretion of dividend on Series A preferred stock		69,865
Balance, December 31, 2001	21,094,321	47,290,965
Issuance of Series E and Series F preferred stock in conjunction with the acquisition of Transchannel	9,078,014	5,700,000
Accretion of dividend on Series A preferred stock		75,623
Accretion of Series E preferred stock to redemption value		65,642
Balance, December 31, 2002	<b>30,172,335</b>	<b>\$53,132,230</b>



**Table of Contents****SUREBRIDGE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Redeemable Convertible Preferred Stock consisted of the following:

		December 31,	
		2002	2001
Series A:	750,000 shares issued and outstanding at December 31, 2002 and 2001 (at liquidation value)	\$ 993,033	\$ 917,410
Series B:	1,200,000 shares issued and outstanding at December 31, 2002 and 2001 (at liquidation value)	1,200,000	1,200,000
Series C:	6,432,603 shares issued and outstanding at December 31, 2002 and 2001 (at liquidation value)	36,961,913	36,961,913
Series D:	12,711,718 shares issued and outstanding at December 31, 2002 and 2001 (at liquidation value)	8,211,642	8,211,642
Series E:	7,262,411 shares issued and outstanding at December 31, 2002 (liquidation value \$5,118,983)	4,265,642	
Series F:	1,815,603 shares issued and outstanding at December 31, 2002 (liquidation value \$1,279,746)	1,500,000	
		\$53,132,230	\$47,290,965

The Company's various series of preferred stock have the following characteristics:

**Dividends**

Holders of Series A are entitled to receive dividends equal to the greater of 8% per annum of the Series A base amount, or an amount per share equal to the dividends payable on the shares of common stock into which such shares are then convertible. Dividends on Series A accrue whether declared or not, and are cumulative. Dividends on Series A are payable quarterly and, if unpaid, increase the base amount of Series A, which was initially \$1.00. At December 31, 2002, Series A had a base amount of approximately \$1.32 per share, including accrued and unpaid dividends. Unpaid dividends shall be paid upon the merger, sale or change of control of the Company (as defined) or in the event of a firmly underwritten public offering in which the price per share of common stock is such that the equity valuation of the Company immediately prior to the public offering is at least \$173,324,000, and the net proceeds to the Company are at least \$15 million. Holders of Series B, Series C, Series D, Series E and Series F are entitled to receive dividends equal to the amount that the holder would have received if the shares were converted to common stock. Unpaid dividends, whether declared or not, on Series A, and declared but unpaid dividends on Series B, Series C, Series D, Series E and Series F are also paid upon liquidation or redemption.

**Liquidation**

Holders of Series D and Series F have preference in liquidation to holders of common stock and holders of Series A, Series B, Series C and Series E in the amount of \$0.64599 per share and \$0.70486 per share, respectively, (adjusted for any stock dividends, combinations, splits, recapitalizations and the like with respect to such shares) plus all unpaid dividends declared on the Series D and Series F.

Holders of Series C and Series E have preference in liquidation to holders of common stock and holders of Series A and Series B in the amount of \$0.70486 per share and \$5.753814 per share, respectively, (adjusted for any stock dividends, combinations, splits, recapitalizations and the like with respect to such shares) plus all unpaid dividends declared on the Series C and Series E.

Holders of Series A and B have preference to holders of common stock in the amount of \$1.00 per share (as adjusted for any stock dividends, combinations, splits, recapitalizations and the like with respect





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**SUREBRIDGE, INC.**

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

to such shares), plus any unpaid dividends declared on the Series B and any unpaid dividends, whether or not declared, on the Series A.

Holders of Series C, Series D, Series E and Series F, along with the holders of common stock, participate in any remaining distribution upon liquidation, on an as-if-converted basis, immediately prior to any such liquidation.

If the payment to the holders of Series C (assuming conversion of all Preferred Stock to common stock and no payment of the Series A, Series B, Series C, Series D, Series E and Series F liquidation amounts) equals or exceeds \$17.2624 per share (adjusted for any stock dividends, combinations, splits, recapitalizations and the like with respect to such shares), the liquidation protection terminates and the holders of the Series C, Series D and Series E shall participate pro rata along with the holders of common stock on an as-if-converted basis without payment of the Series C, Series D and Series E liquidation amounts. If the payment to the holders of Series A and Series B, assuming conversion to common stock, exceeds the Series A and Series B liquidation amount, respectively, then in addition to the accrued dividends (whether or not declared in the case of the Series A) the holders of Series A and Series B shall participate pro rata along with the holders of common stock, and depending on whether there is any pro rata participation of the holders of Series C, Series D, Series E and Series F, in the remaining distribution in all liquidation proceeds as if the Series A and the Series B had been converted into common stock. A sale of the Company or a merger with or into another entity is considered a deemed liquidation.

**Conversion**

Holders of Series E and Series F have the right to convert their shares into common stock at a conversion ratio of one common share for each Series E or Series F share (as adjusted for any stock dividends, combinations, splits, recapitalizations and the like with respect to such shares).

Holders of Series D have the right to convert their shares into common stock at a conversion ratio of 0.916479 common shares for each Series D share (adjusted for any stock dividends, combinations, splits, recapitalizations and the like with respect to such shares).

Holders of Series C have the right to convert their shares into common stock at a conversion ratio of 2.511935 common shares for each Series C share (as adjusted for any stock dividends, combinations, splits, recapitalizations and the like with respect to such shares).

Holders of Series A and Series B also have the right to convert their shares into common stock at a conversion ratio of 2.002962 common shares for each Series A or Series B share (as adjusted for any stock dividends, combinations, splits, recapitalizations and the like with respect to such shares).

Each share of preferred stock automatically converts into common stock at any time upon the election of 66 2/3% of the outstanding Series C shares or immediately upon a firmly underwritten public offering in which the price per share of common stock is such that the equity valuation of the Company immediately prior to the public offering is at least \$173,324,000, and the net proceeds to the Company are at least \$15 million.

If the Company issues additional common shares below the conversion price of the Series A, Series B, Series C, Series D, Series E and Series F (\$0.4992605, \$0.4992605, \$2.29059, \$0.64599, \$0.70486 and \$0.70486 at December 31, 2002, respectively), other than as a dividend or other distribution on the Company's common stock (as defined), then the existing Series A, Series B, Series C, Series D, Series E and Series F conversion price shall be reduced accordingly. This may result in the recording of a beneficial conversion feature in future periods.

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**SUREBRIDGE, INC.**

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

**Voting**

Preferred stockholders are entitled to vote, together with the holders of common stock, on all matters submitted to stockholders for a vote. Each preferred stockholder is entitled to the number of votes equal to the number of shares of common stock into which each preferred share is convertible at the time of such vote. Directors appointed by the Series D shareholders have certain special voting rights related to matters such as changes in the certificate of incorporation, incurring indebtedness, sale of the corporation, acquisition of assets and liabilities other than in the normal course of business and authorization or issuance of any additional class or series of capital stock.

**Redemption**

Between February 11, 2007 and February 11, 2009, the holders of at least fifty percent of the outstanding shares of any series of preferred stock have the right to require the Company to redeem the shares of preferred stock owned by such holders. The redemption price is equal to the greater of \$0.70486 per share for the Series F and Series E, \$0.64599 per share for the Series D, \$5.753814 per share for the Series C and \$1.00 per share for the Series A and B, plus all unpaid dividends accrued on such shares (whether or not earned or declared in the case of the Series A), or the then current fair market value per share.

The holders of Series D and Series F have redemption preference over all other classes of shares and the holders of Series C and Series E have redemption preference over all other classes of shares, with the exception of Series D and Series F.

**10. Common Stock**

The Company has 65,000,000 shares of \$0.01 par value common stock authorized, of which 9,958,552 and 9,901,056 shares were outstanding as of December 31, 2002 and 2001, respectively. Each share of common stock is entitled to one vote. The holders of common stock are entitled to receive dividends whenever funds are legally available, and when and if declared by the Board of Directors, subject to the prior rights of holders of all classes of stock outstanding (see Note 9). Upon the liquidation, dissolution or winding up of the Company, holders of common stock will be entitled to received all available assets, subject to any preferential rights of any then outstanding preferred stock. The Company has never declared or paid dividends on its common stock.

As of December 31, 2002, the Company has reserved 1,502,222, 2,403,554, 16,158,281, 11,650,023, 7,262,411 and 1,815,603 shares of common stock for the conversion of the Series A, Series B, Series C, Series D, Series E and Series F preferred stock, respectively. Additionally, the Company has reserved 6,631,982 shares of common stock for issuance pursuant to the Company's 1998 Stock Plan (see Note 11), and 90,000 shares of common stock for the outstanding warrants, as of December 31, 2002.

**Restricted Stock and Treasury Stock**

On July 1, 2002, the Company sold 725,000 shares of restricted common stock, with a purchase price of \$0.50 per share, to the Chief Executive Officer ( CEO ) of the Company. As consideration for this restricted stock, the CEO executed and delivered a promissory note in the amount of \$362,000 to the Company.

On September 9, 2002, the CEO executed his right to sell all of these restricted shares back to the Company at the \$0.50 per share purchase price, and the Company canceled the indebtedness under the promissory note. These shares are held in treasury at December 31, 2002.

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**SUREBRIDGE, INC.**

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

The Company acquired 158,612 shares of its common stock from an employee during 2001 in exchange for the cancellation of a noncompete agreement. These shares are held in treasury at December 31, 2002 and 2001.

**Warrants**

In connection with the loan and security agreement that the Company entered into during 2002 (see Note 7), the Company granted a warrant to purchase 90,000 shares of common stock at an exercise price of \$0.50. The warrant may be exercised at any time before February 21, 2009, at which time it expires.

**11. Stock Plan**

In May 1998, the Company adopted the 1998 Stock Incentive Plan (the Stock Plan) that provides for the issuance of restricted common stock, and incentive and nonstatutory common stock options to employees, directors and consultants of the Company. The Board of Directors determines the term of each option, option price, number of shares for which each option is granted, whether restrictions will be imposed on the shares subject to options and the rate at which each option is exercisable. The exercise price for incentive stock options may not be less than the fair market value per share of the underlying common stock on the date granted (110% of fair market value in the case of holders of more than 10% of the voting stock of the Company) and the term of incentive stock options may not exceed ten years (five years in the case of holders of more than 10% of the voting stock of the Company). The Board of Directors reserved 6,714,000 shares of common stock to be issued in conjunction with the Stock Plan. There were 6,631,982 and 6,689,478 shares available for issuance under the Stock Plan as of December 31, 2002 and 2001, respectively.

Consistent with the provisions of APB No. 25, the Company recognizes compensation expense for the excess of the fair value of the shares optioned over the exercise price, determined as of the grant date. The Company recognizes compensation cost on an accelerated basis over the periods in which the services being compensated are performed, generally the vesting period (three years).

For purposes of pro forma disclosure, the fair value of each employee option grant was estimated on the date of grant using the minimum value method with the following assumptions for grants in 2002 and 2001: no dividend yield; weighted average risk-free interest rates of 3.40% for 2002 and 4.64% for 2001; and an expected life of five years.

During the year ended December 31, 2001, the Company also granted fully vested options to nonemployees. The fair value of each nonemployee grant was estimated on the date of grant using the Black Scholes method with the following assumptions: no dividend yield; weighted average risk-free interest rate of 4.88%; volatility of 100%; and a contractual life of three years. The Company recorded a compensation charge of \$10,298 during the year ended December 31, 2001 for these nonemployee stock option grants.

In 2001, the Company made an offer to employees to cancel their employee stock options in return for a replacement grant of stock options, with an exercise price at the then current fair market value, six months and one day after the cancellation date. On June 22, 2001 the Company canceled 2,316,500 stock options and recorded a compensation charge to recognize the unamortized deferred compensation previously recorded for stock options issued below fair market value. This charge plus partially offsetting reductions to stock-based compensation for stock options forfeited prior to June 22, 2001 totaled \$2,138,743. On December 26, 2001 the Company issued 1,676,950 replacement options with an exercise price of \$0.50 per share.

**Table of Contents****SUREBRIDGE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The following table summarizes the activity of the Company's stock option plan:

	Year Ended December 31, 2002			Year Ended December 31, 2001		
	Number of Options	Weighted Average Exercise Price	Range of Exercise Prices	Number of Options	Weighted Average Exercise Price	Range of Exercise Prices
Outstanding beginning of year	3,690,935	\$0.75	\$ 0.01 - \$4.50	4,230,085	\$2.59	\$ 0.01 - \$4.50
Granted	3,019,078	\$0.50	\$ 0.50	2,965,300	\$0.58	\$ 0.50 - \$2.87
Exercised	(57,496)	\$0.27	\$0.125 - \$0.65	(19,516)	\$1.56	\$ 0.01 - \$4.50
Canceled/forfeited	(1,707,004)	\$0.61	\$ 0.01 - \$2.87	(3,484,934)	\$2.84	\$0.125 - \$4.50
Outstanding end of year	<u>4,945,513</u>	\$0.64	\$0.125 - \$4.50	<u>3,690,935</u>	\$0.75	\$ 0.01 - \$4.50

The following table summarizes information about stock options granted during the years ended December 31, 2002 and 2001:

	Year Ended December 31, 2002			Year Ended December 31, 2001		
	Number of Options	Weighted Average Exercise Price	Weighted Average Grant Date Fair Value	Number of Options	Weighted Average Exercise Price	Weighted Average Grant Date Fair Value
Granted with an exercise price equal to the fair market value of the stock	3,019,078	\$0.50	\$0.08	2,920,300	\$0.54	\$0.10
Granted with an exercise price above the fair market value of the stock				45,000	\$2.87	\$0.23
Total granted	<u>3,019,078</u>	\$0.50	\$0.08	<u>2,965,300</u>	\$0.58	\$0.11

During 2002, 375,000 stock options with an original exercise price of \$0.65 were repriced to an exercise price of \$0.50, and are therefore subject to a variable accounting model.

The following table summarizes information about stock options outstanding at December 31, 2002:

Exercise Price	Options Outstanding			Options Exercisable	
	Shares	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
\$0.125	48,000	5.59	\$0.125	48,000	\$0.125

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\$0.50		4,435,228	9.32	\$ 0.50	1,458,334	\$ 0.50
\$0.65		181,350	1.66	\$ 0.65	168,925	\$ 0.65
\$2.25		2,000	6.80	\$ 2.25	2,000	\$ 2.25
\$2.87		276,935	0.85	\$ 2.87	274,685	\$ 2.87
\$4.50		2,000	7.86	\$ 4.50	1,333	\$ 4.50
		<u>          </u>			<u>          </u>	
\$0.125	\$4.50	4,945,513	8.52	\$ 0.64	1,953,277	\$ 0.84
		<u>          </u>			<u>          </u>	

**12. Significant Customers**

During 2002 and 2001, the Company did not have any customers that individually accounted for 10% or more of revenue. The Company had a total of five customers that accounted for 19% and 28% of total revenue in 2002 and 2001, respectively.

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**Table of Contents****SUREBRIDGE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****13. Employee Benefit Plan**

In 1998, the Company established a savings plan (the Plan) which was designed to be qualified under Section 401(k) of the Internal Revenue Code, covering substantially all of its employees. Eligible employees are permitted to contribute to the Plan through payroll deductions, within statutory and plan limits. The Plan provides for a discretionary employer matching contribution. The Company authorized matching contributions of \$206,189 and \$529,513 for the years ended December 31, 2002 and 2001, respectively.

**14. Income Taxes**

For the year ended December 31, 2002, the total income tax provision of \$475,297 consists of a federal deferred provision of \$366,476 and a state deferred provision of \$108,821. There is no tax provision or benefit for the year ended December 31, 2001.

The Company's deferred tax assets and (liabilities) are comprised of the following as of December 31, 2002 and 2001:

	2002	2001
Net operating loss carryforwards	\$ 14,354,891	\$ 10,371,563
Amortization/intangibles	1,090,812	1,166,577
Bad debts	82,559	152,623
Accruals and reserves	442,604	388,014
Other	8,870	442
Depreciation	150,297	(127,779)
Cash to accrual differences	(32,245)	(32,245)
Intangibles	(1,490,272)	(678,922)
	14,639,761	11,240,273
Valuation allowance	(14,639,761)	(11,240,273)
Net deferred tax asset	\$	\$

The table below reconciles the expected U.S. federal statutory income tax rate to the effective tax rate for 2002 and 2001:

	2002	2001
U.S. statutory tax rate	(34.0)%	(34.0)%
State taxes	(6.0)	(4.3)
Change in valuation allowance	47.2	28.6
Other	1.6	9.7
Effective tax rate	8.8%	%

As of December 31, 2002, the Company had a federal net operating loss (NOL) carryforward of approximately \$35,840,000 which may be available to offset future federal income tax liabilities through 2022. This net operating loss includes approximately \$5,877,000 of net operating losses acquired through the acquisition of Transchannel. The usage of this net operating loss will be subject to limitations due to the ownership change rules. As required by Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes, management of the

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Company has evaluated the positive and negative evidence bearing upon the realizability of its deferred tax assets, and has determined that it is more likely

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**SUREBRIDGE, INC.**

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

than not that the Company will not be able to recognize the benefits of federal and state deferred tax assets and, as a result, a valuation allowance of \$14,639,761 has been established at December 31, 2002.

Ownership changes, as defined in the Internal Revenue Code, may limit the amount of net operating loss carryforwards that can be utilized annually to offset future taxable income. Subsequent ownership changes could further affect the limitation in future years.

**15. Legal Proceedings**

During 2002, a software vendor asserted claims against the Company for software licensing infringements and filed a complaint in federal court seeking relief for monetary damages and unspecified punitive damages. The Company settled these claims during 2002 for \$375,000, of which \$300,000 was paid during 2002, and the remaining \$75,000 was paid in 2003.

During 2002, the Company began settlement discussions with another software vendor, regarding software-licensing infringements. On March 24, 2003, the Company reached a final settlement with this software vendor in the amount of \$302,000. In addition, in 2002 and 2003, the Company purchased additional licenses in the amount of \$205,537 for other software products, where the Company was not in compliance with software licenses.

For these matters, amounts included in other current liabilities in the consolidated balance sheet totaled \$582,537 and \$712,000 at December 31, 2002 and 2001, respectively.

The Company is subject to a number of other claims and legal proceedings which, in the opinion of the Company's management, are incidental to the Company's normal business operations. In the opinion of the Company, although final settlement of these claims and legal proceedings may impact the Company's financial statements in a particular period, they will not, in the aggregate, have a material adverse effect on the Company's financial position, results of operations or cash flows.

**16. Related Party Transactions**

Included in revenue for the years ended December 31, 2002 and 2001 is \$1,247,086 and \$1,336,558, respectively, of sales to three companies that are affiliated with a director of the Company and partially or fully owned by Berkshire Companies Limited Partnership (BCLP), a shareholder of the Company. Accounts receivable balances related to these customers totaled \$24,797 and \$17,184 at December 31, 2002 and 2001, respectively.

The Company sublets certain office space from BCLP to house its data center. Rent expense related to this lease was \$40,524 and \$206,080 for the years ended December 31, 2002 and 2001, respectively.

**17. Subsequent Events**

**Acquisition**

On March 5, 2003, the Company acquired all of the shares of ManagedOps.com, Inc. ( ManagedOps ), a Delaware company with its principal place of business in New Hampshire. The consideration consisted of 6,039,909 shares of preferred stock (150,135 shares of Series A, 240,216 shares of Series B, 1,287,681 shares of Series C, 2,544,636 shares of Series D, 1,453,792 shares of Series E and 363,448 shares of Series F).

The shares issued to the seller as consideration are subject to a repurchase agreement by the Company. In the event that Surebridge needs to pay cash under certain personal guarantee agreements and certain bonus agreements, Surebridge has the right to repurchase the shares at par value. The number of shares subject to repurchase is determined by the fair value of the shares at the time of the repurchase.





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**SUREBRIDGE, INC.**

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

The fair value is based on the fair value of the Company taking into account the liquidation preferences. The aggregate value of the repurchased shares cannot exceed the cash consideration paid by the Company with respect to the aforementioned obligations.

ManagedOps had issued a warrant to a vendor to purchase 530,519 shares of its common shares at a price of \$0.37 per share. Pursuant to the terms of the warrant agreement, upon the acquisition of the ManagedOps, the warrants become exercisable for shares of common stock of Surebridge.

ManagedOps provided sales, deployment, implementation and application support of Microsoft Software throughout the United States, and as such, complements the business of the Company.

**Loan Facility**

On April 2, 2003, the Company entered into a loan modification agreement, amending certain terms of the existing loan and security agreement (see Note 7). The modification agreement added four additional equipment credit lines, allowing the Company to finance certain equipment purchases through March 31, 2004; the agreement did not change any of the terms related to the borrowings that were outstanding under the already existing term loan and equipment credit lines (see Note 7). The modification agreement also includes certain financial covenants related to quick-ratio and profitability.

The Company had the ability to borrow \$1,000,000 under the first equipment line, which was available through June 30, 2003, \$1,000,000 under the second equipment line, which was available through September 30, 2003, \$750,000 under the third equipment line, which was available through December 31, 2003, and \$750,000 under the fourth equipment line, which was available through March 31, 2004. Borrowings under these equipment lines accrue interest at the rate of prime plus 2%, and are repayable in 33 monthly installments. Borrowings under these equipment credit lines are collateralized by substantially all of the assets of the Company.

On March 4, 2004, the Company entered into a second loan modification agreement and loan and security agreement, amending certain terms of the modified loan agreements, which the Company entered into on April 2, 2003. The second modification agreements establish an additional loan facility, which allows the Company to borrow a maximum of \$2,500,000 through March 3, 2005. Borrowings under this loan facility accrue interest at the rate of prime plus 2%, interest is payable monthly, and any unpaid principal balance is due on March 3, 2005. Borrowings are collateralized by substantially all of the assets of the Company, although the agreements also require the Company to pledge three certificates of deposit totaling \$750,000. The second modification agreements also include certain financial covenants related to profitability and capital expenditures.

**Acquisition by Navisite, Inc.**

On May 6, 2004, NaviSite, Inc. ( NaviSite ) and the Company announced the execution of a definitive asset purchase agreement, pursuant to which NaviSite will acquire substantially all of the assets and liabilities of the Company. Under the terms of the agreement, NaviSite will acquire the assets of the Company in exchange for two promissory notes in the aggregate principal amount of \$39.5 million (subject to certain adjustments), 3 million shares of NaviSite common stock and the assumption of certain liabilities at the time of closing. The closing of the acquisition is expected to occur by the end of May 2004, and is subject to the satisfaction of customary closing conditions.

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**UNAUDITED PRO FORMA CONDENSED COMBINED FINANCIAL INFORMATION**

The following is the unaudited pro forma financial information included in this Information Statement:

Pro Forma Condensed Combined Balance Sheet as of April 30, 2004 (unaudited)

Pro Forma Condensed Combined Statement of Operations for the three months ended April 30, 2004 (unaudited)

Pro Forma Condensed Combined Statement of Operations for the nine months ended April 30, 2004 (unaudited)

Pro Forma Condensed Combined Statement of Operations for the year ended July 31, 2003 (unaudited)

The unaudited pro forma condensed combined balance sheet as of April 30, 2004 combines the unaudited condensed consolidated balance sheet of NaviSite as of April 30, 2004 with the condensed consolidated balance sheet of Surebridge as of March 31, 2004.

The unaudited pro forma condensed combined statement of operations for the year ended July 31, 2003 combines the unaudited pro forma condensed consolidated statement of operations of NaviSite for the fiscal year ended July 31, 2003 with the unaudited condensed consolidated results of operations of Surebridge for the twelve months ended June 30, 2003. In addition, the unaudited pro forma condensed combined statements of operations for the three and nine months ended April 30, 2004 combine the unaudited condensed consolidated statements of operations of NaviSite for the three and nine months ended April 30, 2004 with the unaudited condensed consolidated statements of operations of Surebridge for the three and nine months ended March 31, 2004.

The unaudited pro forma condensed combined statement of operations for the year ended July 31, 2003 also gives pro forma effect to NaviSite's other recent acquisitions of ClearBlue Technologies, Inc., or CBT, Interliant, Inc., or Interliant, Conxion Corporation, or Conxion, and ClearBlue Technologies Management, Inc., or CBTM, as if they had occurred as of August 1, 2002.

The following is a summary of the additional acquisitions noted above for which pro forma effect is given in the unaudited pro forma condensed combined statement of operations for the year ended July 31, 2003 for the portion of the fiscal year ended July 31, 2003 that each respective company was not owned by NaviSite:

In August 2003, NaviSite acquired all of the outstanding shares of six wholly-owned subsidiaries of CBT with data centers in various U.S. locations and assumed the revenue and expense of four additional wholly-owned subsidiaries of CBT. Pursuant to the acquisition agreement, as amended, NaviSite had the right to acquire the four additional subsidiaries for no additional consideration at any time on or prior to August 8, 2005. In April 2004, NaviSite exercised its right to acquire the additional four subsidiaries and thereby acquired all of the outstanding shares of the additional four wholly-owned subsidiaries of CBT. This transaction was accounted for as a combination of entities under common control, similar to a pooling-of-interests, whereby the assets and liabilities of the ten wholly-owned subsidiaries of CBT (as described above) and NaviSite were combined at their historical amounts as of the date CBT had control of both entities (September 11, 2002). CBT's results of operations and cash flows for the eleven months ended July 31, 2003 are included in NaviSite's consolidated statement of operations and consolidated statement of cash flows for the year ended July 31, 2003. The subsidiaries of CBT that NaviSite acquired are now operated as wholly-owned subsidiaries of NaviSite.

In May 2003, NaviSite acquired assets of Interliant related to managed messaging, application hosting and application development services. Interliant's results of operations and cash flows for the two-and-one-half months ended July 31, 2003 are included in NaviSite's consolidated statement

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of operations and consolidated statement of cash flows for the year ended July 31, 2003. The Interliant business is now operated as a wholly-owned subsidiary of NaviSite.

In April 2003, NaviSite acquired Conxion, a provider of application hosting, content and electronic software distribution and security services. Conxion's results of operations and cash flows for the four months ended July 31, 2003 are included in NaviSite's consolidated statement of operations and consolidated statement of cash flows for the year ended July 31, 2003. Conxion is operated as a wholly-owned subsidiary of NaviSite.

In December 2002, NaviSite acquired all of the issued and outstanding stock of CBTM, a wholly-owned subsidiary of CBT, NaviSite's then parent company which previously had acquired assets from the bankrupt estate AppliedTheory Corporation related to application management and application hosting services. As CBT had a controlling interest in both companies at the time of the combination, the transaction was accounted for as a combination of entities under common control, similar to a pooling-of-interests, whereby the assets and liabilities of CBTM and NaviSite were combined at their historical amounts as of the date CBT had control of both entities (September 11, 2002). CBTM's results of operations and cash flows for the eleven months ended July 31, 2003 are included in NaviSite's consolidated statement of operations and consolidated statement of cash flows for the year ended July 31, 2003. CBTM is operated as a wholly-owned subsidiary of NaviSite.

The unaudited pro forma financial information is not necessarily indicative of the results of operations or financial position of NaviSite had the transactions assumed therein occurred, nor are they necessarily indicative of the results of operations or financial position, which may be expected to occur in the future. Furthermore, the unaudited pro forma financial information is based on assumptions that NaviSite believes are reasonable and should be read in conjunction with NaviSite's Form 10-K for the fiscal year ended July 31, 2003 and Forms 10-Q for the fiscal quarters ended October 31, 2003, January 31, 2004 and April 30, 2004 previously filed.

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## NAVISITE, INC. AND SUBSIDIARIES

## PRO FORMA CONDENSED COMBINED BALANCE SHEET

	Consolidated NaviSite April 30, 2004	Surebridge March 31, 2004	Pro Forma Adjustments April 30, 2004	Pro Forma Total April 30, 2004
(Unaudited) (In thousands)				
<b>ASSETS</b>				
Current assets:				
Cash and cash equivalents	\$ 7,630	\$ 1,725	\$	\$ 9,355
Accounts receivable, net	13,583	4,564		18,147
Due from related party	12	43		55
Prepaid expenses and other current assets	4,224	1,461		5,685
	<u>25,449</u>	<u>7,793</u>		<u>33,242</u>
Property and equipment, net	15,388	7,782		23,170
Intangible assets, net	10,279	4,319		14,598
Goodwill	3,206	6,327	40,090(a)	49,623
Other assets	5,913	162		6,075
Restricted cash	1,253	475		1,728
	<u>61,488</u>	<u>26,858</u>	<u>40,090</u>	<u>128,436</u>
<b>LIABILITIES, REDEEMABLE CONVERTIBLE PREFERRED STOCK AND STOCKHOLDERS EQUITY (DEFICIT)</b>				
Current liabilities:				
Accounts receivable financing line	\$ 15,786	\$	\$	\$ 15,786
Current notes payable	1,048	3,618		4,666
Capital lease obligations, current portion	2,418	139		2,557
Current note payable to related party	3,000			3,000
Accounts payable	3,856	4,778		8,634
Accrued expenses	13,628	1,943	500(b)	16,071
Deferred revenue	2,196	936		3,132
Customer deposits	135	250		385
	<u>42,067</u>	<u>11,664</u>	<u>500</u>	<u>54,231</u>
Capital lease obligations, less current portion	830	24		854
Accrued impairment, less current portion	1,782			1,782
Note to AppliedTheory Estate	6,000			6,000
Notes payable	1,352	1,019	39,300(b)	41,671
Other long-term liabilities	737	71		808
	<u>52,768</u>	<u>12,778</u>	<u>39,800</u>	<u>105,346</u>
Redeemable convertible preferred stock		62,144	(62,144)(b)	
Stockholders' equity (deficit):				
Treasury stock		(465)	465(b)	
Common stock	249	109	(79)(b)	279
Deferred compensation	(1,699)			(1,699)
Accumulated other comprehensive income	9			9
Additional paid-in capital	438,482	9,487	4,853(b)	452,822
Accumulated deficit	(428,321)	(57,195)	57,195(b)	(428,321)

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Total stockholders equity (deficit)	8,720	(48,064)	62,434	23,090
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Total liabilities, redeemable convertible preferred stock and stockholders equity (deficit)	\$ 61,488	\$ 26,858	\$ 40,090	\$ 128,436
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>

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**Table of Contents****NAVISITE, INC. AND SUBSIDIARIES****PRO FORMA CONDENSED COMBINED STATEMENT OF OPERATIONS**

	<b>Consolidated NaviSite Three Months Ended April 30, 2004</b>	<b>Surebridge Three Months Ended March 31, 2004</b>	<b>Pro Forma Adjustments</b>	<b>Pro Forma Three Months Ended April 30, 2004</b>
	(Unaudited)			
	(In thousands, except per share data)			
Total revenue	\$ 20,185	\$ 11,940	\$	\$ 32,125
Cost of revenue:				
Cost of revenue	14,217	7,777		21,994
Impairment, restructuring and other				
Total cost of revenue	14,217	7,777		21,994
Gross profit	5,968	4,163		10,131
Operating expenses:				
Product development	230			230
Selling and marketing	1,848	1,961		3,809
General and administrative	6,097	2,534		8,631
Impairment, restructuring and other	206			206
Total operating expenses	8,381	4,495		12,876
Loss from operations	(2,413)	(332)		(2,745)
Other income (expense):				
Interest income	18	2		20
Interest expense	(656)	(89)	(983)(c)	(1,728)
Other income (expense), net	25			25
Net loss	\$ (3,026)	\$ (419)	\$ (983)	\$ (4,428)
Basic and diluted net loss per share	\$ (0.12)			\$ (0.16)
Weighted average basic and diluted shares used in computing net loss per share	24,809		3,000(b)	27,809

**Table of Contents****NAVISITE, INC. AND SUBSIDIARIES****PRO FORMA CONDENSED COMBINED STATEMENT OF OPERATIONS**

	<b>Consolidated NaviSite Nine Months Ended April 30, 2004</b>	<b>Surebridge Nine Months Ended March 31, 2004</b>	<b>Pro Forma Adjustments</b>	<b>Pro Forma Nine Months Ended April 30, 2004</b>
	(Unaudited)			
	(In thousands, except per share data)			
Total revenue	\$ 65,987	\$ 33,079	\$	\$ 99,066
Cost of revenue:				
Cost of revenue	48,899	22,925		71,824
Impairment, restructuring and other	633			633
Total cost of revenue	49,532	22,925		72,457
Gross profit	16,455	10,154		26,609
Operating expenses:				
Product development	890			890
Selling and marketing	5,724	6,533		12,257
General and administrative	16,342	8,633		24,975
Impairment, restructuring and other	1,608			1,608
Total operating expenses	24,564	15,166		39,730
Loss from operations	(8,109)	(5,012)		(13,121)
Other income (expense):				
Interest income	115	10		125
Interest expense	(1,935)	(250)	(2,948)(c)	(5,133)
Other income (expense), net	111			111
Net loss	\$ (9,818)	\$ (5,252)	\$ (2,948)	\$ (18,018)
Basic and diluted net loss per share	\$ (0.40)			\$ (0.65)
Weighted average basic and diluted shares used in computing net loss per share	24,685		3,000(b)	27,685



**Table of Contents****NAVISITE, INC. AND SUBSIDIARIES****PRO FORMA CONDENSED COMBINED STATEMENT OF OPERATIONS**

	<b>Consolidated NaviSite Twelve Months Ended July 31, 2003</b>	<b>Surebridge Twelve Months Ended June 30, 2003</b>	<b>CBT 8/1/02 - 8/31/02</b>	<b>CBTM 8/1/02 - 8/31/02</b>	<b>Conxion 8/1/02 - 3/31/03</b>	<b>Interliant 8/1/02 - 5/15/03</b>	<b>Pro Forma Adjustments</b>	<b>Pro Forma Year Ended July 31, 2003</b>
<b>(Unaudited)</b>								
<b>(In thousands, except per share data)</b>								
Total revenue	\$ 76,591	\$ 34,343	\$ 1,437	\$ 2,536	\$ 12,241	\$ 20,654	\$	\$ 147,802
Total cost of revenue	70,781	22,386	1,263	1,850	19,057	11,517		126,854
Gross profit (deficit)	5,810	11,957	174	686	(6,816)	9,137		20,948
Operating expenses:								
Product development	950					958		1,908
Selling and marketing	5,960	6,702	9	157	4,104	1,853		18,785
General and administrative	20,207	9,728	237	500	1,590	16,479		48,741
Impairment, restructuring and other	8,882				(4,135)			4,747
Total operating expenses	35,999	16,430	246	657	1,559	19,290		74,181
(Loss) income from operations	(30,189)	(4,473)	(72)	29	(8,375)	(10,153)		(53,233)
Other income (expense):								
Interest income	851	102			99	32		1,084
Interest expense	(43,403)	(299)		(140)		(3,284)	(3,930)(c)	(51,056)
Other income (expense), net	(733)	(111)		(21)	(209)	6,149		5,075
Loss before income tax expense	(73,474)	(4,781)	(72)	(132)	(8,485)	(7,256)	(3,930)	(98,130)
Income tax expense	(153)	(237)						(390)
Net loss	\$ (73,627)	\$ (5,018)	\$ (72)	\$ (132)	\$ (8,485)	\$ (7,256)	\$ (3,930)	\$ (98,520)
Basic and diluted net loss per share	\$ (6.32)							\$ (6.72)
Weighted average basic and diluted shares used in computing net loss per share	11,654						3,000(b)	14,654

**Table of Contents****NAVISITE, INC. AND SUBSIDIARIES****NOTES TO THE PRO FORMA CONDENSED COMBINED FINANCIAL INFORMATION****(Unaudited)****Pro Forma Adjustments and Assumptions****(a) Purchase Price Allocation**

The following represents the preliminary allocation of the estimated purchase price for NaviSite's acquisition of Surebridge over the historical net book values of the acquired assets and assumed liabilities of Surebridge as of the date of the pro forma balance sheet, and is for illustrative purposes only. Assuming the transaction occurred on April 30, 2004, the estimated purchase price allocation for the acquisition of Surebridge would have been as follows (in thousands):

Working capital, including cash acquired	\$ (3,871)
Property & equipment, net	7,782
Other non-current assets	4,956
Long-term debt	(1,019)
Non-current liabilities	(95)
Goodwill	46,417
	<hr/>
Purchase price	\$ 54,170
	<hr/>

The goodwill adjustment in the pro forma condensed combined balance sheet was determined as follows (in thousands):

Elimination of pre-existing Surebridge goodwill	\$ (6,327)
Goodwill resulting from the acquisition (see above)	46,417
	<hr/>
Goodwill adjustment	\$ 40,090
	<hr/>

The purchase price allocation for the acquisition of Surebridge is preliminary and is subject to adjustment upon finalization of the purchase accounting as of the date of consummation of the acquisition. In addition, NaviSite has not completed its valuation of intangible assets to be acquired. As a result, the final allocation of the excess of the purchase price over the book value of the net assets acquired could differ materially. Upon completion of its valuation of the intangible assets to be acquired, certain identifiable intangible assets may be recorded and would be subject to amortization. Assuming a five-year life, every \$1.0 million of identifiable intangible assets recorded would result in approximately \$200,000 of annual amortization expense in the pro forma statements of operations.

**(b) Components of the Estimated Purchase Consideration**

The pro forma financial information reflects NaviSite's acquisition of substantially all the assets and liabilities of Surebridge for consideration valued at approximately \$54.2 million. The pro forma adjustments reconcile the historical balance sheet of NaviSite to the allocated purchase price above and include the purchase consideration. The description of the components of the estimated purchase price consideration is as follows (in thousands):

Two promissory notes payable	\$ 39,300
Fair value of 3 million shares of NaviSite common stock	14,370

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Estimated direct acquisition costs	500
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Total estimated purchase price	\$54,170
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**Table of Contents****NAVISITE, INC. AND SUBSIDIARIES****NOTES TO THE PRO FORMA CONDENSED COMBINED****FINANCIAL INFORMATION (Continued)**

The fair value of the shares of NaviSite common stock noted in the table above was determined as follows (in thousands, except per share value):

Issuance of 3 million shares	3,000
Per share price of NaviSite common stock at closing	\$ 4.79
	<hr/>
Fair value of the common stock issued	\$ 14,370
	<hr/>

The equity components of the common stock issued which is noted in the table above are as follows (in thousands):

Common stock (assumes \$.01 par value)	\$ 30
Additional paid-in capital	14,340
	<hr/>
Fair value of the common stock issued	\$ 14,370
	<hr/>

For pro forma purposes, all equity accounts of Surebridge were eliminated. The adjustments to both common stock and additional paid-in capital in the pro forma condensed combined balance sheet were determined as follows (in thousands):

Elimination of pre-existing Surebridge common stock	\$ (109)
Common stock (at par value) resulting from Navisite shares issued	30
	<hr/>
Common stock adjustment	\$ (79)
	<hr/>
Elimination of pre-existing Surebridge additional paid-in capital	\$ (9,487)
Additional paid-capital resulting from NaviSite shares issued	14,340
	<hr/>
Additional paid-in capital adjustment	\$ 4,853
	<hr/>

**(c) Interest Expense on the Promissory Notes**

Interest expense on the two promissory notes payable is calculated at 10% annually. The pro forma statements of operations assume interest will be paid in full. However, the promissory notes provide that no interest shall accrue or be payable on any principal paid within nine months. The interest expense recorded in the pro forma condensed combined statements of operations was calculated as follows (in thousands):

<b>Three Months Ended April 30, 2004</b>	<b>Nine Months Ended April 30, 2004</b>	<b>Year Ended July 31, 2003</b>
<hr/>	<hr/>	<hr/>

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Promissory notes principal	\$ 39,300	\$ 39,300	\$ 39,300
Interest rate	10%	10%	10%
Interest expense recorded	\$ 983	\$ 2,948	\$ 3,930

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**MANAGEMENT'S DISCUSSION AND ANALYSIS OF  
FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

*The following discussion and analysis of our financial condition and results of operations should be read together with our consolidated financial statements and related notes included in this Information Statement. This discussion and analysis contains forward-looking statements that involve risks and uncertainties. Words such as may, will, should, could, expect, plan, anticipate, intend, believe, estimate, predict, potential, continue, or similar words are intended to identify forward-looking statements, although not all forward-looking statements contain these words. Although we believe that our opinions and expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements, and our actual results may differ substantially from the views and expectations set forth below. We expressly disclaim any intent or obligation to update any forward-looking statements after the date hereof to conform such statements to actual results or to changes in our opinions or expectations.*

*Readers are urged to carefully review and consider the various disclosures made by us which attempt to advise interested parties of the factors which affect our business including, but not limited to, those discussed in reports that we file with the Securities and Exchange Commission, including our most recent Quarterly Report on Form 10-Q.*

**Overview**

We provide our services to customers typically pursuant to agreements with a term of one to three years and monthly payment installments. As a result, these agreements provide us with a base of recurring revenue. Our revenue increases by adding new customers or additional services to existing customers. Our overall base of recurring revenue is affected by renewals or terminations of agreements with existing customers.

A large portion of the costs to operate our data centers, such as rent, product development and general and administrative expenses, does not depend strictly on the number of customers or the amount of services we provide. As we add new customers or new services to existing customers, we generally incur limited additional expenses relating to telecommunications, utilities, hardware and software costs, and payroll expenses. We have substantial capacity to add customers to our data centers. Our relatively fixed cost base, sufficient capacity for expansion and limited incremental variable costs provide us with the opportunity to grow profitably. However, these same fixed costs present us with the risk that we may incur losses if we are unable to generate sufficient revenue.

In recent years, we have grown through acquisitions of new businesses and have restructured our historical operations. Specifically, in December 2002, we acquired ClearBlue Technologies Management, Inc. (a wholly-owned subsidiary of our majority stockholder at the time of the acquisition), adding application management and development capabilities to our Managed Application Services; in February 2003, we acquired Avasta, adding capabilities to our Managed Application Services; in April 2003, we acquired Conxion, providing key services to our Managed Application Services and Managed Infrastructure Services; in May 2003, we acquired assets of Interliant, forming the core of our Managed Messaging Services; and in August 2003, we acquired assets of CBT (which was our majority stockholder at that time) related to colocation, bandwidth, security and disaster recovery services, enhancing our Managed Infrastructure Services. In June 2004, we acquired assets of Surebridge adding significant capabilities to our Managed Application and Professional Services. Prior to September 2002, substantially all of our services were managed application services, and we have added managed infrastructure and managed messaging services since that time. This transformation in our business will result in our recent results being more relevant to an understanding of our business than our historical results. We also expect to make additional acquisitions to take advantage of our available capacity, which will have significant effects on our financial results in the future.

Our acquisitions of CBTM and assets of CBT were accounted for in a manner similar to a pooling-of-interest due to common control ownership. The assets and the liabilities of CBT, CBTM and NaviSite

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were combined at their historical amounts beginning on September 11, 2002, the date on which CBT obtained a majority ownership of NaviSite. Our acquisitions of Avasta and Conxion and selected assets of Interliant were accounted for using the purchase method of accounting and as such, the results of operations and cash flows relating to these acquisitions were included in our Consolidated Statements of Operations and Consolidated Statements of Cash Flows for the fiscal year ended July 31, 2003 from their respective dates of acquisition of February 5, 2003, April 2, 2003 and May 16, 2003. The selected assets of Surebridge will be accounted for using the purchase method of accounting and are not yet included in our financial statements.

In August 2003, we acquired assets of CBT related to colocation, bandwidth, security and disaster recovery services. Specifically, we acquired all of the outstanding shares of six wholly-owned subsidiaries of CBT with data centers in various U.S. locations and assumed the revenue and expense of four additional wholly-owned subsidiaries of CBT with data centers located in Dallas, Texas; New York, New York; San Francisco, California; and Santa Clara, California. Pursuant to the acquisition agreement, as amended, we had the right to acquire the four additional subsidiaries for no additional consideration at any time on or prior to August 8, 2005. In April 2004, we exercised our right to acquire the additional four subsidiaries and thereby acquired all of the outstanding shares of the additional four wholly-owned subsidiaries of CBT. In March 2004, we had initially rejected the Santa Clara data center subsidiary, pursuant to our right under the acquisition agreement; however, on April 12, 2004, prior to the expiration of the thirty-day notification period, we revoked this rejection. We will continue to consolidate, as part of our consolidated financial statements, the results of each of these four subsidiaries.

The audit report on our fiscal year 2003 consolidated financial statements from KPMG LLP, our independent auditors, contains KPMG's opinion that our recurring losses from operations since inception and accumulated deficit, as well as other factors, raise substantial doubt about our ability to continue as a going concern. During fiscal year 2003 and thereafter, we have undergone a significant transition, including all of the acquisitions that are described in this Information Statement and a balance sheet restructuring. Included in this transition was a complete turnover of our senior management team and our Board of Directors. While we cannot assure you that we will continue as a going concern, we believe that we have developed and are implementing an operational plan that aligns our cost structure with our projected revenue growth.

**Results of Operations**

The following table sets forth the percentage relationships of certain items from our Consolidated Statements of Operations as a percentage of total revenue.

	Year Ended July 31,			Three Months Ended April 30,		Nine Months Ended April 30,	
	2003	2002	2001	2004	2003	2004	2003
				(Unaudited)		(Unaudited)	
Revenue	98.3%	68.9%	64.6%	99.9%	100.0%	100.0%	97.6%
Revenue, related parties	1.7	31.1	35.4	0.1	0.0	0.0	2.4
Total revenue	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Cost of revenue	92.4	112.8	123.8	70.4	88.2	74.1	93.7
Impairment, restructuring and other	0.0	115.0	1.9	0.0	0.0	1.0	0.0
Total cost of revenue	92.4	227.8	125.7	70.4	88.2	75.1	93.7
Gross profit (deficit)	7.6	(127.8)	(25.7)	29.6	11.8	24.9	6.3

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	Year Ended July 31,			Three Months Ended April 30,		Nine Months Ended April 30,	
	2003	2002	2001	2004	2003	2004	2003
				(Unaudited)		(Unaudited)	
Operating expenses:							
Product development	1.2	8.9	13.7	1.1	0.6	1.3	1.2
Selling and marketing	7.8	16.3	31.4	9.2	7.3	8.7	6.9
General and administrative	26.4	32.4	32.1	30.2	25.6	24.8	25.3
Impairment, restructuring and other	11.6	(4.4)	7.8	1.0	19.5	2.4	11.6
Total operating expenses	47.0	53.2	85.0	41.5	53.0	37.2	45.0
Loss from operations	(39.4)	(181.0)	(110.7)	(11.9)	(41.2)	(12.3)	(38.7)
Other income (expense):							
Interest income	1.1	1.8	2.7	0.1	0.9	0.2	1.3
Interest expense	(56.7)	(24.8)	(7.8)	(3.3)	(12.6)	(3.0)	(37.2)
Other income (expense), net	(1.0)	(0.9)	0.3	0.1	4.7	0.2	(2.0)
Loss before cumulative effect of change in accounting principle and income tax expense	(96.0)	(204.9)	(115.5)	(15.0)	(57.6)	(14.9)	(76.6)
Income tax expense	(0.2)	0.0	0.0	0.0	0.0	0.0	0.0
Loss before cumulative effect of change in accounting principle	(96.2)	(204.9)	(115.5)	(15.0)	(57.6)	(14.9)	(76.6)
Cumulative effect of change in accounting principle	0.0	0.0	(4.2)	0.0	0.0	0.0	0.0
Net loss	(96.2)%	(204.9)%	(119.7)%	(15.0)%	(57.6)%	(14.9)%	(76.6)%

**Comparison of Three and Nine Months Ended April 30, 2004 and 2003***Revenue*

We derive our revenue primarily from outsourced managed hosting, co-location and application services comprised of a variety of service offerings, including providing related professional and consulting services, to mid-sized enterprises, divisions of large multi-national companies and government agencies. Revenue for the nine-month period ended April 30, 2003 contains eight months of revenue from CBTM and CBT.

Total revenue for the three-month period ended April 30, 2004 increased 3% to approximately \$20.2 million from approximately \$19.6 million for the same period in fiscal year 2003. The overall growth in revenue of \$0.6 million was mainly due to revenue resulting from our fiscal 2003 acquisitions, which contributed approximately \$6.4 million in revenue during the quarter ended April 30, 2004. The increased revenue was partially offset by net lost customer revenue of \$5.8 million.

Total revenue for the nine-month period ended April 30, 2004 increased 22% to approximately \$66 million from approximately \$54.3 million for the same period in fiscal year 2003. The overall growth in revenue of \$11.7 million was mainly due to revenue resulting from our fiscal 2003 acquisitions, which contributed approximately \$27.6 million in revenue during the nine-month period ended April 30, 2004. The increased revenue was partially offset by net lost customer revenue of \$15.9 million. Revenue from related parties principally consisted of sales of services to CMGI and its affiliates until September 11, 2002 when CMGI sold its equity and debt interests in NaviSite to CBT. The decrease of \$1.3 million in related party revenue was primarily attributable to CMGI and its affiliates terminating their relationships with NaviSite upon the completion of their contracts although CMGI remains a third-party customer. We expect our total revenue for fiscal year 2004 to be up approximately 15% from fiscal year 2003 total revenue.





**Table of Contents***Cost of Revenue*

Cost of revenue consists primarily of salaries and benefits for operations personnel, bandwidth fees and related Internet connectivity charges, equipment costs and related depreciation and costs to run our data centers, such as rent and utilities.

Gross profit of \$6.0 million for the three-month period ended April 30, 2004 represented 30% of total revenue as compared to gross profit of \$2.3 million for the same period in fiscal year 2003 which represented 12% of total revenue. Total cost of revenue for the three-month period ended April 30, 2004 decreased 18% to approximately \$14.2 million from approximately \$17.3 million for the same period in fiscal year 2003. The decrease in total cost of revenue of \$3.1 million resulted primarily from cost reductions relating to the integration of our acquisitions and the \$1.4 million reduction of cost of revenue due to the gains recognized on the terminations of certain data center leases. The scaling of our fixed infrastructure costs over a larger revenue/customer base has also contributed to our improved gross profit.

Gross profit of \$16.5 million for the nine-month period ended April 30, 2004 represented 25% of total revenue as compared to gross profit of \$3.4 million which represented 6% of total revenue for the same period in fiscal year 2003. Total cost of revenue for the nine-month period ended April 30, 2004 decreased 3% to approximately \$49.5 million from approximately \$50.8 million for the same period in fiscal year 2003. The decrease in the cost of revenue of \$1.3 million resulted primarily from cost reductions relating to the integration of our acquisitions and the \$1.4 million reduction of cost of revenue due to the gains recognized on the terminations of certain data center leases, partially offset by an impairment charge of \$0.6 million in the nine-month period ended April 30, 2004, related to the abandonment of our data center space at the Vienna, VA data center. The scaling of our fixed infrastructure costs over a larger revenue/customer base has also contributed to our improved gross profit. We expect our gross profit to be approximately 24% for fiscal year 2004, as compared to approximately 8% for fiscal year 2003.

*Operating Expenses*

*Product Development.* Product development expenses consist primarily of salaries and related costs. Product development expenses increased 90% to approximately \$0.2 million for the three-month period ended April 30, 2004 from approximately \$0.1 million from the same period in fiscal year 2003. The increase in product development expenses of approximately \$0.1 million is primarily related to increased salary expense resulting from an increased headcount.

Product development expenses increased 43% to approximately \$0.9 million for the nine-month period ended April 30, 2004 from approximately \$0.6 million from the same period in fiscal year 2003. The increase in product development expenses of approximately \$0.3 million, is primarily related to increased salary expense resulting from an increased headcount. We expect product development expenses to remain constant as a percentage of revenue for fiscal year 2004.

*Selling and Marketing.* Selling and marketing expenses consist primarily of salaries and related benefits, commissions and marketing expenses such as advertising, product literature, trade shows, marketing and direct mail programs. Selling and marketing expense increased 29% for the three-month period ended April 30, 2004 to approximately \$1.8 million from approximately \$1.4 million for the same period in fiscal year 2003. The increase of approximately \$0.4 million resulted primarily from increased salary expense resulting from an increased headcount and increases in marketing program expenses. During the third quarter of fiscal 2004, we increased our quota bearing sales force from 16 to 25, excluding the sales force at Surebridge.

Selling and marketing expense increased 52% for the nine-month period ended April 30, 2004 to approximately \$5.7 million from approximately \$3.8 million for the same period in fiscal year 2003. The increase of approximately \$2.0 million resulted primarily from increased salary expense resulting from an increased headcount and increases in marketing program expenses. We expect selling and marketing expenses to slightly increase as a percentage of revenue during fiscal year 2004 as compared with fiscal year 2003 as we hire additional sales resources.

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*General and Administrative.* General and administrative expenses include the costs of financial, human resources, information technology and administrative personnel, professional services, bad debt and corporate overhead. During the three months ended April 30, 2004, general and administrative expenses increased 21% to approximately \$6.1 million from approximately \$5.0 million for the same period in fiscal year 2003. The increase of approximately \$1.1 million was mainly the result of increased salary expense resulting from an increased headcount, increases in utilities costs and depreciation and provision for bad debt offset by reductions in legal and accounting fees, rent, and outside consultants.

General and administrative expenses increased 19% to approximately \$16.3 million for the nine-month period ended April 30, 2004 from approximately \$13.7 million for the same period in fiscal year 2003. The increase of approximately \$2.6 million was mainly the result of increased salary expense resulting from an increased headcount, depreciation, provision for bad debt, and utilities costs. Also included in the nine-month period ended April 30, 2003 are intercompany charges from CMGI for facilities and shared back office and business development support. These costs were eliminated upon the termination of the Facilities and Administrative Agreement between CMGI and us in September 2002. We expect general and administrative expenses to remain constant to slightly lower as a percentage of revenue during fiscal year 2004, as compared with fiscal year 2003.

*Impairment, Restructuring and Other*

Costs associated with impairment, restructuring and abandonment of lease facilities were approximately \$206,000 for the three-month period ended April 30, 2004, which resulted from the write-off of \$300,000 in property and equipment, net of \$94,000 in recovery of impairment charges triggered by the termination and settlement of the abandoned lease in San Francisco, CA, and has been included in operating expenses.

The additional impairment charges recorded in the nine month period ended April 30, 2004 were due primarily to the abandonment of data center space at our Vienna, VA facility, recorded as an increase to cost of sales and the abandonment of administrative space at our San Francisco, CA office recorded as an increase to general and administrative expense. For our impairment costs, we recorded a charge equal to the amount of rent and other direct costs for the period and time the space is expected to remain unoccupied plus the present value of the amount by which the rent paid by us to the landlord exceeds any rent assumed to be paid to us by a subtenant under a sublease over the remainder of the lease term.

*Interest Income*

Interest income decreased 89% to approximately \$18,000 for the three-month period ended April 30, 2004 from approximately \$169,000 for the same period in fiscal year 2003. The decrease is due primarily to lower cash balances during the three-month period ended April 30, 2004 as compared to the same period in fiscal year 2003 and the elimination of interest income from direct financing leases with our customers in fiscal year 2004.

Interest income decreased 83% to approximately \$0.1 million for the nine-month period ended April 30, 2004 from approximately \$0.7 million for the same period in fiscal year 2003. The decrease is due primarily to lower cash balances during the nine-month period ended April 30, 2004 as compared to the same period in fiscal year 2003 and the elimination of interest income from direct financing leases with our customers in fiscal year 2004.

*Interest Expense*

Interest expense decreased 73% to approximately \$0.7 million for the three-month period ended April 30, 2004 from \$2.5 million for the same period in fiscal year 2003. The decrease is due primarily to the reduction of the expense related to the beneficial conversion feature and interest on our convertible debt, which was fully converted in fiscal year 2003.

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Interest expense decreased 90% to approximately \$1.9 million for the nine-month period ended April 30, 2004 from \$20.2 million for the same period in fiscal year 2003. The decrease is due primarily to the reduction of the expense related to the beneficial conversion feature and interest on our convertible debt, which was fully converted in fiscal year 2003.

**Comparison of the Years 2003, 2002 and 2001***Revenue*

Total revenue for fiscal year 2003 increased 29% to approximately \$76.6 million from approximately \$59.4 million in fiscal year 2002. The overall growth in revenue was mainly due to revenue resulting from an increased number of customers gained pursuant to our acquisitions, which contributed \$48.7 million in revenue during fiscal year 2003, offset by net lost customer revenue of \$31.5 million. Revenue from non-related parties increased by 84% to approximately \$75.3 million in fiscal year 2003 from approximately \$41.0 million in fiscal year 2002 but was offset by a decline in revenue from related parties. Revenue from related parties decreased by 93% to approximately \$1.3 million in fiscal year 2003 from approximately \$18.5 million in 2002. Revenue from related parties principally consisted of sales of services to CMGI and its affiliates until September 2002 when CMGI sold its equity and debt interests in us to CBT, and then this related party revenue was recorded as revenue. The decrease in related party revenue for fiscal year 2003 as compared to fiscal year 2002 was primarily attributable to CMGI's affiliates terminating their relationships with us upon the completion of their contracts.

Total revenue for fiscal year 2002 decreased 42% to approximately \$59.4 million from approximately \$102.7 million in fiscal year 2001. Included in fiscal year 2002 revenue is approximately \$2.9 million in non-recurring revenue from early contract termination settlements, primarily from related parties, including \$2.4 million from the termination of a web hosting agreement with Engage, Inc. Excluding settlement revenue, total revenue for fiscal year 2002 decreased 45% to approximately \$56.5 million from approximately \$102.7 million in fiscal year 2001. The decrease in fiscal year 2002 revenue, net of settlement revenue, resulted from a \$25.4 million, or 38%, decrease in unaffiliated revenue combined with a \$17.9 million, or 49%, decrease in revenue from CMGI and its affiliates.

In fiscal year 2003, one unrelated customer accounted for 21% of our revenue as compared to fiscal year 2002 where one CMGI affiliate accounted for approximately 11% of our revenue and fiscal year 2001 where four CMGI affiliates accounted for approximately 25%, 17%, 15% and 14% of our revenue, respectively.

*Cost of Revenue*

Cost of revenue, excluding impairment charges, increased 6% to approximately \$70.8 million in fiscal year 2003 from approximately \$67.0 million in fiscal year 2002. The increase in cost of revenue of \$3.8 million, net of impairment charges, resulted primarily from the addition of approximately \$14.2 million in cost of revenue from the acquisitions of subsidiaries of CBT netted with a \$10.4 million reduction in our cost of revenue. The \$10.4 million reduction in our cost of revenue consisted primarily of reductions in depreciation of \$11.1 million, equipment lease and related costs of \$6.4 million due to restructuring that took place in fiscal year 2002 partially offset by increases in labor costs of \$4.0 million, bandwidth costs of \$1.6 million and software licenses of \$1.4 million related to acquisitions made in fiscal year 2003.

Cost of revenue, excluding impairment charges, decreased 47% to approximately \$67.0 million in fiscal year 2002, from approximately \$127.2 million in fiscal year 2001. The reduction in cost of revenue of \$60.2 million, net of impairment charges, resulted primarily from a \$34.7 million reduction in equipment lease and related costs, a \$10.0 million reduction in labor costs due to head count reductions, a \$9.1 million reduction in consulting fees, a \$5.9 million reduction in bandwidth and bandwidth related costs, a \$2.9 million reduction in rent costs related to the closing of our original data centers on July 31, 2001, and a \$2.9 million reduction in other facility and equipment related costs offset by a \$5.2 million increase in depreciation resulting from the purchase of equipment formerly held under operating leases.

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Included in cost of revenue for fiscal years 2002 and 2001 are impairment charges of \$68.3 million and \$1.9 million, respectively.

*Impairment, Restructuring and Other*

In fiscal year 2002, we recorded a \$68.3 million impairment charge related to leased and owned equipment and long-lived assets. The components of this charge are as follows:

As a result of a physical inventory of our customer-dedicated equipment, we recorded an impairment charge of \$1.5 million for obsolete equipment and for equipment no longer on hand and identified certain excess assets not in use.

We modified the payment amounts and terms of operating leases with three equipment vendors such that the modified leases qualify as capital leases. One of the resulting capital leases is payable in 24 equal monthly payments of \$38,000, starting in December 2001. The second capital lease has total payments of \$2.6 million, of which \$1.0 million was paid in the second quarter of fiscal year 2002 and \$1.6 million was paid in fiscal year 2003. The third capital lease is payable in 28 monthly payments of \$4,700 for the first four months and \$20,400 for the remaining 24 months, starting in April 2002. The equipment under all resulting capital leases was capitalized at the fair market value of the equipment at the time of the modification, determined to be \$1.1 million, which was lower than the present value of the future minimum lease payments based on our estimated incremental borrowing rate of 12%. Because the fair market value of the equipment was less than the consideration given, based on a third-party appraisal, we recorded an asset impairment charge of approximately \$1.0 million. In addition, we returned some equipment held under operating leases with one of the above lessors and incurred and paid a breakage fee of \$397,000.

We recorded a net \$1.9 million charge representing the future estimated remaining minimum lease payments related to certain idle equipment held under various operating leases. The equipment had previously been rented to former customers under operating leases, and upon the loss of the customer, the equipment became idle. Based on our then forecasts, the equipment would not be utilized before the related operating leases expired and/or the equipment became obsolete.

We evaluated the current and forecasted utilization of our purchased software licenses. As a result of this evaluation, during the second quarter of fiscal year 2002, we recorded a \$365,000 impairment for software licenses that would not be utilized before the licenses expired and/or became obsolete.

We finalized agreements with various equipment lessors whereby we purchased equipment previously held under operating leases for approximately \$42.0 million. The fair market value of the equipment at the time of purchase, based on third-party appraisal, was approximately \$14.3 million. As the aggregate fair market value of the equipment, based on third-party appraisal, was less than the aggregate consideration given, we recorded an asset impairment charge of approximately \$25.4 million, as a separate component of cost of revenue, in fiscal year 2002.

A number of factors occurring during the fourth quarter of fiscal year 2002 impacted our long-lived assets including both our expected future cash flow generation and our expected utilization of the assets within revised operating plans. These factors included the further deterioration of market conditions within our industry, excess capacity in the industry and in our two data centers, our anticipated data center utilization and our revised business model.

Based on these factors and their impact on current and future projected cash flows, we performed an assessment of the carrying value of our long-lived assets pursuant to SFAS No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of. The conclusion of this assessment was that the decline in market conditions within our industry was significant and other than temporary. In this assessment, we reviewed our long-lived assets, which included property, equipment and goodwill. The carrying amount of goodwill, which totaled \$186,000, was considered unrecoverable and was written-off as of July 31, 2002 and was included as a component of general and administrative expense.

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In accordance with SFAS No. 121, the measurement of the impairment loss of property and equipment was based on the fair value of the asset, as determined by third-party appraisal. Management determined that the best measure of fair value for the property and equipment was a combination of the market and cost approaches. The cost approach was utilized to determine the fair value of certain computer hardware, leasehold improvements, office furniture and equipment and construction in progress. The cost approach utilizes estimated replacement/reproduction cost, with allowances for physical depreciation and functional obsolescence (i.e. asset utilization). For certain equipment and leasehold improvements, the market approach was used. The market approach typically includes comparing recent sales of similar assets and adjusting these comparable transactions based on factors such as age, condition, and type of sale to determine fair value. Based on the appraised fair value of the property and equipment, we recorded an impairment charge of approximately \$38.1 million during the fourth quarter of fiscal year 2002.

Included in the fiscal year 2001 cost of revenue is a charge of approximately \$1.9 million related to some of our equipment under operating leases, which had been deemed not to have a future economic benefit to us.

*Operating Expenses*

*Product Development.* Product development expenses decreased 82% to approximately \$950,000 in fiscal year 2003 from approximately \$5.3 million in fiscal year 2002. The decrease in product development expenses is primarily related to reduced headcount and related costs resulting from the decrease in product development personnel in fiscal year 2003 from fiscal year 2002, combined with a reduction in allocated depreciation and equipment rental expense.

Product development expenses decreased 63% to approximately \$5.3 million in fiscal year 2002 from approximately \$14.1 million in fiscal year 2001. The decrease in product development expenses is primarily related to reduced headcount and related costs resulting from the decrease in product development personnel in fiscal year 2002 from fiscal year 2001, combined with a reduction in outside consulting fees.

*Selling and Marketing.* Selling and marketing expenses decreased 39% to approximately \$6.0 million in fiscal year 2003 from approximately \$9.7 million in fiscal year 2002. The decrease of approximately \$3.7 million resulted primarily from a reduction in salary and related costs of approximately \$2.6 million, a reduction of allocated rent of approximately \$800,000 and a reduction in marketing program costs of approximately \$300,000.

Selling and marketing expenses decreased 70% to approximately \$9.7 million in fiscal year 2002 from approximately \$32.3 million in fiscal year 2001. The \$22.5 million decrease resulted primarily from a \$8.1 million reduction in headcount expenses related to a decrease in sales and marketing personnel, a \$6.6 million reduction in marketing programs, advertising and product literature, a \$5.2 million reduction in commission expense driven by decreased revenue levels, and a \$765,000 reduction in consulting fees.

*General and Administrative.* General and administrative expenses increased 4.9% to approximately \$20.2 million in fiscal year 2003 from approximately \$19.3 million in fiscal year 2002. The increase of approximately \$935,000 was mainly the result of the addition of approximately \$1.3 million in CBT general and administrative expenses offset by a net decrease in expenses of approximately \$400,000. The \$400,000 is primarily comprised of a reduction in bad debt expense of \$2.5 million partially offset by increases in headcount related expenses of \$1.2 million, increased accounting and legal fees of \$800,000 and increased expense for amortization of intangibles related to the CBTM acquisition during the fiscal year.

General and administrative expenses decreased 42% to approximately \$19.3 million in fiscal year 2002 from approximately \$33.0 million in fiscal year 2001. The \$13.7 million decrease resulted primarily from a \$8.3 million reduction in bad debt expense, a \$5.1 million reduction in headcount expense related to a decrease in general and administrative personnel at July 31, 2002 to 26 from 52 at July 31, 2001, and a \$1.7 million reduction in consulting fees. General and administrative expenses also included a \$600,000

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legal settlement paid to Level 3 to settle a contract dispute regarding colocation space cancelled by NaviSite.

*Impairment, Restructuring and Other*

Costs associated with impairment, restructuring and abandonment of lease facilities increased to approximately \$8.9 million in fiscal year 2003 compared to a reversal of a portion of a previous impairment and restructuring charge of approximately \$2.6 million in fiscal year 2002. The increase is due primarily to abandonment of administrative space at our 400 Minuteman Road, Andover, MA facility and the abandonment of administrative space at our La Jolla, CA office and approximately \$2.0 million impairment of intangible assets by CBT. We recorded a charge equal to the amount of rent and other direct costs for the period the space is expected to remain unoccupied plus the present value of the amount by which the rent paid by us to the landlord exceeds any rent paid to us by a subtenant under a sublease over the remainder of the lease term.

In July 2001, we announced a plan, approved by our Board of Directors, to restructure our operations and consolidate our data centers, which resulted in a charge of approximately \$8.0 million, of which approximately \$5.2 million was accrued for as of July 31, 2001. Of the total restructuring charge, approximately \$1.8 million was related to employee termination benefits. We terminated 126 employees on July 31, 2001. The restructuring charge also included approximately \$6.2 million of costs related to the closing of our two original data centers. The components of the facility closing costs included approximately \$3.8 million of estimated lease obligations associated with restoring the facilities to their original condition, and other contractual obligations, to be paid over the term of the respective agreements through 2002, and approximately \$2.4 million of write-offs of leasehold improvements, which were recorded as of July 31, 2001. During fiscal year 2002, we were able to favorably renegotiate the facility closing costs. The accrual for the two original data centers was reduced by approximately \$1.6 million and the bandwidth termination costs were reduced by approximately \$1.0 million. In addition, \$63,000 in severance and employee costs were forfeited by former employees. As a result, we reversed approximately \$2.6 million in restructuring accrual during fiscal year 2002. As of July 31, 2002, we had completed the restructuring plan and made all related payments.

*Interest Income*

Interest income decreased 20% to approximately \$851,000 in fiscal year 2003 from approximately \$1.1 million in fiscal year 2002. The decrease is due primarily to the reduced levels of average cash on hand.

Interest income decreased 62% to approximately \$1.1 million in fiscal year 2002, from approximately \$2.8 million in fiscal year 2001. The decrease is due primarily to the reduced levels of average cash on hand.

*Interest Expense*

Interest expense increased 195% to approximately \$43.4 million in fiscal year 2003 from approximately \$14.7 million in fiscal year 2002. The increase of \$28.7 million is due mainly to the non-cash write-off of the unamortized beneficial conversion feature related to the conversion of the \$65 million of convertible notes during fiscal year 2003.

Interest expense increased 83% to approximately \$14.7 million in fiscal year 2002 from approximately \$8.0 million in fiscal year 2001. The increase is due to the interest payable on the \$65 million of convertible notes and related beneficial conversion feature amortization.

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*Other Income (Expense), net*

Other income (expense) increased 42% to approximately (\$733,000) in fiscal year 2003 from (\$516,000) in fiscal year 2002. This increase is mainly due to increased fees related to the accounts receivable financing agreement with Silicon Valley Bank.

Other income (expense) decreased 277% to (\$516,000) in fiscal year 2002 from \$292,000 in fiscal year 2001. The decrease is due to the loss on the sale of assets offset by the gain realized on the sale of certain of our Streaming Media assets.

*Fiscal Year 2001 Change in Accounting Principle*

During fiscal year 2001, we adopted SEC Staff Accounting Bulletin No. 101 Revenue Recognition in Financial Statements, or SAB 101. Under SAB 101, installation fees are recognized over the life of the related customer contracts. Prior to fiscal year 2001, we recognized installation fees at the time the installation occurred. The cumulative effect of the change in accounting principle on all prior years resulted in a \$4.3 million increase in net loss for the year ended July 31, 2001 and is reflected as a cumulative effect of change in accounting principle. Revenue for the year ended July 31, 2001 includes \$1.5 million that was included in the cumulative effect adjustment. The \$1.5 million of fiscal year 2001 revenue was primarily attributable to the recognition of the previously deferred revenue on customers lost during fiscal year 2001.



**Table of Contents****Quarterly Results of Operations****(In thousands, except for per share data)**

We have prepared the following table on a basis consistent with the audited consolidated financial statements included in this Information Statement and, in the opinion of management, this chart includes all adjustments necessary for the fair presentation of such data.

	<b>Three Months Ended</b>										
	<b>April 30, 2004</b>	<b>Jan. 31, 2004</b>	<b>Oct. 31, 2003</b>	<b>July 31, 2003(1)</b>	<b>April 30, 2003(1)</b>	<b>Jan. 31, 2003(1)</b>	<b>Oct. 31, 2002</b>	<b>July 31, 2002</b>	<b>April 30, 2002</b>	<b>Jan. 31, 2002</b>	<b>Oct. 31, 2001</b>
	<b>(Unaudited)</b>										
Revenue	\$ 20,173	\$ 22,329	\$ 23,473	\$ 22,341	\$ 19,620	\$ 18,761	\$ 14,561	\$ 6,625	\$ 9,113	\$ 11,747	\$ 13,483
Revenue, related parties	12						1,310	3,126	5,604	3,927	5,796
Total revenue	20,185	22,329	23,473	22,341	19,620	18,761	15,871	9,751	14,717	15,674	19,279
Cost of revenue	14,217	16,758	17,924	19,960	17,312	17,014	16,495	11,166	14,150	20,307	21,377
Impairment, restructuring and other			633(7)					37,717(3)	(3,985)(4)	7,226(3)	27,359(5)
Total cost of revenue	14,217	16,758	18,557	19,960	17,312	17,014	16,495	48,883	10,165	27,533	48,736
Gross profit (deficit)	5,968	5,571	4,916	2,381	2,308	1,747	(624)	(39,132)	4,552	(11,859)	(29,457)
Operating expenses:											
Product development	230	312	348	326	121	121	382	356	1,003	1,945	1,977
Selling and marketing	1,848	1,904	1,972	2,201	1,429	1,043	1,287	1,834	2,731	2,502	2,636
General and administrative	6,097	5,287	4,958	6,489	5,023	5,018	3,677	2,729	2,622	7,086	6,835
Impairment, restructuring and other	206	946(7)	456(7)	2,608(6)	3,819(7)	2,308(7)	147	(138)	(2,495)(8)		
Total operating expenses	8,381	8,449	7,734	11,624	10,392	8,490	5,493	4,781	3,861	11,533	11,448
Income (loss) from operations	(2,413)	(2,878)	(2,818)	(9,243)	(8,084)	(6,743)	(6,117)	(43,913)	691	(23,392)	(40,905)
Other income (expense):											
Interest income	18	33	64	167	169	211	305	339	389	168	164
Interest expense	(656)	(670)	(609)	(23,232)(9)	(2,470)	(13,760)(9)	(3,940)	(3,770)	(3,763)	(3,576)	(3,609)
	25	76	10	376	(919)	61	(253)	(1,186)	639	21	10

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Other income (expense), net											
Loss before income tax expense	(3,026)	(3,439)	(3,353)	(31,932)	(11,304)	(20,231)	(10,005)	(48,530)	(2,044)	(26,779)	(44,340)
Income tax expense				153							
Net loss	\$ (3,026)	\$ (3,439)	\$ (3,353)	\$ (32,085)	\$ (11,304)	\$ (20,231)	\$ (10,005)	\$ (48,530)	\$ (2,044)	\$ (26,779)	\$ (44,340)
Basic and diluted net loss per common share(2):	\$ (0.12)	\$ (0.14)	\$ (0.14)	\$ (1.80)	\$ (0.88)	\$ (2.07)	\$ (1.60)	\$ (7.97)	\$ (0.35)	\$ (4.70)	\$ (10.72)
Basic and diluted weighted average number of common shares outstanding(2)	24,809	24,741	24,506	17,788	12,845	9,751	6,270	6,092	5,917	5,698	4,138

- (1) The three-month periods ended July 31, April 30 and January 31, 2003 have been restated herein to reflect our acquisition of assets of CBT as if the acquisition had taken place on September 11, 2002. This acquisition transpired when both companies were under common control, and therefore, the acquisition is accounted for in a manner similar to a pooling-of-interest.
- (2) As discussed in the notes to our consolidated financial statements, in January 2003 we completed a 1-for-15 reverse stock split of our outstanding shares of common stock. All historical share and per share data have been adjusted for the reverse stock split.
- (3) Impairment related to valuation of our fixed assets.
- (4) Reversal of impaired lease accrual due to change in estimate.
- (5) Impairment of assets purchased during buyout of certain operating leases.
- (6) Impairment of leased facility and write-off of intangible assets at CBT.
- (7) Impairment of leased facility.
- (8) Reversal of fiscal year 2001 restructuring charge due to change in estimate.
- (9) Increase in interest expense related to non-cash expense from conversion of our convertible debt.

The following is a reconciliation from the quarterly reported results previously filed on our annual report on Form 10-K and our quarterly reports on Form 10-Q to the results presented herein.

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	Three Months Ended								
	July 31, 2003			April 30, 2003			January 31, 2003		
	As reported	CBT Results	Combined(1)	As reported	CBT Results	Combined(1)	As reported	CBT Results	Combined(1)
	(Unaudited)								
Revenue	\$ 18,627	\$ 3,713	\$ 22,341	\$ 15,877	\$ 3,743	\$ 19,620	\$ 14,803	\$ 3,958	\$ 18,761
Revenue, related parties		81							
Total revenue	18,627	3,794	22,341	15,877	3,743	19,620	14,803	3,958	18,761
Cost of revenue	16,339	3,741	19,960	13,633	3,622	17,312	13,006	3,989	17,014
Impairment, restructuring and other									
Total cost of revenue	16,339	3,741	19,960	13,633	3,622	17,312	13,006	3,989	17,014
Gross profit (deficit)	2,288	53	2,381	2,244	121	2,308	1,797	(31)	1,747
Operating expenses:									
Product development	326		326	121		121	121		121
Selling and marketing	2,197		2,201	1,367		1,429	996	26	1,043
General and administrative	5,836	797	6,489	4,729	323	5,023	4,716	311	5,018
Impairment, restructuring and other	776	1,831	2,608	3,819		3,819	2,308		2,308
Total operating expenses	9,135	2,628	11,624	10,036	323	10,392	8,141	337	8,490
Loss from operations	(6,847)	(2,575)	(9,243)	(7,792)	(202)	(8,084)	(6,344)	(368)	(6,743)
Other income (expense):									
Interest income	155	12	167	157	12	169	200	11	211
Interest expense	(23,216)	(16)	(23,232)	(2,448)	(22)	(2,470)	(13,721)	(39)	(13,760)
Other income (expense), net	377		376	(909)		(919)	64		61
Loss before income tax expense	(29,531)	(2,579)	(31,932)	(10,992)	(212)	(11,304)	(19,801)	(396)	(20,231)
Income tax expense		153	153						
Net loss	\$ (29,531)	\$ (2,732)	\$ (32,085)	\$ (10,992)	\$ (212)	\$ (11,304)	\$ (19,801)	\$ (396)	\$ (20,231)

(1) The combined amounts include the elimination of intercompany activity consisting of \$81,000 of revenue in the three-month period ended July 31, 2003 and general and administrative expense of \$144,000, \$29,000 and \$9,000 for the three-month periods ended July 31, April 30 and January 31, 2003, respectively.

**Contractual Obligations and Commercial Commitments**

We are obligated under various capital and operating leases for facilities and equipment. Minimum annual rental commitments under operating leases and other commitments are as follows as of April 30, 2004:

Description	Total	Less than 1 Year	Year 2	Year 3	Year 4	Year 5	After 5 Years
(In thousands)							
Short/Long-term debt	\$27,400	\$20,048	\$ 815	\$ 6,537	\$	\$	\$
Interest on debt	1,819	859	480	480			
Capital leases	3,248	2,418	830				
Operating leases	535	523	12				
Bandwidth commitments	7,981	3,095	2,768	1,875	243		
Maintenance for hardware/software	1,019	1,019					
Property leases	57,808	12,599	11,184	8,804	8,655	7,014	9,552
	<u>\$99,810</u>	<u>\$40,561</u>	<u>\$ 16,089</u>	<u>\$ 17,696</u>	<u>\$ 8,898</u>	<u>\$ 7,014</u>	<u>\$ 9,552</u>

**Liquidity and Capital Resources**

As of April 30, 2004, our principal sources of liquidity include cash and cash equivalents and our financing agreement with Silicon Valley Bank. We had a working capital deficit of \$16.6 million, including cash and cash

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equivalents of \$7.6 million at April 30, 2004, as compared to a working capital deficit of \$16.3 million, including cash and cash equivalents of \$3.9 million at July 31, 2003.

The total net change in cash and cash equivalents for the nine months ended April 30, 2004 was an increase of \$3.8 million. The primary uses of cash during this nine-month period included \$2.7 million of cash used for operating activities, \$1.8 million for purchases of property and equipment and \$10.4 million in repayments on notes payable, capital lease obligations and borrowings under our former accounts receivable financing line. Our primary sources of cash during this nine-month period were a \$1.7 million decrease in restricted cash, \$0.4 million in proceeds associated with the exercise of stock options under the employee stock option plans, \$16.0 million in net proceeds from our modified financing agreement and \$0.6 million in proceeds from sale-leaseback and note payable transactions. Net cash used for operating activities of \$2.7 million for the nine months ended April 30, 2004, resulted primarily from our \$9.8 million net loss, partially offset by \$14.3 million in non-cash charges, and \$7.2 million used by net changes in operating assets and liabilities. At April 30, 2004, we had an accumulated deficit of \$428.3 million, and have reported losses from operations since incorporation. At July 31, 2003, we had an accumulated deficit of \$415.7 million.

Prior to May 2003, our primary sources of cash to fund our operations were sales of equity and convertible debt securities. Since May 2003, our primary source of cash to fund our operations and meet our contractual obligations and commitments has been our accounts receivable financing agreement with Silicon Valley Bank. On January 30, 2004, we amended this agreement to, among other things, allow for future borrowing to be based on monthly recurring revenue, increase the maximum borrowings level from \$10.0 million to \$12.8 million, and extend the term until January 29, 2006. On April 29, 2004, we amended this agreement, among other things, to increase the maximum borrowing level from \$12.8 million to \$20.4 million, and extend the term until April 29, 2006. Under the amended agreement, borrowings are based on monthly recurring revenue. We are required to prepare and deliver a written request for an advance of up to three times the value of total monthly recurring revenue, calculated to be monthly revenue (including revenue from New York State Department of Labor) less professional services revenue. The bank may then provide an advance of 85% of such value (or such other percentage as the bank may determine). The interest rate under the amended agreement is variable and is currently calculated at the bank's published prime rate plus four percent. Following the completion of certain equity and debt financings, and provided we continue to meet certain ratios under the amended agreement, the interest rate shall be reduced to the bank's prime rate plus one percent. In no event, however, will the bank's prime rate be less than 4.25%. On April 30, 2004, we had an outstanding balance under the amended agreement of \$16.0 million. On June 11, 2004, we borrowed approximately \$3.9 million under the Silicon Valley Bank amended agreement to repay a Surebridge loan with Silicon Valley Bank that we assumed as part of the Surebridge acquisition. Our outstanding balance under this amended agreement as of June 11, 2004, was \$15.2 million.

We anticipate incurring additional losses throughout our current fiscal year. We have taken several actions we believe will allow us to continue as a going concern through July 31, 2004, including the closing and integration of strategic acquisitions, the changes to our senior management and bringing costs more in line with projected revenue. On January 22, 2004, we filed with the Securities and Exchange Commission a registration statement on Form S-2 (amended Form S-2/A filed on June 29, 2004) to register shares of our common stock to issue and sell in a public offering to raise additional funds. We believe that this proposed offering will allow us to raise the necessary funds to meet our anticipated needs for working capital and capital equipment for at least 12 months following the proposed offering. However, there can be no assurance that we will complete the proposed offering. In the event we are unable to complete the proposed offering, we will need to find alternative sources of financing, in order to remain a going concern. Potential sources include our financing agreement with Silicon Valley Bank and public or private sales of equity or debt securities. We may also consider sales of assets to raise additional cash. If we use a significant portion of the net proceeds from an offering to acquire a company, technology or product, we will need to raise additional debt or equity capital.

During fiscal 2003, we acquired four companies, downsized our workforce and restructured our business and balance sheet to improve operating cash flow. Our operating forecast incorporates material trends, such as our acquisitions, reductions in workforce, loss of related party revenue and closings of facilities. Our forecast also incorporates the future cash flow benefits expected from our continued efforts to increase efficiencies and reduce

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redundancies. Nonetheless, our forecast includes the need to raise additional funds through the proposed offering or alternate sources of financing. Our cash flow estimates are based upon attaining certain levels of sales, maintaining budgeted levels of operating expenses, collections of accounts receivable and maintaining our current borrowing line with Silicon Valley Bank among other assumptions, including the improvement in the overall macroeconomic environment. However there can be no assurance that we will be able to meet such assumptions. Our sales estimate includes revenue from new and existing customers which may not be realized and we may be required to further reduce expenses if budgeted sales are not attained. We may be unsuccessful in reducing expenses in proportion to any shortfall in projected sales and our estimate of collections of accounts receivable may be hindered by our customers' ability to pay. In addition, we are currently involved in various pending and potential legal proceedings. While we believe that the allegations against us in each of these matters are without merit, and that we have a meritorious defense in each, we are not able to predict the final outcomes of any of these matters and the effect, if any, on our financial condition. If we are ultimately unsuccessful in any of these matters, we could be required to pay substantial amounts of cash and/or shares of our common stock to the other parties. The amount and timing of any such payments could adversely affect our financial condition.

**Critical Accounting Policies**

We prepare our consolidated financial statements in accordance with accounting principles generally accepted in the United States of America. As such, management is required to make certain estimates, judgments and assumptions that it believes are reasonable based on the information available. These estimates and assumptions affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses for the periods presented. The significant accounting policies which management believes are the most critical to aid in fully understanding and evaluating our reported financial results include revenue recognition, allowance for doubtful accounts and impairment of long-lived assets. Management reviews the estimates on a regular basis and makes adjustments based on historical experiences, current conditions and future expectations. The reviews are performed regularly and adjustments are made as required by current available information. We believe these estimates are reasonable, but actual results could differ from these estimates.

*Revenue Recognition.* We provide outsourced hosting, colocation and managed application services and related professional and consulting services. Revenue consists of monthly fees for Web site and information technology infrastructure and application management, application rentals and hosting. Revenues related to monthly fees for information technology infrastructure and applications are recognized over the term of the customer contract based on actual usage and services. Revenue from professional services is recognized on a time-and-materials basis as the services are performed or under the percentage-of-completion method for revenue related to fixed-price contracts. Revenue and profits on long-term Internet solutions contracts, performed over extended periods, are recognized under the percentage-of-completion method of accounting, principally based on direct labor dollars. Revenues and profits on long-term contracts are based on our estimates to complete and are reviewed periodically, with adjustments recorded in the period in which the revisions are made. Any anticipated losses on contracts are charged to operations as soon as they are determinable. Fees charged for the installation of customer equipment are generally received in advance and are deferred and recognized as revenue over the life of the related customer contract, typically 12 to 36 months. In the event a customer terminates the agreement prior to its stated maturity, all deferred revenue related to installation services is automatically recognized upon the effective date of the termination, and we generally charge cancellation or termination fees that are also recognized upon the effective date of the termination. Generally, cancellation fees are calculated as the customer's remaining base monthly fees obligation times the number of months remaining in the contract term.

Existing customers are subject to ongoing credit evaluations based on payment history and other factors. If it is determined subsequent to our initial evaluation and at any time during the arrangement that collectability is not reasonably assured, revenue is recognized as cash is received. Due to the nature of our service arrangements, we provide written notice of termination of services, typically 10 days in advance of disconnecting a customer. Revenue for services rendered during this notification period is generally recognized on a cash basis as collectability is not considered probable at the time the services are provided.

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*Allowance for Doubtful Accounts.* We perform periodic credit evaluations of our customers' financial conditions and generally do not require collateral or other security against trade receivables. We make estimates of the uncollectability of our accounts receivables and maintain an allowance for doubtful accounts for potential credit losses. We specifically analyze accounts receivable and consider historical bad debts, customer and industry concentrations, customer credit-worthiness, current economic trends and changes in our customer payment patterns when evaluating the adequacy of the allowance for doubtful accounts. We specifically reserve for 100% of the balance of customer accounts deemed uncollectible. For all other customer accounts, we reserve for 20% of the balance over 90 days old and 2% of all other customer balances. This method historically approximated actual write-off experience. Changes in economic conditions or the financial viability of our customers may result in additional provisions for doubtful accounts in excess of our current estimate.

*Impairment of Long-lived Assets.* We review our long-lived assets, primarily property and equipment, for impairment whenever events or changes in circumstances indicate that the carrying amount of these assets may not be recoverable. Factors we consider important that could trigger an interim impairment review include:

- significant underperformance relative to expected historical or projected future operating results;
- significant changes in the manner of our use of the acquired assets or the strategy of our overall business;
- significant negative industry or economic trends;
- significant declines in our stock price for a sustained period; and
- our market capitalization relative to net book value.

Recoverability is measured by a comparison of the carrying amount of an asset to future undiscounted cash flows expected to be generated by the asset. If the assets were considered to be impaired, the impairment to be recognized would be measured by the amount by which the carrying value of the assets exceeds their fair value. Fair value is determined based on discounted cash flows or appraised values, depending on the nature of the asset. Assets to be disposed of are valued at the lower of the carrying amount or their fair value less disposal costs. Property and equipment is primarily comprised of leasehold improvements, computer and office equipment and software licenses. If our costs are more or less than our estimates, then we record an additional loss or gain in the future period when the actual costs are known. For example, in fiscal year 2002, we reversed approximately \$2.6 million in prior restructuring accrued as a result of the incurrence of less costs than estimated.

**New Accounting Pronouncements**

In January 2003, Financial Accounting Standards Board ( FASB ) Interpretation No. ( FIN ) 46, Consolidation of Variable Interest Entities, was issued. FIN 46 requires certain variable interest entities ( VIE ) to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. FIN 46 is effective for all new VIEs created or acquired after January 31, 2003. During December 2003, the FASB issued a new revision to FIN 46 ( FIN 46R ). Under the revised provisions, public entities are required to apply for guidance if the entity has interests in VIEs commonly referred to as special-purpose entities for the periods ending after December 15, 2003. The adoption of FIN 46 and 46R did not have a material effect on our consolidated financial statements.

In May 2003, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 150, Accounting For Certain Financial Instruments with Characteristics of Both Liabilities and Equity, which establishes standards for how an issuer of financial instruments classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances) if, at inception, the monetary value of the obligation is based solely or predominantly on a fixed monetary amount known at inception, variations in something other than the fair value of the issuer's equity shares or variations inversely related to changes in the fair value of the issuer's equity shares. This Statement is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. On November 7, 2003, the FASB deferred the classification and

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measurement provisions of SFAS No. 150 as they apply to certain mandatory redeemable non-controlling interests. This deferral is expected to remain in effect while these provisions are further evaluated by the FASB. We have not entered into or modified any financial instruments covered by this statement after May 31, 2003 and the application of this standard is not expected to have a material impact on our financial position or results of operations.

In December 2003, the Securities and Exchange Commission ( SEC ) issued Staff Accounting Bulletin ( SAB ) No. 104, Revenue Recognition, which supersedes SAB 101, Revenue Recognition in Financial Statements. SAB 104's primary purpose is to rescind accounting guidance contained in SAB 101 related to multiple element revenue arrangements, superseded as a result of the issuance of Emerging Issues Task Force ( EITF ) 00-21, Accounting for Revenue Arrangements with Multiple Deliverables. The issuance of SAB 104 reflects the concepts contained in EITF 00-21; the other revenue recognition concepts contained in SAB 101 remain largely unchanged. The application of SAB 104 did not have a material impact on our financial position or results of operations.

**Quantitative and Qualitative Disclosures About Market Risk**

We do not enter into financial instruments for trading purposes. We do not use derivative financial instruments or derivative commodity instruments in our investment portfolio or enter into hedging transactions. Our exposure to market risk associated with risk-sensitive instruments entered into for purposes other than trading purposes is not material to NaviSite. We currently have no significant foreign operations and therefore face no material foreign currency exchange rate risk.



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**APPENDIX I**

**WRITTEN CONSENT OF  
STOCKHOLDERS OF NAVISITE, INC.**

The undersigned, being the record holder of a majority of the issued and outstanding shares of Common Stock of NaviSite, Inc., a Delaware corporation (the *Company* ), does hereby take the following actions and adopt the following resolutions in accordance with Section 228(a) of the General Corporation Law of the State of Delaware:

**WHEREAS**, it has been proposed that the Company engage in a business combination (the *Transaction* ) with Surebridge, Inc., a Delaware corporation (the *Target* );

**WHEREAS**, the Board of Directors of the Company has approved the Transaction, the Asset Purchase Agreement (the *Purchase Agreement* ) entered into or to be entered into by and among the Company, Target and Lexington Acquisition Corp., a Delaware corporation and a wholly-owned subsidiary of the Company (the *Acquisition Sub* ), the Primary Note (the *Primary Note* ), the Escrow Note (the *Escrow Note* ), and together with the Primary Note, the *Notes* ), the Registration Rights Agreement, the Escrow Agreement and the related exhibits, annexes and schedules to the Purchase Agreement;

**WHEREAS**, at the Closing (as defined in the Purchase Agreement), in accordance with and subject to the terms and conditions set forth in the Purchase Agreement, the Target will sell substantially all of its assets to the Acquisition Sub (the *Sale* );

**WHEREAS**, as consideration for the purchase of substantially all of the assets of the Target, at the Closing of the Sale, the Company shall (i) issue the Notes to the Target, (ii) issue 3,000,000 shares (the *Company Shares* ) of its common stock, par value \$.01 per share (the *Common Stock* ) to the Target, and (iii) assume certain liabilities of the Target;

**WHEREAS**, NASD Rule 4350(i)(1)(C) requires that the issuer of stock in connection with the acquisition of the stock or assets of another company secure stockholder approval prior to an issuance where the issuance or potential issuance of the shares of common stock, or securities convertible into or exercisable for common stock, would result in the issuance of 20% or more of the common stock or voting power of the issuer before the issuance;

**WHEREAS**, NASD Rule 4350(i)(1)(B) requires that the issuer of stock secure stockholder approval prior to an issuance or potential issuance which will result in a change of control of the issuer;

**WHEREAS**, the issuance of the Company Shares and the issuance or potential issuance of the shares of Common Stock of the Company upon the conversion of the Notes (the *Conversion Shares* ) would potentially equal or exceed the 20% threshold and would potentially result in a change of control of the Company;

**WHEREAS**, the Board of Directors of the Company has approved an amendment (the *Amendment* ) to Section 4(a) of the Company's Amended and Restated 2003 Stock Incentive Plan (the *Plan* ), subject to the approval of the Company's stockholders, to increase the maximum number of shares of Common Stock available for issuance pursuant to the Plan from 3,800,000 to 6,800,000 shares; and

**WHEREAS**, the Board of Directors of the Company is seeking stockholder approval of (i) the issuance of the Company Shares and the Conversion Shares, and (ii) the Amendment.

**NOW, THEREFORE, BE IT RESOLVED**, that the issuance of the Company Shares and the Conversion Shares be and hereby is authorized and approved.

**RESOLVED, FURTHER**, that the amendment to Section 4(a) of the Plan to increase the number of shares of Common Stock of the Company issuable pursuant to the Plan from 3,800,000 to 6,800,000 shares be and hereby is authorized and approved.

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**RESOLVED, FURTHER**, that the directors of the Company are hereby authorized and directed to take any such action as may be deemed necessary and advisable in order to carry out the purpose and intent of the foregoing resolutions.

The actions set forth in this Written Consent of Stockholder shall be effective on the first calendar day that is not less than 20 calendar days after the date that the definitive Schedule 14C information statement, as such term is defined in Rule 14c-1 promulgated under Regulation 14C of the Securities Exchange Act of 1934, as amended ( *Regulation 14C* ), relating to such actions is sent or given in accordance with Rule 14c-2 promulgated under Regulation 14C.

**IN WITNESS WHEREOF**, the undersigned stockholder has caused this Written Consent of Stockholders to be executed on the 6th day of May, 2004.

ATLANTIC INVESTORS LLC

By: UNICORN WORLDWIDE HOLDINGS  
LIMITED, a managing member of Atlantic  
Investors LLC

By: /s/ SIMON COOPER

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Name: Simon Cooper  
Title: Director  
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**APPENDIX II**

**NAVISITE, INC.**

**AMENDED AND RESTATED**

**2003 STOCK INCENTIVE PLAN**

**1. Purpose**

The purpose of this Amended and Restated 2003 Stock Incentive Plan (the **Plan**) of NaviSite, Inc., a Delaware corporation (the **Company**), is to advance the interests of the **Company's** stockholders by enhancing the **Company's** ability to attract, retain and motivate persons who make (or are expected to make) important contributions to the **Company** by providing such persons with equity ownership opportunities and performance-based incentives and thereby better aligning the interests of such persons with those of the **Company's** stockholders. Except where the context otherwise requires, the term **Company** shall include any of the **Company's** present or future parent or subsidiary corporations as defined in Sections 424(e) or (f) of the Internal Revenue Code of 1986, as amended, and any regulations promulgated thereunder (the **Code**) and any other business venture (including, without limitation, joint venture or limited liability company) in which the **Company** has a controlling interest, as determined by the Board of Directors of the **Company** (the **Board**).

**2. Eligibility**

All of the **Company's** employees, officers, directors, consultants and advisors are eligible to be granted options or restricted stock awards (each, an **Award**) under the **Plan**. Each person who has been granted an **Award** under the **Plan** shall be deemed a **Participant**.

**3. Administration and Delegation**

(a) **Administration by Board of Directors.** The **Plan** will be administered by the **Board**. The **Board** shall have authority to grant **Awards** and to adopt, amend and repeal such administrative rules, guidelines and practices relating to the **Plan** as it shall deem advisable. The **Board** may correct any defect, supply any omission or reconcile any inconsistency in the **Plan** or any **Award** in the manner and to the extent it shall deem expedient to carry the **Plan** into effect and it shall be the sole and final judge of such expediency. All decisions by the **Board** shall be made in the **Board's** sole discretion and shall be final and binding on all persons having or claiming any interest in the **Plan** or in any **Award**. No director or person acting pursuant to the authority delegated by the **Board** shall be liable for any action or determination relating to or under the **Plan** made in good faith.

(b) **Appointment of Committees.** To the extent permitted by applicable law, the **Board** may delegate any or all of its powers under the **Plan** to one or more committees or subcommittees of the **Board** (a **Committee**). All references in the **Plan** to the **Board** shall mean the **Board** or a **Committee** of the **Board** or the executive officers referred to in Section 3(c) to the extent that the **Board's** powers or authority under the **Plan** have been delegated to such **Committee** or executive officers.

(c) **Delegation to Executive Officers.** To the extent permitted by applicable law, the **Board** may delegate to one or more executive officers of the **Company** the power to grant **Awards** to employees or officers of the **Company** or any of its present or future subsidiary corporations and to exercise such other powers under the **Plan** as the **Board** may determine, provided that the **Board** shall fix the terms of the **Awards** to be granted by such executive officers (including the exercise price of such **Awards**, which may include a formula by which the exercise price will be determined) and the maximum number of shares subject to **Awards** that the executive officers may grant; provided further, however, that no executive officer shall be authorized to grant **Awards** to any executive officer of the **Company** (as defined by Rule 3b-7 under the Securities Exchange Act of 1934, as amended (the **Exchange Act**)) or to any officer of the **Company** (as defined by Rule 16a-1 under the **Exchange Act**).

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**4. Stock Available for Awards**

(a) Number of Shares. Subject to adjustment under Section 7, Awards may be made under the Plan for up to 3,800,000 shares of common stock, \$.01 par value per share, of the Company (the Common Stock ). If any Award expires or is terminated, surrendered or canceled without having been fully exercised or is forfeited in whole or in part (including as the result of shares of Common Stock subject to such Award being repurchased by the Company at the original issuance price pursuant to a contractual repurchase right) or results in any Common Stock not being issued, the unused Common Stock covered by such Award shall again be available for the grant of Awards under the Plan, subject, however, in the case of Incentive Stock Options (as hereinafter defined), to any limitations under the Code. Shares issued under the Plan may consist in whole or in part of authorized but unissued shares or treasury shares.

(b) Per-Participant Limit. Subject to adjustment under Section 7, the maximum number of shares of Common Stock with respect to which Awards may be granted to any Participant under the Plan shall be 650,000 per calendar year. The per-Participant limit described in this Section 4(b) shall be construed and applied consistently with Section 162(m) of the Code ( Section 162(m) ).

**5. Stock Options**

(a) General. The Board may grant options to purchase Common Stock (each, an Option ) and determine the number of shares of Common Stock to be covered by each Option, the exercise price of each Option and the conditions and limitations applicable to the exercise of each Option, including conditions relating to applicable federal or state securities laws, as it considers necessary or advisable. An Option which is not intended to be an Incentive Stock Option (as hereinafter defined) shall be designated a Nonstatutory Stock Option .

(b) Incentive Stock Options. An Option that the Board intends to be an incentive stock option as defined in Section 422 of the Code (an Incentive Stock Option ) shall only be granted to employees of NaviSite, Inc., any of NaviSite, Inc.'s present or future parent or subsidiary corporations as defined in Sections 424(e) or (f) of the Code, and any other entities the employees of which are eligible to receive Incentive Stock Options under the Code, and shall be subject to and shall be construed consistently with the requirements of Section 422 of the Code. The Company shall have no liability to a Participant, or any other party, if an Option (or any part thereof) that is intended to be an Incentive Stock Option is not an Incentive Stock Option.

(c) Exercise Price. The Board shall establish the exercise price at the time each Option is granted and specify it in the applicable option agreement.

(d) Duration of Options. Each Option shall be exercisable at such times and subject to such terms and conditions as the Board may specify in the applicable option agreement.

(e) Exercise of Option. Options may be exercised by delivery to the Company of a written notice of exercise signed by the proper person or by any other form of notice (including electronic notice) approved by the Board together with payment in full as specified in Section 5(f) for the number of shares for which the Option is exercised.

(f) Payment Upon Exercise. Common Stock purchased upon the exercise of an Option granted under the Plan shall be paid for as follows:

(1) in cash or by check, payable to the order of the Company;

(2) except as the Board may, in its sole discretion, otherwise provide in an option agreement, by (i) delivery of an irrevocable and unconditional undertaking by a creditworthy broker to deliver promptly to the Company sufficient funds to pay the exercise price and any required tax withholding or (ii) delivery by the Participant to the Company of a copy of irrevocable and unconditional instructions to a creditworthy broker to deliver promptly to the Company cash or a check sufficient to pay the exercise price and any required tax withholding;

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(3) when the Common Stock is registered under the Securities Exchange Act of 1934 (the Exchange Act ), by delivery of shares of Common Stock owned by the Participant valued at their fair market value as determined by (or in a manner approved by) the Board in good faith ( Fair Market Value ), provided (i) such method of payment is then permitted under applicable law and (ii) such Common Stock, if acquired directly from the Company was owned by the Participant at least six months prior to such delivery;

(4) to the extent permitted by the Board, in its sole discretion by (i) delivery of a promissory note of the Participant to the Company on terms determined by the Board, or (ii) payment of such other lawful consideration as the Board may determine; or

(5) by any combination of the above permitted forms of payment.

(g) Substitute Options. In connection with a merger or consolidation of an entity with the Company or the acquisition by the Company of property or stock of an entity, the Board may grant Options in substitution for any options or other stock or stock-based awards granted by such entity or an affiliate thereof. Substitute Options may be granted on such terms as the Board deems appropriate in the circumstances, notwithstanding any limitations on Options contained in the other sections of this Section 5 or in Section 2.

**6. Restricted Stock**

(a) Grants. The Board may grant Awards entitling recipients to acquire shares of Common Stock, subject to the right of the Company to repurchase all or part of such shares at their issue price or other stated or formula price (or to require forfeiture of such shares if issued at no cost) from the recipient in the event that conditions specified by the Board in the applicable Award are not satisfied prior to the end of the applicable restriction period or periods established by the Board for such Award (each, a Restricted Stock Award ).

(b) Terms and Conditions. The Board shall determine the terms and conditions of any such Restricted Stock Award, including the conditions for repurchase (or forfeiture) and the issue price, if any.

(c) Stock Certificates. Any stock certificates issued in respect of a Restricted Stock Award shall be registered in the name of the Participant and, unless otherwise determined by the Board, deposited by the Participant, together with a stock power endorsed in blank, with the Company (or its designee). At the expiration of the applicable restriction periods, the Company (or such designee) shall deliver the certificates no longer subject to such restrictions to the Participant or if the Participant has died, to the beneficiary designated, in a manner determined by the Board, by a Participant to receive amounts due or exercise rights of the Participant in the event of the Participant s death (the Designated Beneficiary ). In the absence of an effective designation by a Participant, Designated Beneficiary shall mean the Participant s estate.

**7. Adjustments for Changes in Common Stock and Certain Other Events**

(a) Changes in Capitalization. In the event of any stock split, reverse stock split, stock dividend, recapitalization, combination of shares, reclassification of shares, spin-off or other similar change in capitalization or event, or any distribution to holders of Common Stock other than a normal cash dividend, (i) the number and class of securities available under this Plan, (ii) the per-Participant limit set forth in Section 4(b), (iii) the number and class of securities and exercise price per share subject to each outstanding Option, and (iv) the repurchase price per share subject to each outstanding Restricted Stock Award shall be appropriately adjusted by the Company (or substituted Awards may be made, if applicable) to the extent the Board shall determine, in good faith, that such an adjustment (or substitution) is necessary and appropriate. If this Section 7(a) applies and Section 7(c) also applies to any event, Section 7(c) shall be applicable to such event, and this Section 7(a) shall not be applicable.

(b) Liquidation or Dissolution. In the event of a proposed liquidation or dissolution of the Company, the Board shall upon written notice to the Participants provide that all then unexercised Options will

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(i) become exercisable in full as of a specified time at least 10 business days prior to the effective date of such liquidation or dissolution and  
(ii) terminate effective upon such liquidation or dissolution, except to the extent exercised before such effective date. The Board may specify the effect of a liquidation or dissolution on any Restricted Stock Award granted under the Plan at the time of the grant.

(c) Reorganization Events

(1) Definition. A Reorganization Event shall mean: (a) any merger or consolidation of the Company with or into another entity as a result of which all of the Common Stock of the Company is converted into or exchanged for the right to receive cash, securities or other property or  
(b) any exchange of all of the Common Stock of the Company for cash, securities or other property pursuant to a share exchange transaction.

(2) Consequences of a Reorganization Event on Options. Upon the occurrence of a Reorganization Event, or the execution by the Company of any agreement with respect to a Reorganization Event, the Board shall provide that all outstanding Options shall be assumed, or equivalent options shall be substituted, by the acquiring or succeeding corporation (or an affiliate thereof). For purposes hereof, an Option shall be considered to be assumed if, following consummation of the Reorganization Event, the Option confers the right to purchase, for each share of Common Stock subject to the Option immediately prior to the consummation of the Reorganization Event, the consideration (whether cash, securities or other property) received as a result of the Reorganization Event by holders of Common Stock for each share of Common Stock held immediately prior to the consummation of the Reorganization Event (and if holders were offered a choice of consideration, the type of consideration chosen by the holders of a majority of the outstanding shares of Common Stock); provided, however, that if the consideration received as a result of the Reorganization Event is not solely common stock of the acquiring or succeeding corporation (or an affiliate thereof), the Company may, with the consent of the acquiring or succeeding corporation, provide for the consideration to be received upon the exercise of Options to consist solely of common stock of the acquiring or succeeding corporation (or an affiliate thereof) equivalent in fair market value to the per share consideration received by holders of outstanding shares of Common Stock as a result of the Reorganization Event.

Notwithstanding the foregoing, if the acquiring or succeeding corporation (or an affiliate thereof) does not agree to assume, or substitute for, such Options, then the Board shall, upon written notice to the Participants, provide that all then unexercised Options will become exercisable in full as of a specified time prior to the Reorganization Event and will terminate immediately prior to the consummation of such Reorganization Event, except to the extent exercised by the Participants before the consummation of such Reorganization Event; provided, however, that in the event of a Reorganization Event under the terms of which holders of Common Stock will receive upon consummation thereof a cash payment for each share of Common Stock surrendered pursuant to such Reorganization Event (the Acquisition Price), then the Board may instead provide that all outstanding Options shall terminate upon consummation of such Reorganization Event and that each Participant shall receive, in exchange therefor, a cash payment equal to the amount (if any) by which (A) the Acquisition Price multiplied by the number of shares of Common Stock subject to such outstanding Options (whether or not then exercisable), exceeds (B) the aggregate exercise price of such Options. To the extent all or any portion of an Option becomes exercisable solely as a result of the first sentence of this paragraph, upon exercise of such Option the Participant shall receive shares subject to a right of repurchase by the Company or its successor at the Option exercise price. Such repurchase right (1) shall lapse at the same rate as the Option would have become exercisable under its terms and (2) shall not apply to any shares subject to the Option that were exercisable under its terms without regard to the first sentence of this paragraph.

(3) Consequences of a Reorganization Event on Restricted Stock Awards. Upon the occurrence of a Reorganization Event, the repurchase and other rights of the Company under each outstanding Restricted Stock Award shall inure to the benefit of the Company's successor and shall apply to the cash, securities or other property which the Common Stock was converted into or exchanged for pursuant to such

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Reorganization Event in the same manner and to the same extent as they applied to the Common Stock subject to such Restricted Stock Award.

**8. General Provisions Applicable to Awards**

(a) Transferability of Awards. Except as the Board may otherwise determine or provide in an Award, Awards shall not be sold, assigned, transferred, pledged or otherwise encumbered by the person to whom they are granted, either voluntarily or by operation of law, except by will or the laws of descent and distribution, and, during the life of the Participant, shall be exercisable only by the Participant. References to a Participant, to the extent relevant in the context, shall include references to authorized transferees.

(b) Documentation. Each Award shall be evidenced in such form (written, electronic or otherwise) as the Board shall determine. Each Award may contain terms and conditions in addition to those set forth in the Plan.

(c) Board Discretion. Except as otherwise provided by the Plan, each Award may be made alone or in addition or in relation to any other Award. The terms of each Award need not be identical, and the Board need not treat Participants uniformly.

(d) Termination of Status. The Board shall determine the effect on an Award of the disability, death, retirement, authorized leave of absence or other change in the employment or other status of a Participant and the extent to which, and the period during which, the Participant, the Participant's legal representative, conservator, guardian or Designated Beneficiary may exercise rights under the Award.

(e) Withholding. Each Participant shall pay to the Company, or make provision satisfactory to the Board for payment of, any taxes required by law to be withheld in connection with Awards to such Participant no later than the date of the event creating the tax liability. Except as the Board may otherwise provide in an Award, when the Common Stock is registered under the Exchange Act, Participants may satisfy such tax obligations in whole or in part by delivery of shares of Common Stock, including shares retained from the Award creating the tax obligation, valued at their Fair Market Value; provided, however, that the total tax withholding where stock is being used to satisfy such tax obligations cannot exceed the Company's minimum statutory withholding obligations (based on minimum statutory withholding rates for federal and state tax purposes, including payroll taxes, that are applicable to such supplemental taxable income). The Company may, to the extent permitted by law, deduct any such tax obligations from any payment of any kind otherwise due to a Participant.

(f) Amendment of Award. The Board may amend, modify or terminate any outstanding Award, including but not limited to, by substituting therefor another Award of the same or a different type, changing the date of exercise or realization, and converting an Incentive Stock Option to a Nonstatutory Stock Option, provided that the Participant's consent to such action shall be required unless the Board determines that the action, taking into account any related action, would not materially and adversely affect the Participant.

(g) Conditions on Delivery of Stock. The Company will not be obligated to deliver any shares of Common Stock pursuant to the Plan or to remove restrictions from shares previously delivered under the Plan until (i) all conditions of the Award have been met or removed to the satisfaction of the Company, (ii) in the opinion of the Company's counsel, all other legal matters in connection with the issuance and delivery of such shares have been satisfied, including any applicable securities laws and any applicable stock exchange or stock market rules and regulations, and (iii) the Participant has executed and delivered to the Company such representations or agreements as the Company may consider appropriate to satisfy the requirements of any applicable laws, rules or regulations.

(h) Acceleration. The Board may at any time provide that any Award shall become immediately exercisable in full or in part, free of some or all restrictions or conditions, or otherwise realizable in full or in part, as the case may be.

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**9. Miscellaneous**

(a) No Right to Employment or Other Status. No person shall have any claim or right to be granted an Award, and the grant of an Award shall not be construed as giving a Participant the right to continued employment or any other relationship with the Company. The Company expressly reserves the right at any time to dismiss or otherwise terminate its relationship with a Participant free from any liability or claim under the Plan, except as expressly provided in the applicable Award.

(b) No Rights as Stockholder. Subject to the provisions of the applicable Award, no Participant or Designated Beneficiary shall have any rights as a stockholder with respect to any shares of Common Stock to be distributed with respect to an Award until becoming the record holder of such shares. Notwithstanding the foregoing, in the event the Company effects a split of the Common Stock by means of a stock dividend and the exercise price of and the number of shares subject to such Option are adjusted as of the date of the distribution of the dividend (rather than as of the record date for such dividend), then an optionee who exercises an Option between the record date and the distribution date for such stock dividend shall be entitled to receive, on the distribution date, the stock dividend with respect to the shares of Common Stock acquired upon such Option exercise, notwithstanding the fact that such shares were not outstanding as of the close of business on the record date for such stock dividend.

(c) Effective Date and Term of Plan. The Plan shall become effective on the date on which it is adopted by the Board, but no Award granted to a Participant that is intended to comply with Section 162(m) shall become exercisable, vested or realizable, as applicable to such Award, unless and until the Plan has been approved by the Company's stockholders to the extent stockholder approval is required by Section 162(m) in the manner required under Section 162(m) (including the vote required under Section 162(m)). No Awards shall be granted under the Plan after the completion of ten years from the earlier of (i) the date on which the Plan was adopted by the Board or (ii) the date the Plan was approved by the Company's stockholders, but Awards previously granted may extend beyond that date.

(d) Amendment of Plan. The Board may amend, suspend or terminate the Plan or any portion thereof at any time, provided that to the extent required by Section 162(m), no Award granted to a Participant that is intended to comply with Section 162(m) after the date of such amendment shall become exercisable, realizable or vested, as applicable to such Award, unless and until such amendment shall have been approved by the Company's stockholders if required by Section 162(m) (including the vote required under Section 162(m)).

(e) Governing Law. The provisions of the Plan and all Awards made hereunder shall be governed by and interpreted in accordance with the laws of the State of Delaware, without regard to any applicable conflicts of law.

*Adopted by the Board of Directors on November 11, 2003.*

*Approved by the Stockholders on December 9, 2003.*



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**AMENDMENT NO. 1 TO THE NAVISITE, INC.**

**AMENDED AND RESTATED  
2003 STOCK INCENTIVE PLAN**

The Amended and Restated 2003 Stock Incentive Plan (the Plan ) of NaviSite, Inc. is hereby amended as follows (capitalized terms used herein and not defined herein shall have the respective meaning ascribed to such terms in the Plan):

1. Section 4(a) of the Plan shall be deleted in its entirety and replaced with the following:

(a) Number of Shares. Subject to adjustment under Section 7, Awards may be made under the Plan for up to 6,800,000 shares of common stock, \$.01 par value per share, of the Company (the Common Stock ). If any Award expires or is terminated, surrendered or canceled without having been fully exercised or is forfeited in whole or in part (including as the result of shares of Common Stock subject to such Award being repurchased by the Company at the original issuance price pursuant to a contractual repurchase right) or results in any Common Stock not being issued, the unused Common Stock covered by such Award shall again be available for the grant of Awards under the Plan, subject, however, in the case of Incentive Stock Options (as hereinafter defined), to any limitations under the Code. Shares issued under the Plan may consist in whole or in part of authorized but unissued shares or treasury shares.

2. Except as aforesaid, the Plan shall remain in full force and effect.

*Adopted by the Board of Directors on May 6, 2004.*

*Approved by the Stockholders on May 6, 2004.*

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