NAVISITE INC
Form 10-K
October 29, 2002
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

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

(Mark One)

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

For the fiscal year ended July 31, 2002

OR

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

For the transition period from to

Commission file number: 0-27597

NAVISITE, INC.

(Exact name of registrant as specified in its charter)

Delaware **(State or other jurisdiction of incorporation)**	**52-2137343** **(I.R.S. Employer Identification No.)**
400 Minuteman Road **Andover, Massachusetts** **(jurisdiction of incorporation)**	**01810** **(Zip Code)**

(978) 682-8300
(Registrant s telephone number, including area code)

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

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

The aggregate market value of the registrant s common stock, $0.01 par value per share, held by non-affiliates of the registrant was approximately $3,707,334, based on the last reported sale price of the registrant s common stock on the Nasdaq SmallCap Market as of the close of business on October 25, 2002.

As of October 25, 2002 there were 95,610,362 shares outstanding of the registrant s common stock, par value $0.01 per share.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant s definitive proxy statement for its annual meeting of stockholders for the fiscal year ended July 31, 2002, which will be filed with the Securities and Exchange Commission within 120 days after the end of the registrant s fiscal year, are incorporated by reference into Part III hereof.

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PART I

Special Note Regarding Forward-Looking Statements

This Form 10-K contains forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, that involve risks and uncertainties. All statements other than statements of historical information provided herein are forward-looking statements and may contain information about financial results, economic conditions, trends and known uncertainties. Our actual results could differ materially from those discussed in the forward-looking statements as a result of a number of factors, which include those discussed in this section and elsewhere in this report and the risks discussed in our other filings with the Securities and Exchange Commission. Readers are cautioned not to place undue reliance on these forward- looking statements, which reflect management s analysis, judgment, belief or expectation only as of the date hereof. We undertake no obligation to publicly reissue these forward-looking statements to reflect events or circumstances that arise after the date hereof.

Item 1. ***Business***

Company Overview

NaviSite, Inc. (NaviSite) provides outsourced Web hosting and managed application services for companies conducting mission critical business on the Internet, including enterprises and other businesses deploying Internet applications. Our goal is to help customers focus on their core competencies by outsourcing the management and hosting of their Web operations and applications, allowing customers to fundamentally improve the efficiency of their Web operations. We also provide related professional and consulting services. Our focus on enhanced management services, beyond basic co-location and infrastructure services, allows us to meet the expanding needs of businesses as their Web sites and Internet applications become more complex.

We provide Always On Managed Hosting^{SM} and we believe that there are a relatively small number of companies that combine a highly scalable and developed infrastructure with expertise, experience, intellectual property, software platforms, processes and procedures for delivering complex managed hosting services. We define Always On Managed Hosting^{SM} as a combination of high availability infrastructure, high performance monitoring systems and proactive problem resolution and change management processes designed to recognize patterns and identify and address potentially crippling problems before they are able to cause downtime in customers Web operations. The price for our services varies from customer to customer based on the number of managed servers and the nature, extent and level of services provided.

We derive our revenue primarily from managed hosting services, but within that framework, from a variety of service offerings, including:

Managed Applications for customers who want to outsource the end-to-end management of their packaged or custom e-business application.

Managed Servers for customers who intend to manage the application, but want to outsource the management of the infrastructure software OS, web servers, database servers, application servers and integration and transaction processing middleware to a trusted third party.

Managed Infrastructure for customers who want to be able to select value added security, network, application load balancing, storage, advanced backup and recovery services on an a la carte basis, knowing that they are designed to be used either alone or together.

Managed Facilities for customers with significant internal IT resources but who want a vendor to manage the underlying data center and bandwidth facilities.

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Expertise Services for customers who want to leverage industry experts for specialized services including solutions architecture, data center migration, application and infrastructure consolidation and scalability testing that address their unique business needs.

NaviSite was incorporated in Delaware in December 1998 and is a 79.6% owned subsidiary of ClearBlue Technologies, Inc. (ClearBlue). Prior to September 11, 2002, we were a 75.8% owned subsidiary of CMGI, Inc. (CMGI). Since January 31, 2000, our corporate headquarters have been located at 400 Minuteman Road, Andover, Massachusetts. Additionally, we operate two state of the art data centers, one in Andover, Massachusetts and one in San Jose, California.

Fiscal 2002 Operating Plan and Recent Developments

Fiscal year 2002 has been a challenging year for the technology industry and the telecommunications and IT services market, in particular. In fiscal year 2002, we executed a plan to restructure our business model and our business operations. Over the course of the year, we raised new financing, restructured our operating leases and fixed cost infrastructure contracts to significantly reduce excess capacity, implemented labor efficiencies, managed out non-productive customers, eliminated low margin product lines, and divested a non-core business. As a result, we have reduced our revenue requirement for EBITDA (we define EBITDA as earnings before interest, tax, depreciation and amortization, including the amortization of the beneficial conversion feature of our convertible debt) break-even from $44 million per quarter at July 31, 2001 to $11 million per quarter at July 31, 2002, while improving the quality of our service delivery, customer satisfaction and our publicly available and industry leading operating metrics.

During fiscal year 2002, we systematically reduced our run rate cash burn from $7.3 million per month in the fourth quarter of fiscal year 2001 to $1.4 million per month in the fourth quarter of fiscal year 2002. Further, as we have shifted our business model away from a return on our physical infrastructure to one focused on generating a return on our managed services platform, such as IP, software infrastructure and work processes, we expect to leverage the capital investments already made without significant new capital requirements going forward.

HPFS/CMGI Financing

Under the terms of an agreement dated October 29, 2001, NaviSite received a total of $65 million in financing from Compaq Financial Services Corporation, a wholly owned subsidiary of Compaq Computer Corporation and now known as Hewlett-Packard Financial Services Company (HPFS), and CMGI. We received $20 million and $10 million in cash from HPFS and CMGI, respectively, in the form of notes payable (collectively, the Convertible Notes) with interest payable in the first three years and principal and interest payable thereafter. We also purchased certain equipment previously under operating leases for approximately $35 million.

Also in connection with this agreement, CMGI converted its existing $80 million in outstanding notes due in December 2003 into approximately 14.5 million shares of our common stock and approximately $16.2 million of amounts due to CMGI were converted into approximately 9.9 million shares of our common stock.

Restructured Operating Leases and Infrastructure Contracts

Operating Leases. At the beginning of fiscal year 2002, NaviSite had $82 million in assets under operating leases with third parties and an additional $23 million under operating leases held by CMGI but used by NaviSite. A portion of this equipment became undeployed during fiscal year 2002 and was not being utilized.

In fiscal year 2002, we renegotiated, restructured or bought out $73.6 million in NaviSite operating assets comprised of 199 leases with seven different lessors. In conjunction with these transactions, we returned

$5.6 million of equipment, paid approximately $7.6 million in one time cash payments and took asset impairment charges of $30.2 million as the equipment was marked to fair market value. The impact on the business was a significant reduction in operating lease payments from $44.5 million in fiscal year 2001 to $8.3 million in fiscal year 2002. Going forward, the contractual operating lease commitments in fiscal year 2003 will be approximately $1.9 million.

The $23 million in CMGI leased equipment utilized by NaviSite has been returned to CMGI in conjunction with a settlement agreement executed on August 19, 2002. As part of the settlement agreement with CMGI, we settled a net liability to CMGI of $7.7 million for $3.2 million in cash, which was paid in August 2002.

Bandwidth. NaviSite deploys a N+1 bandwidth architecture with direct private transit Internet connections into multiple major Internet backbone providers, thereby increasing speed, reliability and consistency of performance for our customers Internet applications. We believe this differentiates our network infrastructure from those of our competitors.

In fiscal year 2002, we executed an aggressive cost reduction plan that both eliminated overall excess capacity and lowered unit bandwidth costs. We actively renegotiated two major bandwidth contracts and concurrently brought in three additional providers under monthly or pure usage based contracts with minimal usage commitments. As a result, overall bandwidth expenses in fiscal year 2002 were down 62% from fiscal year 2001 and fully loaded unit costs decreased by 45% in fiscal year 2002 compared with the prior fiscal year. Making changes to our bandwidth architecture, providers and contracts require long lead times. Consequently, we expect to fully realize the economic benefits of these actions in fiscal year 2003 when overall bandwidth expenses will be reduced by 83% from fiscal year 2001 and fully loaded unit costs will be reduced by 67% over fiscal year 2001.

Finally, another significant outcome of our cost reduction plan is that minimum contracted bandwidth commitments have been dramatically reduced. For fiscal year 2002, minimum contracted bandwidth payments were $3.6 million versus $9.5 million in fiscal year 2001. In fiscal year 2003, our minimum committed bandwidth payments are approximately $937,000.

Maintenance. NaviSite has maintenance contracts with various providers for 24x7 support of all infrastructure, equipment, software and data center facilities. In fiscal year 2001, NaviSite entered into multiple, long-term maintenance support contracts with significant minimum volume commitments. These volume commitments were driven by expected growth and market analysis. When this growth did not materialize, we incurred maintenance expenses for idle software and hardware assets.

In fiscal year 2002, we renegotiated, downsized or bought out approximately 70% of our maintenance contracts. Each of our restructured maintenance contracts now has a usage-based clause that allows us to adjust volumes monthly or quarterly, which gives us flexibility without the minimum commitments. Concurrently, we consolidated infrastructure and network architectures to increase utilization and further drive cost savings. In fiscal year 2002, we reduced our maintenance expenses by 20% over fiscal year 2001. The majority of the annualized savings will be realized in fiscal year 2003 when we expect an additional 44% savings over fiscal year 2002, assuming current volume.

Labor and Operating Efficiencies

In fiscal year 2002 we aggressively restructured our organization and implemented labor efficiencies across the entire organization. As a result, overall labor and consulting expenses in fiscal year 2002 were approximately $36 million, down from $80 million in fiscal year 2001.

Examples of these efficiencies include the following: In the area of customer service, we consolidated what were previously two organizations that interacted with the customer into one integrated account management

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function. This increased the quality of customer service, increased solutions up-selling and reduced costs. In operations, we consolidated end-to-end service responsibility into an integrated service delivery organization. Additionally, our investments in automation combined with the maturation of our software and management systems allowed us to refine our work processes and further drive efficiencies. In research and development, we focused on a much more narrow set of initiatives with near term return on investments. We tracked and managed sales force and marketing productivity and we gained administrative efficiencies through consolidating functions.

The effectiveness of our actions is best measured by the steady and systematic improvements in the quality of the services delivered to our customer base. We believe we are currently the only managed services provider to make our monthly operating metrics publicly available on a monthly basis. These objective measures ensure transparency into our operations. There are three metrics we report: (1) mean time to notify a customer of an incident, which improved 57% from an average of 10.03 minutes in fiscal year 2001 to 4.32 minutes in fiscal year 2002; (2) mean time to respond, which is the time it takes to get an engineer to resolve an issue, improved 60% from 20.08 minutes in fiscal year 2001 to 8.01 minutes in fiscal year 2002; and (3) overall site availability, which was 99.999% in both fiscal year 2001 and 2002.

Going forward, we will continue to look for areas of improvement, to re-evaluate staffing levels and to implement additional labor efficiencies as we deem appropriate.

Data Center and Real Estate Consolidation

At the end of fiscal year 2001, we made the decision to consolidate two first generation data centers into our two second generation data center facilities. We completed the customer migration with no downtime to our customers and we completed the consolidation in the third quarter of fiscal year 2002 ahead of schedule and $2.5 million under budget.

At our Andover facility, NaviSite leases both office and data center space. Subsequent to the fiscal year end, we had been in negotiations with our Andover landlord to buy-out the office space portion of the lease. The terms are described under Item 2 Properties. Contingent upon receiving consent from the mortgage company, we intend to execute this transaction. The transaction is expected to be operating cash flow break-even in approximately 15 months and is expected to result in $1.8 million in annual savings for the remaining nine years and two months of the lease.

Product Lines

Last fall, we made a decision to sell our Streaming Media Division. The Streaming Media Division was cash flow negative, faced a difficult competitive market and was non-core to our overall strategy. On March 21, 2002, we sold certain Streaming Media Division assets to SMC Corporation and discontinued our streaming service offerings. We received proceeds of approximately $1.6 million in cash and entered into a sublease of our La Jolla, California facility for approximately $700,000 to be paid over two years to cover the cost of the facilities.

During the second quarter of fiscal year 2002, we made the decision to discontinue our practice, on a prospective basis, of obtaining equipment under lease arrangements and subsequently renting the equipment to our customers. The decision was made for three reasons. First, it is a low margin business and we can continue to service our customers as the single point of procurement and management without assuming the lease or title to the equipment. Second, many of our enterprise customers can acquire hardware equipment with a lower cost of capital. Third, it eliminates additional credit and financial risk associated with an early customer contract termination. While this decision is expected to improve overall margins, it will reduce revenue potential from future customers and impact overall revenues as existing equipment leases terminate and are not renewed or when existing customers renew their contracts and enter into a direct finance relationship with NaviSite for their equipment. Revenue from equipment rental accounted for approximately 22% in fiscal year 2002 compared with 25% in fiscal year 2001.

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On October 18, 2002, we eliminated our practice of re-selling Akamai s content delivery network (CDN) services. We have entered into a new referral relationship with Akamai whereby we will expand our offerings to include the full Akamai EdgeSuite product line and continue to service our customers as a single point of management. Although we will no longer recognize revenues from the resale of CDN services, we expect that this decision will improve margins and eliminate approximately $500,000 in minimum annual commitments.

Implementation of Revised Business Model

Over the past few quarters, we have been evaluating a business model whereby we would provide integrated managed hosting services in data centers owned by third parties in addition to our own data centers. We believe that this approach would augment our existing management expertise, software and operating processes by increasing distribution and geographic reach. In fact, subsequent to the fiscal year end, we publicly launched our remote management services in which we delivered our application management services in customer locations and third-party data centers. This approach is consistent with our overall shift in focus from generating returns on physical infrastructure to generating returns on our managed services platform. In conjunction with our decision to exit the equipment rental business, we believe this change in our business model will result in a higher quality of revenue, improved overall margins and strengthened strategic position in the marketplace.

As part of our accounting procedures at July 31, 2002, we evaluated the impairment of long lived assets. It was determined that certain assets were impaired and we realized an impairment charge of $38.1 million in fiscal year 2002.

Managing the Customer Base

Over the course of fiscal year 2002, we had proactively managed out non-productive and unprofitable customers. At the end of fiscal year 2001,67% of our customer base was concentrated in small start-up Internet based businesses and independent software vendors (ISVs). Many of these customers experienced difficulty with their business models and have gone out of business over the course of the past year. Our overall customer count has decreased from 288 customers at July 31, 2001 to approximately 145 customers at July 31, 2002. Further, the bad debt expense has decreased from $11.9 million in fiscal year 2001 to $3.5 million in fiscal year 2002. Equally, accounts receivable days sales outstanding have correspondingly improved from 56 days in the fourth quarter of fiscal year 2001 based on the collectibility method, to 44 days in the fourth quarter of fiscal year 2002. We believe these statistics are indications of a healthier and much more stable customer base.

Over the past year, we have focused on strengthening our relationships with key customers. In addition to moving to a customer relationship management model within a customer support organization, we now provide all customers with monthly performance summaries, perform quarterly account reviews with approximately 80% of our customers, and we perform system health checks and application audits either annually or semi-annually where we meet with customers in person to review their technology solutions and upcoming needs.

New Revenue Growth through Channels

In fiscal year 2002, we focused on building and delivering customized enterprise solutions with system integration partners who perform the implementation and manage the customer specific content. We launched managed Oracle 11i business applications with four regional system integration firms and two large national consulting firms. Additionally, we recently launched a channel partnership with Progress Software Corporation where we are working together to enable their base of ISVs to provide their software as a service, known as application service provider or ASP.

New Majority Stockholder

On September 11, 2002, each of CMGI and HPFS sold and transferred all of their respective equity and debt interests in NaviSite to ClearBlue. As a result of these transactions, ClearBlue owns, directly or indirectly through

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its wholly owned subsidiaries, approximately 79% of the outstanding capital stock of NaviSite. If ClearBlue were to convert the Convertible Notes it acquired from CMGI and HPFS as described in note 16 of the financial statements, ClearBlue would own approximately 94% of the outstanding capital stock of NaviSite.

NaviSite and ClearBlue are evaluating the possibility of a business combination involving ClearBlue, its affiliated entities and NaviSite. ClearBlue is our majority stockholder and could unilaterally implement any such combination. The parties expect that such a potential combination could enhance our suite of services, increase revenues, provide significant cost synergies, strengthen the long-term competitive position of the companies and improve operating efficiencies in the two businesses. However, the parties currently have no plan for such a combination and, therefore, the impact of such a combination, if implemented, on our business is undetermined.

Expansion through Acquisitions

With the support of our new majority stockholder, ClearBlue, we are exploring acquisitions in our space as a means to accelerate our business, build scale and solidify our competitive position. Leveraging the high quality of our service delivery function and the operating efficiency of managed services platform, we will seek to structure any acquisitions in this space such that they would be EBITDA accretive soon after integration.

Industry Background

The Overall Market Driver: Growth of Internet Business Applications. We believe that the dramatic growth in Internet usage combined with enhanced functionality, accessibility and security, has made the Internet increasingly attractive to businesses as a medium for communication and commerce. Initial use of the Internet was, for the most part, focused on consumer applications. Businesses are now deploying Internet applications on a large scale, to enhance their core business operations.

As business use of the Internet grows, we believe that businesses utilizing the Internet are seeking to identify and implement increasingly sophisticated Internet applications. These new applications permit businesses to:

- increase operating efficiencies and reduce sales, general and administrative costs;
- engage in business-to-business and business-to-consumer e-commerce;
- build and enhance customer relationships by providing Internet-based customer service and technical support;
- manage vendor and supplier relationships through Web-based technologies such as online training, e-commerce enablement, and streaming; and
- communicate and conduct business more rapidly and cost-effectively with customers, suppliers and employees worldwide.

As a result, the proliferation of business Web sites and Internet applications has created a strong underlying demand for specialized information technology support and application expertise. Tier 1 Research has estimated that the managed hosting market will rise from $4.3 billion in 2002 to $7.5 billion in 2005.

Underlying Demand: Movement Toward Outsourcing. A growing number of businesses using the Internet as part of their business strategy have chosen to outsource Internet application development, implementation and support, particularly the hosting and management of their Web sites and Internet applications.

The outsourced hosting and management of Web sites and Internet applications is driven by a number of factors, including:

- the need to improve the reliability, availability and overall performance of Internet applications and Web sites as those applications increase in importance and complexity;

- requirements for rapid time to market and a reduced time to deploy operationally efficient Internet applications;
- challenges faced by businesses in hiring, training and retaining application engineers and information technology employees with the requisite range of IT expertise;
- increasing complexity of managing the operations of Web sites; and
- deployment risk and the risk of technological obsolescence as businesses attempt to capitalize on leading-edge technologies.

Challenging Market in the Near Term: Service Provider Market Consolidation. As the United States economy slowed down over the past few years, enterprises re-evaluated their existing IT budgets and planned spending. Projects not deemed critical to the bottom line were put on hold while existing projects were required to meet the more rigorous demand of lower costs and increased efficiency.

Concurrent with the dot-com shakeout, this slowdown in corporate IT spending has dramatically compounded the problems of excess capacity within the overall IT industry. As a result, mergers, acquisitions, bankruptcies and liquidations have been the dominant trends in the telecommunications, service providers and professional services segments of the IT services market. Regarding their purchasing decisions, customers have taken a cautious approach towards their service providers and technology partners.

Strategic Considerations: Evolution of Complex Managed Services. The market for managed services has evolved rapidly over the past few years. While co-location providers at the low-end of the hosting market have faced significant pricing pressures, the high-end of the market, particularly complex managed services, continues to grow. Web sites with simple e-commerce functionality two years ago have progressed into more complex transaction processing tools. Back-end connectivity, integration with legacy business systems, an increased focus on business continuance and security are characteristic of this progression.

As ISVs and other companies begin to deploy application or Web services, new application management requirements are emerging. Customer demands for remote management services across geographically dispersed IT topologies further drive the move towards complex managed services.

Strategy

NaviSite s objective is to be the trusted, full service provider of outsourced application services to the mid-sized enterprise spending between $300,000 to $1 million per year on its Internet applications. We seek to achieve this goal by continuing to enhance and leverage our expertise, service offerings and infrastructure to provide customers with integrated, reliable and secure Internet-based business solutions. Four key components of our strategy include:

Deliver Industry-Leading Operational Metrics. NaviSite has developed, and delivers to its customers, consistently high levels of operational metrics across the areas that are most critical to businesses, including the performance of customer applications, network elements, and service levels. We believe our operating metrics are among the highest metrics in the managed services industry. Because the quality, service level and efficiency of our managed services are transparent, we believe that our operating metrics are a critical differentiator in the marketplace. NaviSite plans to continue driving improvements in its operating metrics and corresponding improvements in the quality of its customer service.

Focus on High Value-Added Managed Services. NaviSite currently provides horizontal application and infrastructure services that have broad appeal across most market segments, including a wide range of industry

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segments, including enterprises, ISVs and e-commerce companies. To meet the changing needs of our current and prospective customer base, we intend to augment our current service offerings by focusing on a sub-set of complex, scale and expertise driven services that build on our value proposition of outsourced IT operations. As a practice, we focus on network and application services that are repeatable, meaning that they require minimal additional customization and integration. We believe that this repeatability decreases our time to market, reduces our operating risks and produces a higher return on our investment and provides higher levels of consistency to our customers.

Partner to Deliver Integrated Application Solutions. We believe that companies will require an increasingly diverse range of capabilities and point technologies as their applications and application ecosystems increase in complexity. While NaviSite specializes in delivering highly scalable management services for the infrastructure, network and foundation application layers of the application stack, we intend to leverage relationships with key system integration and technology partners for services that extend beyond our product range. Driven by differences in economic models, these are services that we will not perform ourselves, but rather, will leverage partners in order to deliver integrated, customized and complete solutions to our end-user customers.

Build Leveraged Distribution Channels with Strategic Partners. Historically, NaviSite has built strong industry relationships with leading technology companies. We work closely with a small and select group of partners to jointly develop higher value proposition offerings and distribute them through joint marketing and sales efforts. We believe that by leveraging our industry relationships, and our partners distribution capabilities, we are able to increase visibility and sales productivity.

The NaviSite Solution

NaviSite provides a range of integrated, scalable Web hosting and remote business application management services that can be deployed in a cost-effective and rapid manner. We specialize in developing, deploying and managing dedicated mission critical Web-based solutions for our customers. We serve as the single point of management for their Web-based business applications and our focus on management of customer business computing infrastructure allows us to meet an expanding set of customer needs as their applications become more complex. Key advantages of our solution include:

Comprehensive and Integrated Solutions. We provide an integrated suite of products and services that address the full application stack including data center, bandwidth, storage, servers, security, databases, OS, Web and application servers and enterprise resource applications. Further, we provide our services across Unix, Windows, and Linux platforms and in highly secure, highly available and redundant environments.

Cost-Effective Management Services. The combination of our scalable infrastructure, the repeatability of our management processes and our extensive base of expertise allow us to provide our customers with Web-based business application hosting and management services on a cost-effective basis. Because NaviSite has already deployed state-of-the-art infrastructure from the industry s leading providers, our customers can immediately leverage equipment and services that would typically not be cost effective for them to purchase and deploy themselves. Second, we have made significant investments in our operating platform and our automation capabilities. Furthermore, we have refined these processes over time and across a large base of customers. By leveraging this expertise, we can more efficiently configure, deploy and manage complex applications and, thus, save our customers from hiring or developing that same expertise in-house. By off-loading these resources and time-intensive Web site operations, we allow our customers to focus on their core business. We believe that our customers would otherwise be required to make significant expenditures to replicate our performance, reliability and expertise either internally or by using outside vendors.

Location Independent. Our management services can be delivered to customers located at customer and third-party data centers. This capability enables us to capture the full potential of the managed services market where a vast majority of all computing infrastructure are located at the customer s premises. By leveraging the

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experience, tools and processes developed over the last six years, we can drive down incremental management costs and deliver a higher value for our customers.

Rapid Deployment. We offer our customers the ability to rapidly deploy, scale and adapt their Web-based business applications, often in a matter of days or weeks, rather than months. Because NaviSite has already deployed sophisticated infrastructure components and has the experience of deploying similar applications for hundreds of customers, we believe that we can deploy sophisticated Web sites much more rapidly than businesses can in-house. This is especially important to many of our customers who deploy mission critical applications for revenue enhancement or cost improvement objectives.

High-Performance Infrastructure. Our infrastructure has been built by integrating best of breed components and has been designed specifically to meet the more demanding technical requirements of providing managed application hosting, compared to co-location hosting services. Our high-performance infrastructure, together with our trained and experienced staff, enable us to offer levels of service which are backed by high service level guarantees.

Services, Managed Services Platform, Technology and Operations

Management Services. NaviSite provides management services for the lifecycle of Internet and Internet enabled applications. These management services include: (1) architecture, deployment and testing of an application; (2) problem resolution management; (3) application change management; (4) root cause analysis and proactive change; and (5) integration management services. Further, as these applications are increasingly deployed across distributed geographies and topologies and/or distributed points of integration both with legacy systems and other Web services, the ability to perform these management services exponentially increases in complexity.

Managed Internet Applications. We serve our customers as the single point of management for their end-to-end custom e-business applications and their Internet enabled packaged enterprise application suites. Whether NaviSite manages the customer application itself, or partners with application developers who design and build custom applications on top of our managed services platform, NaviSite serves its customers as a full-service provider of outsourcing application management. Additionally, NaviSite also partners with system integration firms in order to deliver outsourced Internet enabled enterprise applications. Through these partnerships, we are able to provide customers with complex enterprise solutions through leveraged distribution channels.

Managed Servers. NaviSite manages physical servers and application servers on the Sun, Windows and Linux platforms. These services are intended for customers who are interested in managing their own custom applications, but want to outsource management of the physical infrastructure and the software infrastructure. NaviSite specializes in the management of the OS, Web servers, database servers, application servers and integration and transaction processing middleware.

Network Security, Storage and Backup. Our network incorporates host-based security with CheckPoint back-end firewalls and Cisco router access control lists, as well as SecureID token-based authentication. In addition to these physical security measures, we have a formal security policy in place, including employee training, that governs all facets of our business and guidelines governing internal and external access to information housed in our network system. We deliver a number of high capacity managed storage services built on EMC, Sun, HP/Compaq and Net Appliance products. We offer incremental, differential and full backup and restore capabilities for all customer applications and data.

Managed Services Platform. In order to service our customers requirements effectively and efficiently, we leverage our managed services platform which consists of an integrated set of proprietary work processes, business support systems, best of breed software and automation platforms. Some of these tools include a knowledge-based problem resolution and trouble-ticketing system, a distributed monitoring and management

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platform, sophisticated data storage system, a corporate intranet with built-in document management and source control system. These tools are unique in their integration with each other and our proprietary workflows, work processes and procedures. We continue to refine and improve these capabilities and we have sought to integrate our platform with those of our system integration partners and customers. We believe our platform and our ability to work with partners is a source of differentiation and competitive advantage.

Network Operations Centers. We monitor the operations of our infrastructure and customer Internet applications from our own network operations centers. Our primary network operations center in Andover is fully staffed 24 hours a day, seven days a week with Network, Security, Windows NT and UNIX personnel. We run a fully operational real-time backup network operations center in San Jose, California. Our network operations centers perform first-level problem identification, validation and resolution. The design of our network operations centers allows network engineers and support personnel to be promptly alerted to problems and we have established procedures for rapidly resolving any technical issues that arise. Network management and monitoring tools continuously monitor the network and server performance.

Data Centers. We currently serve customers from two data centers located in Andover, Massachusetts and in San Jose, California. These state-of-the-art data centers incorporate technically sophisticated components, which are designed to be fault-tolerant. The components used in our data centers include Cisco redundant core routers, Cisco redundant core switching hubs and secure virtual local area networks. We utilize the equipment and tools necessary for our data center operations, including our infrastructure hardware, networking and software products, from industry leaders such as BMC, Cisco, Hewlett Packard, Dell, EMC, Microsoft, Oracle and Sun Microsystems.

Private Transit Internet Connectivity. Our use of direct private transit Internet connections to three major Internet backbone providers differentiates our network infrastructure from those of our competitors. We have redundant high-capacity Internet connections to UUNet, InterNap, and Cable and Wireless on the east coast and UUNet and InterNap on the west coast. We have deployed direct private transit Internet connections specifically to avoid congestion and data loss at public Internet exchange points and the resulting degradation of performance. Our private transit system enables us to provide fast, reliable access for our customers Web sites and Internet applications.

Service Level Agreements. The combination of our state-of-the-art infrastructure, our customer-focused operations group and our hosting and management expertise enable us to offer our customers guaranteed service levels. For example, one of our offerings is a 99.99% full site high availability service level agreement that covers their entire application.

Sales and Marketing

Our sales and marketing strategy is to cost effectively penetrate the mid-sized enterprise market through a combination of direct sales and channel partnerships.

Direct Sales. Our direct sales professionals are organized into groups located in Andover, Massachusetts, New York, New York, San Francisco, San Jose and Los Angeles, California, and Vienna, Virginia.

Channel Sales. We have developed important industry relationships to enhance our channel sales and marketing capabilities. We have developed a range of partnerships, including relationships with many companies that have formally joined NaviSite s Alliance program, including Web and application developers, system integrators/consultants, ISVs, and technology partners. These partners provide complementary services and, thus, allow NaviSite customers to benefit from more comprehensive solutions and this allows NaviSite to focus on its core value-added services. Many of these partners also provide a significant source of lead referrals to NaviSite and, in some cases are also our customers. As a result, many of our partners customers have become NaviSite customers.

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Marketing. Our marketing group is responsible for building brand awareness through public relations and marketing communications, identifying key market and customer segments and creating marketing programs to target those segments. The marketing organization focuses on supporting the direct sales as well as developing and enhancing channel partner relationships.

Customers

We were organized in 1996 by CMGI to support the networks and host the Web sites of CMGI companies and a number of CMGI affiliates. In the fall of 1997, we began supplying Web site hosting and management services to companies unaffiliated with CMGI. As of July 31, 2002, we had approximately 145 customers, down from 288 customers as of July 31, 2001.

Competition

We compete in the managed application hosting service market. The overall hosting market is fragmented, evolving rapidly, highly competitive and likely to be characterized by industry consolidation. We believe that NaviSite s focus on higher-level managed application services provides significant differentiation from traditional co-location hosting providers, and provides significantly higher customer value. We believe that participants in this market must grow rapidly and achieve a significant presence to compete effectively. We believe that the primary competitive factors determining success in our market include:

- quality of service delivered;
- ability to consistently measure, track and report on operational metrics;
- Web site and Internet application hosting and management expertise;
- fast, redundant, and reliable Internet connectivity;
- a state-of-the-art infrastructure providing availability, speed, scalability and security;
- comprehensive and diverse service offerings and timely addition of value-added services;
- brand recognition;
- competitive pricing; and
- adequate capital to permit continued investment in infrastructure, customer service and support and sales and marketing.

Our current and prospective competitors include:

- other providers of complex Web site hosting and related services, including Digex Corporation, Globix Corporation, Genuity, Inc., divine Managed Services, and a large number of local and regional hosting providers;
- large system integrators and information technology outsourcing firms, including Electronic Data Systems Corporation, International Business Machines Corporation, Accenture; and
- global telecommunications companies, including AT&T and Sprint.

Many of our competitors may be able to develop and expand their network infrastructures and service offerings more rapidly, adapt to new or emerging technologies and changes in customer requirements more quickly, take advantage of acquisitions and other opportunities more readily, devote greater resources to the marketing and sale of their services and adopt more aggressive pricing policies than we can. Because of these competitive factors and due to our comparatively small size and our lack of financial resources, we may be unable to successfully compete in the Internet application service market.

In addition, we believe that there will be continued consolidation within the Internet hosting market in which we compete. Our competitors may consolidate with one another or acquire software application vendors or technology providers, enabling them to more effectively compete with us. This consolidation could affect prices and other competitive factors in ways which would impede our ability to compete successfully in the Internet application service market.

Proprietary Rights

We rely on a combination of trademark, service mark, copyright and trade secret laws and contractual restrictions to establish and protect our proprietary rights and promote our reputation and the growth of our business. We do not own any patents that would prevent or inhibit competitors from using our technology or entering our market. While it is our practice to require our employees, consultants and independent contractors to enter into agreements containing non-disclosure, non-competition (for employees only) and non-solicitation restrictions and covenants, and while our agreements with some of our customers and suppliers include provisions prohibiting or restricting the disclosure of proprietary information, we can not assure you that these contractual arrangements or the other steps taken by us to protect our proprietary rights will prove sufficient to prevent misappropriation of our proprietary rights or to deter independent, third-party development of similar proprietary assets. In addition, we offer our services in other countries where the laws may not afford adequate protection for our proprietary rights.

We license or lease most technologies used in our Internet application services. Our technology suppliers may become subject to third-party infringement claims, or other claims or assertions, which could result in their inability or unwillingness to continue to license their technology to us. The loss of certain of our technologies could impair our ability to provide services to our customers or require us to obtain substitute technologies of lower quality or performance standards or at greater cost. We expect that we and our customers increasingly will be subject to third-party infringement claims as the number of Web sites and third-party service providers for Web-based businesses grows. We cannot assure you that third parties will not assert claims alleging the infringement of service marks and trademarks against us in the future or that these claims will not be successful. Any infringement claim as to our technologies or services, regardless of its merit, could be time-consuming, result in costly litigation, cause delays in service, installation or upgrades, adversely impact our relationships with suppliers or customers or require us to enter into costly royalty or licensing agreements.

Government Regulation

While there currently are few laws or regulations directly applicable to the Internet or to managed application hosting service providers, due to the increasing popularity of the Internet and Web-based applications, such laws and regulations are being considered and may be adopted. These laws may cover a variety of issues including, for example, user privacy and the pricing, characteristics and quality of products and services. The adoption or modification of laws or regulations relating to commerce over the Internet could substantially impair the future growth of our business or expose us to unanticipated liabilities. Moreover, the applicability of existing laws to the Internet and managed application hosting service providers is uncertain. These existing laws could expose us to substantial liability if they are found to be applicable to our business. For example, we offer services over the Internet in many states in the United States and internationally and we facilitate the activities of our customers in those jurisdictions. As a result, we may be required to qualify to do business, be subject to taxation or be subject to other laws and regulations in these jurisdictions, even if we do not have a physical presence or employees or property there. The application of existing laws and regulations to the Internet or our business, or the adoption of any new legislation or regulations applicable to the Internet or our business, could materially adversely affect our financial condition and operating results.

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Employees

As of July 31, 2002, we had 198 employees. Of these employees, 144 were principally engaged in operations, 18 were principally engaged in sales and marketing, 10 were principally engaged in product development and 26 were principally engaged in finance and administration. None of our employees is party to a collective bargaining agreement and we believe our relationship with our employees is good. We also employ consultants and independent contractors on a regular basis to assist in the completion of projects. Since July 31, 2002, we have implemented additional reductions in force affecting approximately 65 employees.

Certain Risk Factors That May Affect Future Results

The risks and uncertainties described below are not the only risks we face. Additional risks and uncertainties not presently known to us or that are currently deemed immaterial may also impair our business operations. If any of the following risks actually occurs, our financial condition and operating results could be materially adversely affected.

We have a history of losses and may never achieve profitability and may not continue as a going concern. Since our inception in 1996, we have experienced operating losses and negative cash flows for each quarterly and annual period. As of July 31, 2002, we had approximately $21.8 million of cash and cash equivalents, working capital of $16.5 million and had incurred losses since inception resulting in an accumulated deficit of $337.3 million. We believe that, on a standalone basis, we will have sufficient cash resources as of July 31, 2002 to meet the projected needs for working capital and capital expenditures through the end of fiscal year 2003. These projections are based on assumptions that include the maintenance of a certain level of revenue, the improvement in collections of accounts receivable, the ability to achieve projected cash expense reductions and the ability to obtain a waiver for the cash payments for all or a portion of fiscal year 2003 quarterly interest due on the $65 million Convertible Notes. In addition, we are considering the possibility of business combinations involving our majority stockholder, ClearBlue, and its affiliates, which could also affect our future estimated cash flows. Management is working to address these uncertainties, although we cannot assure you that these efforts will be successful and that we will ever achieve profitability or, if we achieve profitability, that it will be sustainable, or that we will continue as a going concern. See Management s Discussion and Analysis of Financial Condition and Results of Operations and the Company s Consolidated Financial Statements included elsewhere in this report.

ClearBlue is currently a majority stockholder and may have interests that conflict with the interests of our other stockholders. On September 11, 2002, CMGI and HPFS sold and transferred to ClearBlue the following equity and debt interests in NaviSite:

> Pursuant to a note and stock purchase agreement by and between ClearBlue and CMGI, CMGI sold and transferred to ClearBlue 71,029,391 shares of NaviSite s common stock representing approximately 76% of the outstanding capital stock of NaviSite, warrants to purchase 5,203,252 shares of NaviSite common stock and a Convertible Note with an aggregate principal amount outstanding of $10 million.
>
> Pursuant to a note and stock purchase agreement by and between ClearBlue and HPFS, HPFS sold and transferred to ClearBlue 3,207,053 shares of NaviSite common stock, representing approximately 3.4% of the outstanding capital stock of NaviSite and a Convertible Note with an aggregate principal amount outstanding of approximately $55 million.

As a result of these transactions, ClearBlue owns, directly or indirectly through its wholly owned subsidiaries, approximately 79% of the outstanding capital stock of NaviSite. If ClearBlue were to convert the Convertible Notes it acquired from CMGI and HPFS, ClearBlue would own approximately 94% of the outstanding capital stock of NaviSite. Accordingly, ClearBlue has the power, acting alone, to elect a majority of our board of directors and has the ability to determine the outcome of any corporate action requiring stockholder approval, regardless of how our other stockholders may vote. Under Delaware law, ClearBlue may exercise its voting power by written consent, without convening a meeting of the stockholders, which means that ClearBlue could effect a sale or merger of our company without prior notice to, or the consent of, our other stockholders. ClearBlue s ownership may have the effect of delaying, deterring or preventing a change in control of our company or discouraging a potential acquirer from attempting to obtain control of us, which in turn could adversely affect the market price of our common stock.

After the consummation of the above transactions on September 11, 2002, the board of directors of NaviSite, which had consisted of David S. Wetherell and George A. McMillan, elected Andrew Ruhan, Chairman of ClearBlue, and Arthur Becker, director of ClearBlue, to the board. As a result of CMGI s reduction in ownership of NaviSite, Messrs. Wetherell and McMillan resigned from the board effective October 2, 2002. Also, Gabriel Ruhan, the Chief Operating Officer and a director of ClearBlue and the brother of Andrew Ruhan, was subsequently elected to the board. Thus, NaviSite s current board of directors is composed solely of executives of ClearBlue. ClearBlue has the power, acting alone, to maintain a majority of the board of directors and would have the ability to determine the outcome of any corporate actions requiring stockholder approval regardless of how our other stockholders may vote. ClearBlue may have interests that conflict with the interests of our other stockholders.

ClearBlue, as a majority stockholder, may combine NaviSite with ClearBlue or a ClearBlue affiliate, which may result in disruptions to our business or distractions of our management due to difficulties in assimilating acquired personnel and operations. ClearBlue, as the majority stockholder of NaviSite, may combine NaviSite with ClearBlue or a ClearBlue affiliate. If such a business combination occurs, our ongoing business may be disrupted and management s attention and resources may be diverted from other business concerns. Additional risks include the difficulty in assimilating acquired operations, technologies and personnel and changes in management or other key personnel that may harm relationships with our customers and employees. We cannot assure you that, in the event of such a combination with ClearBlue or its affiliates, the combined business, assets or technologies will generate sufficient revenue to offset the associated costs or other adverse effects.

A significant portion of our revenue is currently generated by services provided to CMGI and companies affiliated with CMGI, and the loss of this revenue would substantially impair our operating results and the growth of our business. We anticipate that we will continue to receive a significant portion of our revenue in the future from CMGI and CMGI affiliates. CMGI and CMGI affiliates accounted for approximately 31% of our revenue in fiscal year 2002 and approximately 35% of our revenue for fiscal year 2001. We cannot assure you that revenues generated by CMGI and CMGI affiliates will continue or that we will be able to secure business from other customers to replace this revenue in the future. The loss of revenue from CMGI and CMGI affiliates, or our inability to replace this operating revenue, would substantially impair our operating results and the growth of our business. The number of CMGI and CMGI affiliated customers decreased 66% to 5 at July 31, 2002 from 15 at July 31, 2001, although the revenues from such customers continued to be significant.

We may need to raise additional funds, and such funding may not be available to us on favorable terms, if at all. We currently anticipate that our available cash resources at July 31, 2002 will be sufficient to meet our anticipated needs, barring unforeseen circumstances and subject to the impact of the factors discussed herein, for working capital and capital expenditures through the end of fiscal year 2003. In the event NaviSite s revenues are less than as currently projected by NaviSite, ClearBlue has stated that it will waive or defer the interest payments on the Convertible Notes. Our projected cash usage could be significantly impacted by: (1) our ability to maintain our current revenue levels by retaining existing customer accounts and acquiring revenue growth at levels greater than customer revenue churn; (2) our ability to achieve our projected operating results; (3) our ability to collect accounts receivables in a timely manner; and (4) our ability to achieve expected cash expense reductions. However, we may need to raise additional funds in order to develop new, or enhance existing, services or products, to respond to competitive pressures, to acquire complementary businesses, products or technologies and we cannot assure you that the additional financing will be available on terms favorable to us, if at all. In addition, pursuant to our financing arrangements with HPFS as of October 29, 2001 (which Convertible Notes were subsequently transferred to ClearBlue on September 11, 2002), we may need to obtain approval from ClearBlue for incremental funding, and we may not obtain this approval from ClearBlue.

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The loss of key officers, key management and other personnel could adversely affect our ability to successfully execute our business strategy or to continue to provide services to our customers. We believe that the continued service of key personnel, including Tricia Gilligan, our President and Chief Executive Officer, is a key component of the future success of our business. None of our key officers or personnel is currently a party to an employment agreement with us. This means that any officer or employee can terminate his or her relationship with us at any time. In addition, we do not carry life insurance on any of our key personnel. Furthermore, the loss of key members of our sales and marketing teams or key technical service personnel could jeopardize relations with our customers. Any loss of key technical personnel would jeopardize the stability of our infrastructure and our ability to provide the guaranteed service levels our customers expect. Over the past year, we have had significant reductions in force and a number of departures of key management. In addition, with ClearBlue having recently become our majority stockholder and taken seats on our board of directors, there could be additional changes in management. In the event that future reductions or departures of employees occur, our ability to successfully execute our business strategy or to continue to provide services to our customers, could be adversely affected.

The unpredictability of our quarterly results may adversely affect the trading price of our common stock. Our quarterly operating results may vary significantly from quarter to quarter as a result of a number of factors, many of which are outside of our control and any one of which may cause our stock price to fluctuate. The primary factors that may affect us include the following: reduction of market demand and/or acceptance from our Web site and Internet application hosting and management services; oversupply of data center space in the industry; our ability to develop, market and introduce new services on a timely basis; the length of the sales cycle for our services; the timing and size of sales of our services; the budgeting cycles of our customers and potential customers; downward price adjustments by our competitors; changes in the mix of services provided by our competitors; technical difficulties or system downtime affecting the Internet generally or our hosting operations specifically; our ability to meet any increased technological demands of our customers; the amount and timing of costs related to our marketing efforts and service introductions; and economic conditions specific to the Internet application service provider industry. Due to the above factors, we believe that quarter-to-quarter comparisons of our operating results are not a good indication of our future performance. Our operating results for any particular quarter may fall short of our expectations or those of investors or securities analysts. In this event, the market price of our common stock would be likely to fall.

Our common stock may not be transferred back to the Nasdaq National Market or could be delisted from the Nasdaq SmallCap Market. On February 14, 2002, we received a deficiency notice from Nasdaq indicating that our common stock had not maintained a minimum market value of publicly held shares of $15,000,000 and had failed to maintain a minimum bid price per share of $3.00 over the previous 30 consecutive trading days, and that we had until May 15, 2002 to regain compliance with the Nasdaq National Market s listing requirements. Nasdaq informed us that if we failed to demonstrate compliance with Nasdaq s listing requirements on or before May 15, 2002, Nasdaq would provide us with written notification that it had determined that we did not meet the standards for continued listing, and our securities would be delisted from the Nasdaq National Market. On May 10, 2002, we applied to transfer voluntarily to the Nasdaq SmallCap Market. On June 4, 2002, Nasdaq approved our transfer application and our common stock was transferred to the Nasdaq SmallCap Market at the opening of business on June 10, 2002. Although we are eligible to transfer back to the Nasdaq National Market if, among other things, the bid price of our common stock is at least $1.00 for 30 consecutive trading days by February 10, 2003 and we have maintained compliance with the Nasdaq National Market s continued listing requirements while listed on the Nasdaq SmallCap Market, excluding bid price, we may not meet these requirements. If we are unable to regain compliance with the Nasdaq National Market s listing requirements, our common stock will remain on the Nasdaq SmallCap Market. Moreover, if we fail to meet the Nasdaq SmallCap Market maintenance standards, we could be delisted from the Nasdaq SmallCap Market and may be traded on the over-the-counter electronic bulletin board (OTCBB), which is operated by the National Association of Securities Dealers, Inc. If our common stock is not eligible to transfer back to the Nasdaq National Market in the future or is delisted from the Nasdaq SmallCap Market, this could result in a number of negative implications, including continued reduced liquidity in our common stock as a result of the loss of market efficiencies associated with the Nasdaq National Market and the loss of federal preemption of state securities laws as well as the potential loss of confidence by suppliers, customers and employees, the loss of analyst coverage and institutional investor interest, fewer business development opportunities and greater difficulty in obtaining financing.

NaviSite s current board of director composition does not include any independent directors. NaviSite s current board of directors is composed of individuals who are not independent of NaviSite and may have interests that conflict with the interests of our stockholders. In addition, NaviSite s status as a Nasdaq SmallCap listed company requires us to be compliant with Nasdaq regulations, including audit committee composition of three independent directors. NaviSite s audit committee currently does not comply with the audit committee requirements and our continued noncompliance may result in a delisting from the Nasdaq SmallCap Market. Further, the loss of current directors, or NaviSite s inability to attract additional directors, particularly independent directors, could impair our ability to successfully create and execute business strategy, because we substantially rely on their experience and management skills.

You may experience dilution because of recent transactions between ClearBlue, HPFS and CMGI. The Convertible Notes obtained by ClearBlue from HPFS and CMGI includes terms that allow ClearBlue, in its discretion, to convert $65 million principal amount of Convertible Notes into common stock at a conversion price of $0.26 per share. This conversion would increase the number of issued and outstanding shares of our common stock by approximately 250 million shares. In addition, upon the prior written consent of ClearBlue, we may pay all or a portion of the interest due to ClearBlue with our common shares. Moreover, if additional funds are raised through the issuance of additional equity or convertible debt securities, your percentage of ownership in us will be reduced and you may experience additional dilution. In certain circumstances, if we issue equity or convertible debt securities at values below those currently held by ClearBlue, we must issue ClearBlue additional shares of our common stock which will further dilute existing stockholders.

If the market for Internet commerce and communication does not continue, or it continues to decrease, there may be insufficient demand for our services and, as a result, our business strategy may not be successful. The increased use of the Internet for retrieving, sharing and transferring information among businesses and consumers has developed only recently, and the market for the purchase of products and services over the Internet is new and emerging. If acceptance and growth of the Internet as a medium for commerce and communication does not continue, our business strategy may not be successful because there may not be a continuing market demand for our Web site and Internet application hosting and management services. Our growth could be substantially impaired if the market for Internet application services fails to continue to develop or if we cannot continue to achieve broad market acceptance.

Our decision to discontinue our practice, on a prospective basis, of obtaining equipment under leases and subsequently renting the equipment to our customers may have a material adverse effect on our future results and business operations. New customers and current customers seeking to renew their agreements will have to obtain equipment directly from equipment vendors. We may not be successful in attracting new customers who would prefer to obtain equipment from us. Current customers may not renew their agreements, but rather, may seek a hosting provider who would also rent equipment directly to them to satisfy their equipment needs. If we are unable to keep our current customers and attract new customers, our future results and business operations could be materially harmed.

Our ability to grow our business would be substantially impaired if we were unable to obtain, on commercially reasonable terms, certain equipment that is currently provided under leases. Certain of the equipment that we use or provide to our customers for their use in connection with our services is provided under lease. We or our customers will have to obtain this equipment for new leases and renewal of existing leases directly, on a stand alone basis. Our business would be substantially impaired if we were unable to obtain or continue these leases on commercially reasonable terms.

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Our ability to successfully market our services could be substantially impaired if we are unable to deploy new Internet applications or if new Internet applications deployed by us prove to be unreliable, defective or incompatible. We cannot assure you that we will not experience difficulties that could delay or prevent the successful development, introduction or marketing of Internet application services in the future. If any newly introduced Internet applications suffer from reliability, quality or compatibility problems, market acceptance of our services could be greatly hindered and our ability to attract new customers could be adversely affected. We cannot assure you that new applications deployed by us will be free from any reliability, quality or compatibility problems. If we incur increased costs or are unable, for technical or other reasons, to host and manage new Internet applications or enhancements of existing applications, our ability to successfully market our services could be substantially impaired.

The market we serve is highly competitive, and we may lack the financial and other resources, expertise or capability needed to capture increased market share or maintain market share. We compete in the Internet application service market. This market is rapidly evolving, highly competitive and likely to be characterized by over capacity and industry consolidation. We believe that participants in this market must grow rapidly and achieve a significant presence to compete effectively. Our business is not as developed as that of many of our competitors. Many of our competitors have substantially greater financial, technical and market resources, greater name recognition and more established relationships in the industry. We may lack the financial and other resources, expertise or capability needed to capture increased market share in this environment in the future.

Any interruptions in, or degradation of, our private transit Internet connections could result in the loss of customers or hinder our ability to attract new customers. Our customers rely on our ability to move their digital content as efficiently as possible to the people accessing their Web sites and Internet applications. We utilize our direct private transit Internet connections to major backbone providers as a means of avoiding congestion and resulting performance degradation at public Internet exchange points. We rely on these telecommunications network suppliers to maintain the operational integrity of their backbones so that our private transit Internet connections operate effectively.

Increased costs associated with our private transit Internet connections could result in the loss of customers or significant increases in operating costs. Our private transit Internet connections are already more costly than alternative arrangements commonly utilized to move Internet traffic. If providers increase the pricing associated with utilizing their bandwidth, we may be required to identify alternative methods to distribute our customers digital content. We cannot assure you that our customers will continue to be willing to pay the higher costs associated with direct private transit or that we could effectively move to another network approach. If we were unable to access alternative networks to distribute our customers digital content on a cost-effective basis or to pass any additional costs on to our customers, our operating costs would increase significantly.

If we are unable to maintain existing and develop additional relationships with Internet application software vendors, the sales marketing and provision of our Internet application services may be unsuccessful. We believe that to penetrate the market for Web site and Internet application hosting and management services we must maintain existing and develop additional relationships with industry-leading Internet application software vendors and other third parties. We license or lease select software applications from Internet application software vendors. The loss of our ability to continually obtain and utilize any of these applications could materially impair our ability to provide services to our customers or require us to obtain substitute software applications of lower quality or performance standards or at greater cost. In addition, because we generally license applications on a non-exclusive basis, our competitors may license and utilize the same software applications. In fact, many of the companies with which we have strategic relationships currently have, or could enter into, similar license agreements with our competitors or prospective competitors. We cannot assure you that software applications will continue to be available to us from Internet application software vendors on commercially reasonable terms. If we are unable to identify and license software applications which meet our targeted criteria for new application introductions, we may have to discontinue or delay introduction of services relating to these applications.

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We purchase key components of our infrastructure from a limited number of suppliers, including networking equipment. We cannot assure you that we will have the necessary hardware or parts on hand or that our suppliers will be able to provide them in a timely manner in the event of equipment failure. Our ability to obtain and continue to maintain the necessary hardware or parts on a timely basis could result in sustained equipment failure and a loss of revenue due to customer loss or claims for service credits under our service level guarantees. Our ability to continue to meet the needs of a substantial number of customers while maintaining superior performance is largely unproven. If our network infrastructure is not scalable, we may not be able to provide our services to additional customers, which would result in decreased revenue.

Our customer base includes a significant number of small start-up Internet-based businesses that face increased risk of loss of funding depending upon the availability of private and/or public funding. Many of our customers are small start-up Internet based businesses that have traditionally been initially funded by venture capital firms and then through public securities offerings. If the market for technology and Internet based businesses is not supported by the private investors who have funded these customers, we face the risk that these customers may cease, curtail or limit Web site operations hosted by us. We have experienced and may continue to experience a loss of revenue associated with these customers and will then have to increase sales to other businesses using the Internet in order to preserve and grow our revenue.

Our network infrastructure could fail, which would impair our ability to provide guaranteed levels of service and could result in significant operating losses. To provide our customers with guaranteed levels of service, we must operate our network infrastructure 24 hours a day, seven days a week without interruption. In order to operate in this manner, we must protect our network infrastructure, equipment and customer files against damage from human error, natural disasters, unexpected equipment failure, power loss or telecommunications failures, sabotage or other intentional acts of vandalism. Even if we take precautions, the occurrence of a natural disaster, equipment failure or other unanticipated problem at one or more of our data centers could result in interruptions in the services we provide to our customers. We cannot assure you that our disaster recovery plan will address all, or even most, of the problems we may encounter in the event of such a disaster.

We have experienced service interruptions in the past, and any future service interruptions could require us to spend substantial amounts of money to replace equipment or facilities, entitle customers to claim service credits under our service level guarantees, cause customers to seek damages for losses incurred, cause customers to seek alternate providers, or make it more difficult for us to attract new customers, retain current customers or enter into additional strategic relationships. Any of these occurrences could result in significant operating losses.

The misappropriation of our proprietary rights could result in the loss of our competitive advantage in the market. We rely on a combination of trademark, service mark, copyright and trade secret laws and contractual restrictions to establish and protect our proprietary rights. We do not own any patents that would prevent or inhibit competitors from using our technology or entering our market. We cannot assure you that the contractual arrangements or other steps taken by us to protect our proprietary rights will prove sufficient to prevent misappropriation of our proprietary rights or to deter independent, third-party development of similar proprietary assets. In addition, we provide our services in other countries where the laws may not afford adequate protection for our proprietary rights.

Third-party infringement claims against our technology suppliers, customers or us could result in disruptions in service, the loss of customers or costly and time-consuming litigation. We license or lease most technologies used in the Internet application services that we offer. Our technology suppliers may become subject to third-party infringement or other claims and assertions, which could result in their inability or unwillingness to continue to license their technology to us. We expect that we and our customers increasingly will be subject to third-party infringement claims as the number of Web sites and third-party service providers for Web-based businesses grows. We cannot assure you that third parties will not assert claims against us in the future or that these claims will not be successful. Any infringement claim as to our technologies or services, regardless of its merit, could result in delays in service, installation or upgrades, the loss of customers or costly and time-consuming litigation, or require us to enter into royalty or licensing agreements.

If we fail to attract or retain skilled personnel, our ability to provide Web site and Internet application management and technical support may be limited and, as a result, we may be unable to attract customers. Our business requires individuals with significant levels of Internet application expertise to win consumer confidence in outsourcing the hosting and management of mission-critical applications. Qualified technical personnel are likely to remain a limited resource for the foreseeable future. We may not be able to retain or hire the necessary personnel to implement our business strategy or may need to provide higher compensation to such personnel than we currently anticipate.

Any future acquisitions we make of companies or technologies may result in disruptions to our business or distractions of our management due to difficulties in assimilating acquired personnel and operations. Our business strategy contemplates future acquisitions of complementary technologies. If we do pursue additional acquisitions, our risks may increase because our ongoing business may be disrupted and management s attention and resources may be diverted from other business concerns. In addition, through acquisitions, we may enter into markets or market segments in which we have limited prior experience.

In the event that we complete an acquisition, we will face additional risks. These risks include the following: difficulty assimilating acquired operations, technologies and personnel; inability to retain management and other key personnel of the acquired business; and changes in management or other key personnel that may harm relationships with the acquired business s customers and employees. We cannot assure you that any acquisitions will be successfully identified and completed or that, if one or more acquisitions are completed, the acquired business, assets or technologies will generate sufficient revenue to offset the associated costs or other adverse effects.

Any future divestitures we make of companies or technologies may result in disruptions to our business or distractions of our management due to difficulties disassimilating personnel, technologies or operations. Our business strategy may include divestiture of certain technologies. If we do pursue divestitures, our risks may increase because our ongoing business may be disrupted and management s attention and resources may be diverted from other business concerns.

The emergence and growth of a market for our Internet application services will be impaired if third parties do not continue to develop and improve the Internet infrastructure. The recent growth in the use of the Internet has caused frequent periods of performance degradation, requiring the upgrade of routers and switches, telecommunications links and other components forming the infrastructure of the Internet-by-Internet service providers and other organizations with links to the Internet. Any perceived degradation in the performance of the Internet as a means to transact business and communicate could undermine the benefits and market acceptance of our Web site and Internet application hosting and management services. Our services are ultimately limited by, and dependent upon, the speed and reliability of hardware, communications services and networks operated by third parties. Consequently, the market for our Internet application services will be impaired if improvements are not made to the entire Internet infrastructure to alleviate overloading and congestion.

We could be subject to increased operating costs, as well as claims, litigation or other potential liability, in connection with risks associated with Internet security and the security of our systems. A significant barrier to the growth of e-commerce and communications over the Internet has been the need for secure transmission of confidential information. Several of our Internet application services utilize encryption and authentication

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technology licensed from third parties to provide the protections necessary to ensure secure transmission of confidential information. We also rely on security systems designed by third parties and the personnel in our network operations centers to secure those data centers. Any unauthorized access, computer viruses, accidental or intentional actions and other disruptions could result in increased operating costs. For example, we may incur additional significant costs to protect against these interruptions and the threat of security breaches or to alleviate problems caused by such interruptions or breaches, and we expect to expend additional financial resources in the future to equip our data centers with enhanced security measures. If a third party were able to misappropriate a consumer s personal or proprietary information, including credit card information, during the use of an application solution provided by us, we could be subject to claims, litigation or other potential liability.

We may become subject to burdensome government regulation and legal uncertainties that could substantially impair our business or expose us to unanticipated liabilities. It is likely that laws and regulations directly applicable to the Internet or to Internet application service providers may be adopted. These laws may cover a variety of issues, including user privacy and the pricing, characteristics and quality of products and services. The adoption or modification of laws or regulations relating to commerce over the Internet could substantially impair the growth of our business or expose us to unanticipated liabilities. Moreover, the applicability of existing laws to the Internet and Internet application service providers is uncertain. These existing laws could expose us to substantial liability if they are found to be applicable to our business. For example, we provide services over the Internet in many states in the United States and elsewhere and facilitate the activities of our customers in such jurisdictions. As a result, we may be required to qualify to do business, be subject to taxation or be subject to other laws and regulations in these jurisdictions, even if we do not have a physical presence, employees or property there.

We may be subject to legal claims in connection with the information disseminated through our network, which could have the effect of diverting management s attention and requires us to expend significant financial resources. We may face potential direct and indirect liability for claims of defamation, negligence, copyright, patent or trademark infringement, violation of securities laws and other claims based on the nature and content of the materials disseminated through our network. For example, lawsuits may be brought against us claiming that content distributed by some of our current or future customers may be regulated or banned. In these and other instances, we may be required to engage in protracted and expensive litigation that could have the effect of diverting management s attention from our business and require us to expend significant financial resources. Our general liability insurance may not necessarily cover any of these claims or may not be adequate to protect us against all liability that may be imposed.

In addition, on a limited number of occasions in the past, businesses, organizations and individuals have sent unsolicited commercial e-mails from servers hosted at our facilities to a number of people, typically to advertise products or services. This practice, known as spamming , can lead to complaints against service providers that enable such activities, particularly where recipients view the materials received as offensive. We have in the past received, and may in the future receive, letters from recipients of information transmitted by our customers objecting to such transmission. Although we prohibit our customers by contract from spamming, we cannot assure you that our customers will not engage in this practice, which could subject us to claims for damages.

The market price of our common stock may experience extreme price and volume fluctuations. The market price of our common stock may fluctuate substantially due to a variety of factors, including: any actual or anticipated fluctuations in our financial condition and operating results; public announcements concerning us, our competitors, or the Internet industry; the introduction or market acceptance of new service offerings by us or our competitors; changes in industry research analysts earnings estimates; changes in accounting principles; sales of our common stock by existing stockholders; and the loss of any of our key personnel.

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In addition, the stock market has experienced extreme price and volume fluctuations. The market prices of the securities of technology and Internet-related companies have been especially volatile. This volatility often has been unrelated to the operating performance of particular companies. In the past, securities class action litigation often has been brought against companies that experience volatility in the market price of their securities. Whether or not meritorious, litigation brought against us could result in substantial costs and a diversion of management s attention and resources.

In the event we were to change our business strategy whereby the facility component of our service delivery would be outsourced to data centers owned by third parties rather than NaviSite and are not successful, our business could be materially adversely affected. We are currently evaluating our business model whereby we would provide integrated managed hosting services in data centers owned by third parties in addition to our own data centers. We believe that this approach could augment our existing management expertise, software and operating processes with third-party infrastructure and geographic reach. The strategy is in the preliminary stages. This new business strategy may not be successful due to failures of such third-party data center providers. We would rely on these providers to supply critical components of our business, and we may not have direct control over the facility or any of these components. We may not be able to attract new customers or renew current customers as such customers may require us to own the facility being utilized. If the third-party data center providers are inadequate or if our present or potential customers prefer that we own the data centers, our business could be materially adversely affected.

Item 2. ***Properties***

Facilities

Our executive offices are located at 400 Minuteman Road, Andover, Massachusetts and is approximately 153,000 square feet. These facilities are also utilized as a data center (52,000 square feet of raised floor). Our lease for these premises expires in 2011.

In September 2002, in exchange for the consent of 400 River Limited Partnership (the Landlord) to the transaction between ClearBlue, HPFS and CMGI, ClearBlue entered into an agreement with the Landlord regarding the property located at 400 Minuteman Road in Andover, Massachusetts (the Building). Upon the consent of General American Life Insurance Company as mortgage holder of the Building, NaviSite will enter into a series of transactions (collectively, the Transactions) with the Landlord for the Building in the form of a purchase, sale and new lease of the Building. As a result of the Transactions, NaviSite will reduce its total rented office space in the Building from 153,000 to 76,500 square feet. The reduced space profile will be at the same price per square foot and for the same term as prior to the Transactions. NaviSite will purchase the Building for $16,356,901 subject to the current mortgage of $10,856,901 and will pay the difference, $5,500,000, in cash at closing. $2,000,000 of that cash will be paid out of the cash on hand at NaviSite and the remaining $3,500,000 will be paid by allowing the Landlord to draw on the letter of credit that NaviSite tendered pursuant to the original lease. The cash deposit of $2,500,000 that NaviSite tendered pursuant to the original lease will also be released to the Landlord. Upon the closing of the purchase of the Building, NaviSite will sell the Building, along with our leasehold improvements and certain furniture and fixtures, to Farm Associates Limited Partnership, an affiliate of the Landlord, for $10,857,400, in the form of the assumption of the mortgage by Farm Associates Limited Parntership, and enter into the new lease agreement for the 76,500 rentable square feet in the Building as described above. In the event General American Life Insurance Company does not consent to the Transactions by November 12, 2002, NaviSite will not be obligated to enter into such Transactions.

Data centers

We currently have two domestic data center locations with a total of approximately 74,000 square feet of raised floor. In addition to the 400 Minuteman Road data center, we also occupy a 66,000 square foot facility located in the Valley Technology Centre, 2720 Zanker Road, San Jose, California (22,000 square feet of raised floor), part of which is utilized as a data center, leased pursuant to an agreement that expires in 2006.

In addition to our existing data centers, we presently utilize approximately 10,000 square feet of space in Sunnyvale, California and approximately 2,000 square feet of space in New York through an arrangement with Level 3.

Other Office Space

We lease approximately 16,800 square feet at 4225 Executive Square, La Jolla, California, pursuant to an agreement that expires November 2006. These premises were previously occupied by our Streaming Media Division. In conjunction with the sale of our Streaming Media Division to SMC Corporation, SMC Corporation entered into a sublease for approximately half of this space for a two-year period.

In the course of fiscal year 2002, we closed sales offices located at 11601 Wilshire Boulevard, Suite 500, Los Angeles, California; 680 Third Avenue 10th Floor, New York, New York; 3340 Peachtree Road, Atlanta, Georgia; 575 Market Street, San Francisco, California and 8300 Boone Boulevard, Suite 540, Vienna, Virginia.

Item 3. ***Legal Proceedings***

On or about June 13, 2001, Stuart Werman and Lynn McFarlane filed a lawsuit against us, BancBoston Robertson Stephens, Inc., 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 undisclosed commissions on transactions in other securities and required its customers 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.

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, FleetBoston Robertson Stephens, Inc. 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 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.

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We believe that the two allegations above are without merit, and we intend to vigorously defend against the plantiffs claims. As the litigation is in an initial stage, we are not able to predict the possible outcome of the suits and their ultimate effect, if any, on our financial condition.

On or about September 27, 2002, NaviSite received a demand for a wage payment of $850,000 from our former Procurement Director, Joseph Cloonan. 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. We believe the allegations are without merit, and we intend to vigorously defend against Mr. Cloonan s claims. 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. As the litigation is in an initial stage, we are not able to predict the possible outcome of this matter and its ultimate effect, if any, on our financial condition.

We are also subject to other legal proceedings and claims that 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 the consolidated financial position or results from operations of our company.

Item 4. ***Submission of Matters to a Vote of Security Holders***

No matters were submitted to a vote of security holders during the fourth quarter of the fiscal year ended July 31, 2002.

Executive Officers of NaviSite

Patricia Gilligan, age 51, has served as NaviSite s President and Chief Executive Officer since July 2001. From June 2000 to July 2001, Ms. Gilligan served as NaviSite s Chief Operating Officer. From January 1999 to June 2000, Ms. Gilligan served as Vice President of Worldwide Services of Incentive Systems, an incentive compensation application developer. From April 1997 to January 1999, Ms. Gilligan served as Vice President of East Coast Operations of Razorfish, Inc., a digital solutions provider. From January 1992 to April 1997, Ms. Gilligan served as Chief Information Officer of Cahners Publishing Company, a business information company.

Kevin H. Lo, age 29, has served as NaviSite s Chief Financial Officer and Senior Vice President of Finance and Strategy since January 2002. From July 2001 to January 2002, he served as NaviSite s Vice President of Products, Services and Business Development, and from January 2001 to July 2002, he served as NaviSite s Chief Technology Officer. From October 2000 to January 2001, Mr. Lo served NaviSite as the Director of Utility Infrastructure Services. From August 1997 to October 2000, Mr. Lo served as Chairman and Chief Executive Officer at X-Collaboration Software Corporation, an application infrastructure provider of collaborative web services. From September 1995 to August 1997, Mr. Lo was a Strategy Consultant at Bain & Company.

Robert C.B. Poon, age 55, has served as NaviSite s Vice President of Service Delivery since January 2002. From March 2001 to January 2002, Mr. Poon served as Senior Vice President, Engineering and Systems Operations of Trapezo, Inc., a start-up company with a product line in web content management. From July 2000 to March 2001, Mr. Poon served as Vice President, Engineering and Operations of Tacit Knowledge Systems, a software start-up company that developed a knowledge management tool. From February 1997 to July 2000, Mr. Poon served as Vice President, Service Delivery for IBM Global Services, Telecommunications and Media Industries.

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PART II

Item 5. ***Market for Registrant s Common Equity and Related Stockholder Matters***

Price Range of Common Stock

Our common stock is currently traded on the Nasdaq SmallCap Market under the symbol NAVI . Our common stock first began trading on October 22, 1999 on the Nasdaq National Market. On May 10, 2002, we applied to transfer voluntarily from the Nasdaq National Market to the Nasdaq SmallCap Market. On June 4, 2002, Nasdaq approved our transfer application and our common stock was transferred to the Nasdaq SmallCap Market at the opening of business on June 10, 2002. As of September 30, 2002, there were 175 holders of record of our common stock. Because brokers and other institutions on behalf of stockholders hold many of such shares, we are unable to estimate the total number of stockholders represented by these record holders. The following table sets forth for the periods indicated the high and low sales prices for our common stock as reported on the Nasdaq National Market or Nasdaq SmallCap Market, and is adjusted to reflect the effect of the April 5, 2000 two-for-one stock split.

	Closing Price	
	High	**Low**
Fiscal Year Ending July 31, 2002:		
May 1, 2002 through July 31, 2002	$ 0.26	0.12
February 1, 2002 through April 30, 2002	0.36	0.21
November 1, 2001 through January 31, 2002	0.61	0.26
August 1, 2001 through October 31, 2001	0.82	0.15
Fiscal Year Ending July 31, 2001:		
May 1, 2001 through July 31, 2001	$ 2.85	$ 0.75
February 1, 2001 through April 30, 2001	3.59	1.03
November 1, 2000 through January 31, 2001	12.75	2.03
August 1, 2000 through October 31, 2000	53.00	7.78

We believe that a number of factors may cause the market price of our common stock to fluctuate significantly. See Item 1. Business Certain Factors That May Affect Future Results.

We have never paid cash dividends on our capital stock. We currently anticipate retaining all available funds, if any, to finance internal growth and product development. Payment of dividends in the future will depend upon our earnings and financial condition and such other factors as the directors may consider or deem appropriate at the time.

Recent Sales of Unregistered Securities

On November 8, 2001, in connection with an agreement dated October 29, 2001 among NaviSite, CMGI and HPFS, we purchased certain equipment previously leased by NaviSite from HPFS under operating lease agreements expiring through 2003 in exchange for a note payable in the face amount of approximately $35 million. Additionally, we received $20 million and $10 million in cash from HPFS and CMGI, respectively, in exchange for six-year Convertible Notes payable in the face amounts of $20 million and $10 million to HPFS and CMGI, respectively, making the total notes payable issued by NaviSite to HPFS and CMGI approximately $55 million and $10 million, respectively. The notes require payment of interest only, at 12% per annum, for the first three years from the date of issuance and then repayment of principal and interest, on a straight-line basis, over the next three years until maturity on the sixth anniversary of the date of issuance. At NaviSite s option, we

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may make interest payments (i) 100% in shares of NaviSite common stock, in the case of amounts owed to CMGI, through December 2007 and (ii) approximately 16.67% in shares of NaviSite common stock, in the case of amounts owed to HPFS, through December 2003. The Convertible Notes payable are secured by substantially all of the assets of NaviSite and cannot be prepaid.

The principal balances may be converted into NaviSite common stock at the option of the holders at any time prior to or at maturity at a conversion rate of $0.26 per share. CMGI also converted its $80 million in aggregate principal outstanding under its existing notes payable, plus the accrued interest thereon, into 14,724,481 shares of NaviSite common stock. CMGI also converted approximately $16.2 million in other amounts due by NaviSite to CMGI into approximately 9,905,419 shares of NaviSite common stock.

Holders of the Convertible Notes payable are entitled to both demand and piggyback registration rights, and HPFS is entitled to anti-dilution protection under certain circumstances. The agreement with HPFS also contains certain restrictive covenants, including but not limited to limitations on the issuance of additional debt, the sale of equity securities to affiliates and certain acquisitions and dispositions of assets.

On June 30, 2002, NaviSite paid $300,000 in accrued interest owed to CMGI under a convertible note by issuing to CMGI 1,875,000 shares of NaviSite common stock. Also on June 30, 2002, NaviSite paid $275,522 in accrued interest owed to HPFS under a convertible note by issuing to HPFS 1,722,011 shares of NaviSite common stock.

On September 11, 2002, each of CMGI and HPFS sold their interests in the Convertible Notes to ClearBlue, as described in note 16 of the financial statements.

The Convertible Notes and the shares of NaviSite common stock issued as interest payments under the Convertible Notes were issued in reliance upon the exemptions from registration under Section 4(2) of the Securities Act and Regulation D promulgated thereunder, relative to sales by an issuer not involving a public offering. No underwriters were involved in the sale of these securities.

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Item 6. ***Selected Consolidated Financial Data***

The following selected consolidated financial data should be read in conjunction with our consolidated financial statements and related notes and Management s Discussion and Analysis of Financial Condition and Results of Operations included elsewhere in this Form 10-K. Historical results are not necessarily indicative of results of any future period.

(Amounts in 000 s except per share data)	Year Ended July 31,				
	2002	2001	2000	1999	1998
STATEMENT OF OPERATIONS DATA:					
Revenue:					
Revenue	$ 40,968	$ 66,358	$ 24,870	$ 3,461	$ 158
Revenue, related parties	18,453	36,368	24,893	7,058	3,871
Total revenue	59,421	102,726	49,763	10,519	4,029
Cost of revenue	67,000	127,155	68,496	20,338	8,876
Impairment of long lived assets	68,317	1,930			
Gross margin	(75,896)	(26,359)	(18,733)	(9,819)	(4,847)
Operating expenses:					
Product development	5,281	14,072	5,197	2,620	287
Selling and marketing	9,703	32,251	22,805	6,888	2,530
General and administrative	19,272	33,011	12,270	4,823	1,412
Restructuring	(2,633)	8,011			
Total operating expenses	31,623	87,345	40,272	14,331	4,229
Loss from operations	(107,519)	(113,704)	(59,005)	(24,150)	(9,076)
Other income (expense):					
Interest income	1,060	2,753	2,027	4	
Interest expense	(14,718)	(8,042)	(1,001)	(347)	(85)
Other income (expense), net	(516)	292	9	(39)	(11)
Loss before cumulative effect of change in accounting principle	(121,693)	(118,701)	(57,970)	(24,532)	(9,172)
Cumulative effect of change in accounting principle		(4,295)			
Net loss	$ (121,693)	(122,996)	(57,970)	(24,532)	(9,172)
Accretion of dividends on Series C and D convertible redeemable preferred stock				(172)	
Net loss applicable to common shareholders	$ (121,693)	$ (122,996)	$ (57,970)	$ (24,704)	$ (9,172)
Basic and diluted net loss per common share:					
Before cumulative effect of change in accounting principle	$ (1.49)	$ (2.01)	$ (1.37)	$ (3.71)	$ (0.57)
Cumulative effect of change in accounting principle		(0.07)			
Basic and diluted net loss per common share	$ (1.49)	$ (2.08)	$ (1.37)	$ (3.71)	$ (0.57)
Basic and diluted weighted average number of common shares outstanding	81,859	58,993	42,270	6,663	16,034

BALANCE SHEET DATA:					
Working capital (deficit)	$ 16,516	$ (9,683)	$ 48,159	$ (1,355)	$ (13,552)
Total assets	$ 53,534	$ 112,266	$ 175,461	$ 21,111	$ 5,479
Long-term obligations	$ 28,073	$ 69,852	$ 24,988	$ 1,935	$ 1,090
Shareholder s equity (deficit)	$ 8,544	$ (6,962)	$ 97,474	$ (4,369)	$ (10,066)

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Item 7. ***Management s Discussion and Analysis of Financial Condition and Results of Operations***

Overview

NaviSite was incorporated in Delaware in December 1998 and is a 79.6% owned subsidiary of ClearBlue. Prior to September 11, 2002, we were a 75.8% owned subsidiary of CMGI. Since January 31, 2000, our corporate headquarters have been located at 400 Minuteman Road, Andover, Massachusetts. Additionally, we operate two state of the art data centers, one in Andover, Massachusetts and one in San Jose, California.

NaviSite provides outsourced Web hosting and managed application services for companies conducting mission critical business on the Internet, including enterprises and other businesses deploying Internet applications. Our goal is to help customers focus on their core competencies by outsourcing the management and hosting of their Web operations and applications, allowing customers to fundamentally improve the efficiency of their Web operations. We also provide related professional and consulting services. Our focus on enhanced management services, beyond basic co-location and infrastructure services, allows us to meet the expanding needs of businesses as their Web sites and Internet applications become more complex.

We provide Always On Managed Hosting[SM] and we believe that there are a relatively small number of companies that combine a highly scalable and developed infrastructure with expertise, experience, intellectual property, software platforms, processes and procedures for delivering complex managed hosting services. We define Always On Managed Hosting[SM] as a combination of high availability infrastructure, high performance monitoring systems and proactive problem resolution and change management processes designed to recognize patterns and identify and address potentially crippling problems before they are able to cause downtime in customers web operations. The price for our services varies from customer to customer based on the number of managed servers and the nature, extent and level of services provided.

Fiscal 2002 Operating Plan

Fiscal year 2002 has been a challenging year for the technology industry and the telecommunications and IT services market in particular. In fiscal year 2002, we executed a plan to restructure our business model and our business operations. Over the course of the year, we raised new financing, restructured our operating leases and fixed cost infrastructure contracts to significantly reduce excess capacity, implemented labor efficiencies, managed out non-productive customers, eliminated low margin product lines, and divested a non-core business. As a result, we have reduced our revenue requirement for EBITDA break-even from $44 million per quarter at July 31, 2001 to $11 million per quarter in July 31, 2002, while improving the quality of our service delivery, customer satisfaction and our publicly available and industry leading operating metrics.

During the fiscal year 2002, we have systematically reduced our run rate cash burn from $7.3 million per month in fourth quarter fiscal year 2001 to $1.4 million per month in fourth quarter fiscal year 2002. Further, as we have shifted our business model away from a return on our physical infrastructure to one focused on generating a return on our managed services platform, such as IP, software infrastructure and work processes, we expect to leverage the capital investments already made without significant new capital requirements going forward.

For fiscal year 2003, although we still expect some churn in our revenue base, primarily driven by pricing pressures in the marketplace, we believe that we have a fundamentally healthier base of customers. For fiscal year 2003, we expect lower annual revenue than fiscal year 2002. We are forecasting revenues stabilizing in the first half of fiscal year 2003 and we expect net revenue growth in the second half of fiscal year 2003. However, because of our restructuring efforts, we now have a flexible cost structure that allows us to match costs with actual revenue levels. Therefore, in fiscal year 2003, absent unforeseen circumstances, we expect to achieve sustained stand-alone run-rate EBITDA profitability.

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Results of Operations

The following tables set forth the consolidated statements of operations data for the periods indicated as a percentage of revenues:

	2002	2001	2000
Revenue:			
Revenue	$ 68.9%	64.6%	50.0%
Revenue, related parties	31.1%	35.4%	50.0%
Total revenue	100.0%	100.0%	100.0%
Cost of revenue	112.8%	123.8%	137.6%
Impairment of long lived assets	115.0%	1.9%	0.0%
Total cost of revenue	227.7%	125.7%	137.6%
Gross deficit	127.7%	25.7%	37.6%
Operating expenses:			
Product development	8.9%	13.7%	10.4%
Selling and marketing	16.3%	31.4%	45.8%
General and administrative	32.4%	32.1%	24.7%
Restructuring	4.4%	7.8%	0.0%
Total operating expenses	53.2%	85.0%	80.9%
Loss from operations	180.9%	110.7%	118.5%
Other income (expense):			
Interest income	1.8%	2.7%	4.1%
Interest expense	24.8%	7.8%	2.0%
Other income (expense), net	0.9%	0.3%	0.0%
Total other income (expense)	23.9%	4.9%	2.1%
Loss before cumulative effect of change in accounting principle	204.8%	115.6%	116.4%
Cumulative effect of change in accounting principle	0.0%	4.2%	0.0%
Net loss	204.8%	119.7%	116.4%

Comparison of Fiscal Years 2002, 2001 and 2000

Revenue

We derive our revenue primarily from managed hosting services such as managed application, managed servers, managed infrastructure, managed facilites and expertise services.

During fiscal year 2001, we adopted SEC Staff Accounting Bulletin No. 101 Revenue Recognition in Financial Statements (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 previously deferred revenue on customers lost during fiscal year 2001.

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 settlements primarily from related parties.

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 affiliated customers of CMGI. During fiscal year 2002, we lost 169 customers, with an estimated $4.3 million in annual revenues, inclusive of contract termination fees. As of July 31, 2002, we had 140 unaffiliated and 5 affiliated customers of CMGI, as compared to 273 unaffiliated customers and 15 affiliated customers of CMGI at July 31, 2001. As a percentage of revenue, unaffiliated revenue for fiscal year 2002 increased to 69% of total revenue, from 65% of total revenue for fiscal year 2001. Net of settlement revenue, unaffiliated revenue for fiscal year 2002 increased to 72% of total revenue, from 65% of total revenue for fiscal year 2001.

Our revenue from related parties principally consists of sales of services to CMGI and other customers that are CMGI affiliates. In general, in pricing the services provided to CMGI and its affiliates, we have negotiated the services and levels of service to be provided, calculated the price of the services at those service levels based on our then-current standard prices, and, in exchange for customer referrals provided to us by CMGI, discounted these prices by 10%. We sold services to CMGI and CMGI affiliates totaling approximately $18.5 million, or 31% of revenue in fiscal year 2002 and $36.4 million, or 35% of revenue in fiscal year 2001. In fiscal year 2002 one of these customers accounted for approximately 11% of revenue, as compared to fiscal year 2001 where four of these customers accounted for approximately 25%, 17%, 15% and 14% of revenue, respectively. As of July 31, 2002, CMGI owned approximately 69% of our outstanding common stock. On September 11, 2002, CMGI sold its equity and debt holdings.

Total revenue for fiscal year 2001 increased 106% to approximately $102.7 million, from approximately $49.8 million in fiscal 2000. The increase in revenue is due primarily to an increase of approximately $13.8 million of revenue related to the 114 new unaffiliated customers in fiscal year 2001 and additional business with both existing unaffiliated customers, and affiliated customers of CMGI. Revenue from unaffiliated customers increased to approximately $66.4 million or 65% of total revenue, from approximately $24.8 million or 50% of total revenue for fiscal year 2000. The number of unaffiliated customers decreased 19% to 273 at July 31, 2001 from 338 as of July 31, 2000.

For fiscal year 2003, although we still expect some churn in our revenue base, primarily driven by pricing pressures, we believe that we have a fundamentally healthier base of customers. For fiscal year 2003, we expect lower annual revenue than fiscal year 2002. We are forecasting revenues stabilizing in the first half of fiscal year 2003 and we expect net revenue growth in the second half of fiscal year 2003. As new revenue does not include equipment and other hardware rentals, slower new revenue growth is partially offset by a higher percentage of services, which have higher margins.

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 four data centers, such as rent and utilities. In the fourth quarter of fiscal year 2001, a restructuring plan was approved and the costs to shut down our two original data centers were accrued as part of the restructuring costs. As a result of the restructuring plan, the financial periods before August 2001 include the costs of the two original data centers and the financial periods subsequent to July 2002 do not. Our fourth quarter fiscal year 2001 restructuring plan, combined with our continuing efforts to improve operating efficiencies has resulted in significantly lower cost of revenue levels for fiscal year 2002, excluding impairment charges of $68.3 million related to long-lived assets, as compared to fiscal year 2001.

In fiscal year 2002, we recorded a $68.3 million impairment charge related to certain leased and owned equipment and long-lived assets. The $68.3 million charge has been shown as a separate component of cost of revenue in fiscal year 2002.

Cost of revenue in dollars increased 5% to approximately $135.3 million in fiscal year 2002, from approximately $129.1 million in fiscal year 2001. Included in cost of revenue are impairment charges of

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$68.3 million and $1.9 million, for fiscal years 2002 and 2001, respectively. Excluding the impairment charges, cost of revenues decreased approximately 47% to $67.0 million in fiscal year 2002, from approximately $127.2 million in fiscal year 2001. The $60.2 million value decrease, net of impairment charges, resulted from a $34.7 million reduction in equipment lease and related costs; a $10.0 million reduction in labor costs due to a head count reduction from 215 at July 31, 2001 to 198 at July 31, 2002; a $9.1 million reduction in consultants; a $5.9 million reduction in bandwidth and bandwidth related costs; a $2.9 million reduction in rent costs related to the shut down 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 certain equipment formerly held under operating lease.

As a percentage of revenue, cost of revenue increased to 228% in fiscal year 2002 from 126% in fiscal year 2001. Net of impairment charges, as a percentage of revenue, cost of revenue decreased to 113% in fiscal year 2002 from 124% in fiscal year 2001.

Cost of revenue in dollars increased 88% to approximately $129.1 million in fiscal year 2001, from approximately $68.5 million in fiscal year 2000. As a percentage of revenue, cost of revenue decreased to 126% in fiscal 2001, from 138% in fiscal year 2000. The dollar-value increase is due primarily to the costs associated with increased investment in our data centers. These costs principally include labor and headcount expenses, additional equipment and maintenance costs and increased bandwidth. Included in the fiscal year 2001 cost of revenue is a charge of approximately $1.9 million related to certain equipment under operating leases, which has been deemed not to have a future economic benefit to us.

For fiscal year 2003, we are anticipating that the cost of sales will decrease from the fiscal year 2002 levels on both an absolute and a unit cost basis. However, because of our restructuring efforts, we believe that we now have a flexible cost structure that allows us to match costs with actual revenue levels. Further, because of the fixed cost nature of our business, and the economies of scale achieved by spreading the various layers of expertise and software tools and infrastructure across more customers, each new dollar of revenues is marginally more profitable.

During fiscal year 2002, we recorded an impairment charge of $68.3 million related to certain leased and owned equipment and other long-lived assets. The components of this charge are as follows:

NaviSite performed a physical inventory of its customer dedicated equipment. As a result of this inventory, NaviSite 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.

NaviSite modified the payment amounts and terms of certain 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 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 is payable in January 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, $1.1 million, which was lower than the present value of the future minimum lease payments based on NaviSite s estimated incremental borrowing rate of 12%. Since the fair market value of the equipment was less than the consideration given, based on a third-party appraisal, NaviSite recorded an asset impairment charge of approximately $1.0 million. In addition, NaviSite returned certain equipment held under certain operating leases with one of the above lessors and incurred and paid a breakage fee of $397,000.

NaviSite 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 forecasts, the equipment will not be utilized before the related operating leases expire and/or the equipment becomes obsolete.

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NaviSite 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, we recorded a $365,000 impairment for software licenses that would not be utilized before the licenses expired and/or became obsolete.

NaviSite 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, 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 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 the Web hosting 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 were 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 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 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 $38.1 million during the fourth quarter of fiscal year 2002.

Gross Margin

Gross margin decreased to approximately a negative 128% of total revenue for fiscal year 2002 from approximately a negative 26% of total revenue for fiscal year 2001. Net of impairment charges, gross margin improved to approximately a negative 13% of total revenue for fiscal year 2002 from approximately a negative 24% of total revenue for fiscal year 2001. This compares with an improvement in gross margin to approximately a negative 26% of total revenue for fiscal year 2001, from approximately a negative 38% of total revenue for fiscal year 2000.

The improvement in the gross margin is a direct result of our fourth quarter fiscal 2001 restructuring and our ongoing restructuring efforts. We anticipate that our gross margins will continue to improve as we realize the full impact of our fiscal year 2002 cost savings initiatives in fiscal year 2003.

Operating Expenses

Product Development. Product development expenses consist mainly of salaries and related costs.

Product development expenses decreased 63% to approximately $5.3 million in fiscal year 2002 from approximately $14.1 million in fiscal year 2001. As a percentage of revenue, product development decreased to 9% in fiscal year 2002 from 14% in fiscal year 2001. The dollar value decrease in product development expenses is primarily related to reduced headcount and related costs resulting from the decrease in product development personnel at July 31, 2002 to 10 from 54 at July 31, 2001, combined with a reduction in outside consultants.

Product development expenses increased 171% to $14.1 million in fiscal year 2001, from approximately $5.2 million in fiscal year 2000. As a percentage of revenue, product development expenses increased to 14% in fiscal year 2001, from 10% in fiscal year 2000. The dollar-value increase in product development expenses in fiscal year 2001 was primarily related to the headcount and related costs resulting from the increase in product development personnel to 54 at July 31, 2001 from 31 at July 31, 2000.

For fiscal year 2003, we expect the product development expenses to decline in dollar value and on a percentage of revenue basis as we narrow our focus of our investments in mobile infrastructure and Web services technologies. Additionally, we continue to augment our own product development capabilities by working with and leveraging key technology go-to-market partners.

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 expenses decreased 70% to $9.7 million in fiscal year 2002 from $32.3 million in fiscal year 2001. As a percentage of revenue, sales and marketing decreased to 16% in fiscal year 2002 from 31% in fiscal year 2001. The $22.6 million decrease resulted primarily from a $8.1 million reduction in headcount expenses related to a decrease in sales and marketing personnel at July 31, 2002 to 18 from 65 at July 31, 2001, 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 consultants.

Selling and marketing expenses increased 41% to approximately $32.3 million in fiscal year 2001, from approximately $22.8 million in fiscal year 2000. As a percentage of revenue, selling and marketing expenses decreased to 31% in fiscal year 2001, from 46% in fiscal year 2000. The dollar-value increase is due primarily to increased headcount, salaries and commissions and expenses for marketing programs, advertising and product literature.

For fiscal year 2003, we expect the sales and marketing expense to decline in dollar value and on a percentage of revenue basis as we realize the full expense reductions of fiscal year 2002.

General and Administrative. General and administrative expenses include the costs of financial, leasing, human resources, IT and administrative personnel, professional services, bad debt and corporate overhead. Also included are intercompany charges from CMGI for facilities and shared back office and business development support.

General and administrative expenses decreased 42% to $19.3 million from $33.0 million in fiscal year 2001. As a percentage of revenue, general and administrative expense was consistent at 32% for fiscal years 2002 and 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 consultant expenses. General and administrative expenses also included a $600,000 legal settlement paid to Level 3 Communications, LLC.

General and administrative expenses increased 170% to approximately $33.0 million in fiscal year 2001, from approximately $12.3 million in fiscal year 2000. As a percentage of revenue, general and administrative expenses increased to 32% in fiscal year 2001, from 25% in fiscal year 2000. The dollar-value increase in general and administrative expenses is primarily due to an increase in headcount, salaries and related costs, to approximately $9.9 million in fiscal year 2001, from approximately $4.3 million in fiscal year 2000, resulting from the hiring of additional administrative, legal, human resource, IT and finance personnel and an increase in bad debt expense to approximately $11.9 million in fiscal year 2001, from approximately $1.0 million in fiscal year 2000.

For fiscal year 2003, we expect the general and administrative expenses to decline in dollar value and on a percentage of revenue basis as we realize the full expense reductions of fiscal year 2002.

Restructuring. 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/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 62% to $1.1 million in fiscal year 2002, from $2.8 million in fiscal year 2001. The decrease is due primarily to the reduced levels of average cash on hand.

Interest income increased 36% to $2.8 million in fiscal year 2001 from $2.0 million in fiscal year 2000. The increase was due primarily to the increase of average cash on hand due to financing events during fiscal year 2001.

Interest Expense

Interest expense increased 83% to $14.7 million in fiscal year 2002 from $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.

Interest expense increased 703% to $8.0 million in fiscal year 2001 from $1.0 million in fiscal year 2000. The increase was due primarily to the interest on the $80.0 million CMGI notes and related warrant amortization expense.

Other Income (expense), net

Other income (expense) decreased 276% 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 certain assets offset by the gain realized on the sale of assets of our Streaming Media Division.

Other income (expense) increased to $292,000 in fiscal year 2001 from $9,000 in fiscal year 2000. Other income in fiscal year 2001 consisted of miscellaneous income and gains from the sale of assets.

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Liquidity and Capital Resources

Since our inception, our operations have been funded primarily by CMGI through the issuance of common stock, preferred stock and convertible debt, the issuance of preferred stock and convertible debt to strategic investors, our initial public offering in October 1999 and the related exercise of an over-allotment option by the underwriters in November 1999.

Our cash and cash equivalents decreased to $21.8 million at July 31, 2002 from $22.2 million at July 31, 2001 and we had working capital of $16.5 million at July 31, 2002. Net cash used in operating activities was $27.0 million for the year ended July 31, 2002, resulting primarily from net losses and decreases in accrued expenses and accounts payables, partially offset by non-cash charges including asset impairment, depreciation and amortization, an increase in amounts due to CMGI, and provision for bad debt.

Net cash provided by investing activities was $636,000 for the year ended July 31, 2002, primarily associated with the sale of certain assets and equipment associated with our Streaming Media Division and the decrease in restricted cash requirements, offset by the acquisition of property and equipment. Net cash provided by financing activities was $26.0 million for the year ended July 31, 2002, comprised primarily of $30 million received through the issuance of Convertible Notes payable to CMGI and HPFS offset by payments under capital lease obligations and notes payable.

In connection with an agreement dated October 29, 2001 among us, CMGI and HPFS, we purchased certain equipment with a fair market value of $9.6 million, previously leased by us from HPFS under operating lease agreements expiring through 2003, in exchange for a note payable in the face amount of approximately $35 million. As the fair market value of the equipment, based on a third-party appraisal, was less than the associated debt obligation, we recorded an asset impairment charge in the first quarter of fiscal year 2002 of $25.4 million. We recorded the assets purchased and associated impairment charge effective August 1, 2001 with a corresponding obligation to HPFS. Based on the terms of the $35 million obligation, interest accrues commencing on November 8, 2001. We recognized $4.1 million of interest expense in fiscal year 2002.

On November 8, 2001, in connection with the October 29, 2001 agreement, we received $20 million and $10 million in cash from HPFS and CMGI, respectively, in exchange for six-year Convertible Notes payable in the face amounts of $20 million and $10 million to HPFS and CMGI, respectively, making the total notes payable issued by NaviSite to HPFS and CMGI, approximately $55 million and $10 million, respectively. The Convertible Notes require payment of interest only, at 12% per annum, for the first three years from the date of issuance and then repayment of principal and interest, on a straight-line basis, over the next three years until maturity on the sixth anniversary of the date of issuance. At our option, we may make interest payments (i) 100% in shares of our common stock, in the case of amounts owed to CMGI, through December 2007 and (ii) approximately 16.67% in shares of our common stock, in the case of amounts owed to HPFS, through December 2003. The payment of interest in our stock requires that we be listed for trading on the Nasdaq National Market. At July 31, 2002, we were listed on the Nasdaq SmallCap Market and therefore must make 100% of the interest payments in cash or receive a waiver from the holders of the notes for the Nasdaq National Market requirement. The Convertible Notes payable are secured by substantially all of the assets of the Company and cannot be prepaid.

The principal balances of these Convertible Notes may be converted into our common stock at the option of the holders at any time prior to or at maturity at a conversion rate of $0.26 per share. The conversion rate of $0.26 resulted in beneficial conversion rights for both CMGI and HPFS. The intrinsic value of the beneficial conversion rights amounted to $6.5 million and $36.0 million for CMGI and HPFS, respectively. The value of the beneficial conversion rights is being amortized into interest expense over the life of the Convertible Notes payable. Holders of the Convertible Notes payable are entitled to both demand and piggyback registration rights and HPFS is entitled to anti-dilution protection under certain circumstances. The agreement with HPFS and CMGI also contains certain restrictive covenants, including but not limited to limitations on the issuance of additional debt, the sale of equity securities to affiliates and certain acquisitions and dispositions of assets.

Subsequent to July 31, 2002, we had not paid the interest payable on the Convertible 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 Convertible 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 waiving any noncompliance of timely payments of interest or principal. In August 2002 we paid the interest due to ClearBlue.

In fiscal year 2002, we issued 6,700,859 shares of common stock in satisfaction of accrued interest associated with the $65 million notes payable to CMGI and HPFS.

In fiscal year 2002, we modified the payment amounts and terms of certain 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 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 fiscal year 2002 and $1.6 million is payable in January 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. In addition during fiscal year 2002, we returned certain equipment held under certain operating leases with one of the above lessors and incurred and paid a breakage fee of $397,000.

We currently anticipate that our available cash resources at July 31, 2002 will be sufficient to meet our needs on a standalone basis for working capital and capital expenditures through the end of fiscal year 2003. Our projections for cash usage assume: (1) our ability to retain customers in light of market and NaviSite uncertainties; (2) our ability to obtain a waiver for the cash payments of all or a portion of fiscal year 2003 quarterly interest due on the $65 million convertible notes; (3) our ability to collect accounts receivables in a timely manner; and (4) our ability to achieve expected cash expense reductions. In addition, ClearBlue and NaviSite are evaluating the possibility of a business combination involving ClearBlue, its affiliate entities and NaviSite. ClearBlue is our majority stockholder and could unilaterally implement any such combinations. The parties currently have no plans for such a combination and its impact, if implemented, on our cash resources cannot be determined. Further, continued market uncertainties, including delays or restrictions in IT spending, may affect our business results and our projected use of cash could also be impacted by any merger or acquisition activity.

To address these uncertainties, management is working to: (1) quantify the potential impact on cash flows of its evolving relationship with ClearBlue; (2) continue our practice of managing costs; and (3) aggressively pursue new revenue through channel partners, direct sales and acquisitions.

We may need to raise additional funds in order to respond to competitive and industry pressures, to respond to operational cash shortfalls, to acquire complementary businesses, products or technologies, or to develop new, or enhance existing, services or products. In addition, on a long-term basis, we may require additional external financing for working capital and capital expenditures through credit facilities, sales of additional equity or other financing vehicles. Our ability to raise additional funds may be impacted by: (1) the de-listing of our stock from Nasdaq; (2) our inability to transfer back to the Nasdaq National Market in the future from the Nasdaq SmallCap Market; and (3) restrictions imposed on us by ClearBlue. Under our arrangement with ClearBlue we must obtain its consent in order to issue debt securities or sell shares of our common stock to affiliates. We may not receive ClearBlue s consent. If additional funds are raised through the issuance of equity or convertible debt securities, the percentage ownership of our stockholders will be reduced and our stockholders may experience additional dilution. We cannot assure you that additional financing will be available on terms favorable to us, if at all. If adequate funds are not available or are not available on acceptable terms, our ability to fund our expansion, take advantage of unanticipated opportunities, develop or enhance services or products, respond to competitive pressures, or continue as a going concern, would be significantly limited.

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Contractual Obligations and Commercial Commitments

In the normal course of our business, we enter into contracts related to the leasing of facilities and equipment and the purchase of minimum bandwidth. In addition, we had $65 million face value of long-term debt outstanding at July 31, 2002. Future payments required under these long-term obligations are as follows:

Payment Due by Period
(in thousands)

	Total	Less than 1 year	1-3 years	4-5 years	After 5-years
Long-term debt	$ 65,093	$	10,849	43,395	$ 10,849
Interest on debt	24,516	5,509	11,432	7,162	413
Capital leases	2,699	2,302	397		
Operating leases	1,209	840	369		
Bandwidth commitments	1,695	937	758		
Level 3 agreement	2,057	2,057			
Maintenance for hardware and software	722	456	266		
Property leases	28,324	4,339	8,953	6,803	8,229
Total	$ 126,315	$ 16,440	$ 33,024	$ 57,360	$ 19,491

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 they believe 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.

Revenue Recognition. We provide outsourced Web hosting and managed application services and related professional and consulting services. Revenue consists of monthly fees for Web site and Internet application management, application rentals, and hosting. Revenues related to monthly fees for Web site and Internet application management, application rentals and hosting are recognized over the term of the customer contract based on actual usage and services. 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 24 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. 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 90 days in advance of disconnecting a customer. Revenue for services rendered during this notification period is recognized on a cash basis as collectability is not considered probable at the time the services are provided.

Allowance for Doubtful Accounts. We perform periodic credit evaluations of our customers financial condition and generally do not require collateral or other security against trade receivables. Our customer base includes a significant number of small start-up Internet-based businesses that face increased risk of loss of funding depending on the availability of private and or public funding. 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 50% of the balance over 120 days old and 3% 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. 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 such 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. During the fourth quarter of fiscal year 2002, due to significant industry and economic trends affecting both our current and future operations as well as a significant decline in our stock price, we completed an impairment review of our property and equipment. This review included a comparison of the carrying amount of such assets to the estimated fair values of the specific assets. 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 types of sale to determine fair value. Based on the appraised fair value of the property and equipment, we recorded an impairment charge of $38.1 million during the fourth quarter of fiscal year 2002. The selection of valuation methodologies and approaches, as well as assumptions of future asset utilization, requires judgments and estimates. The use of different valuation methodologies or assumptions could have increased or decreased the impairment charge.

Item 7A. ***Quantitative and Qualitative Disclosures About Market Risk***

Our exposure to market rate risk for changes in interest rates relates primarily to our cash equivalents. We invest our cash primarily in money market funds. An increase or decrease in interest rates would increase or decrease interest expense on capital lease obligations due to the fixed nature of such obligations. We also have fixed rate notes payable to CMGI and HPFS. An increase or decrease in interest rates would not have an impact on these notes. These notes were subsequently sold to ClearBlue. We do not currently have any foreign operations and thus are not exposed to foreign currency fluctuations.

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Item 8. ***Financial Statements and Supplementary Data***

NAVISITE, INC.

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INDEPENDENT AUDITORS REPORT

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

We have audited the accompanying consolidated balance sheets of NaviSite, Inc. and Subsidiary as of July 31, 2002 and 2001, 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, 2002. 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 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 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 Subsidiary as of July 31, 2002 and 2001, and the results of their operations and their cash flows for each of the years in the three-year period ended July 31, 2002, 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 2(c) 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 2(c) 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 2(c). The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

/s/ KPMG LLP
Boston, Massachusetts
October 28, 2002

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NAVISITE, INC. AND SUBSIDIARY

CONSOLIDATED BALANCE SHEETS

	July 31,	
ASSETS	**2002**	**2001**
	(In thousands, except par value)	
Current assets:		
Cash and cash equivalents	$ 21,842	$ 22,214
Accounts receivable, less allowance for doubtful accounts of $617 and $6,859 at July 31, 2002 and 2001, respectively	3,553	10,933
Due from CMGI and affiliates	3,724	4,362
Prepaid expenses and other current assets	3,292	2,184
Assets held for sale	1,022	
Total current assets	33,433	39,693
Property and equipment, net	12,412	63,410
Other assets	3,839	3,718
Restricted cash	3,850	5,051
Goodwill		394
Total assets	$ 53,534	112,266
LIABILITIES AND STOCKHOLDERS EQUITY (DEFICIT)		
Current liabilities:		
Capital lease obligations, current portion	$ 2,123	$ 42
Due to CMGI	3,241	14,821
Accounts payable	1,803	10,341
Accrued expenses	7,932	19,299
Deferred revenue	1,619	3,818
Software vendor payable, current portion		837
Customer deposits	199	218
Total current liabilities	16,917	49,376
Capital lease obligations, less current portion	378	
Convertible notes payable to HPFS, net	23,440	
Software vendor payable, less current portion		79
Convertible notes payable to CMGI, net	4,255	69,773
Total liabilities	44,990	119,228
Commitments and contingencies (note 8)		
Stockholders equity (deficit):		
Preferred Stock, $0.01 par value. Authorized 5,000 shares; no shares issued or outstanding at July 31, 2002 and 2001		
Common Stock, $0.01 par value. Authorized 395,000 shares; issued and outstanding 93,723 and 61,868 shares at July 31, 2002 and 2001, respectively	937	619
Additional paid-in capital	344,945	208,064
Accumulated deficit	(337,338)	(215,645)
Total stockholders equity (deficit)	8,544	(6,962)
Total liabilities and stockholders equity (deficit)	$ 53,534	$ 112,266

See accompanying notes to consolidated financial statements.

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NAVISITE, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF OPERATIONS

	Years Ended July 31,		
	2002	2001	2000
	(In thousands, except par value)		
Revenue:			
Revenue	$ 40,968	66,358	24,870
Revenue, related parties	18,453	36,368	24,893
Total revenue	59,421	102,726	49,763
Cost of revenue	67,000	127,155	68,496
Impairment of long-lived assets	68,317	1,930	
Total cost of revenue	135,317	129,085	68,496
Gross deficit	(75,896)	(26,359)	(18,733)
Operating expenses:			
Product development	5,281	14,072	5,197
Selling and marketing	9,703	32,251	22,805
General and administrative	19,272	33,011	12,270
Restructuring	(2,633)	8,011	
Total operating expenses	31,623	87,345	40,272
Loss from operations	(107,519)	(113,704)	(59,005)
Other income (expense):			
Interest income	1,060	2,753	2,027
Interest expense	(14,718)	(8,042)	(1,001)
Other income (expense), net	(516)	292	9
Loss before cumulative effect of change in accounting principle	(121,693)	(118,701)	(57,970)
Cumulative effect of change in accounting principle		(4,295)	
Net loss	(121,693)	(122,996)	(57,970)
Basic and diluted net loss per common share:			
Before cumulative effect of change in accounting principle	$ (1.49)	(2.01)	(1.37)
Cumulative effect of change in accounting principle		(0.07)	
Basic and diluted net loss per common share	$ (1.49)	(2.08)	(1.37)
Basic and diluted weighted average number of common shares outstanding	81,859	58,993	42,270
Unaudited pro forma basic and diluted net loss per share	$		(1.08)
Pro forma weighted average number of basic and diluted shares outstanding			53,829

See accompanying notes to consolidated financial statements.

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NAVISITE, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY (DEFICIT)

Years ended July 31, 2002, 2001, and 2000
(in thousands, except per share data)

	Series A Convertible Preferred Stock		Series B Convertible Preferred Stock		Common Stock					
	Shares	Amount	Shares	Amount	Shares	Amount	Deferred Compensation	Additional Paid-In Capital	Accumulated Deficit	Stockholders Equity (Deficit)
Balance at July 31, 1999	1,324	$ 13	542	$ 5	138	$ 1	$	$ 30,291	$ (34,679)	$ (4,369)
Conversion of debt to CMGI into Series B preferred stock			88					12,257		12,257
Conversion of Series B, C, and D convertible redeemable preferred stock into common stock	(1,324)	(13)	(630)	(5)	43,244	432		15,006		15,420
Issuance of common stock in conjunction with public offering, net of offering costs of $8,169					13,631	137		130,054		130,191
Issuance of common stock in connection with employee stock purchase plan and exercise of stock options					1,283	13		1,105		1,118
Deferred stock compensation related to acquisition					68	1	(1,589)	1,588		
Amortization of deferred stock compensation							827			827
Net loss									(57,970)	(57,970)
Balance at July 31, 2000		$		$	58,364	$ 584	$ (762)	$ 190,301	$ (92,649)	$ 97,474
Issuance of common stock in connection with employee stock purchase plan and exercise of stock options					714	7		975		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					2,790	28		3,581		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		$		$	61,868	$ 619	$	$ 208,064	$ (215,645)	$ (6,962)
Issuance of common stock in connection with employee stock purchase plan and exercise of stock options					524	5		31		36

Conversion of CMGI convertible debt and other amounts due to CMGI					24,359	244		86,910		87,154
Issuance of common stock in connection with the interest on convertible debt					6,972	69		2,915		2,984
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		$		$	93,723	$ 937	$	$ 344,945	$ (337,338)	$ 8,544

See accompanying notes to consolidated financial statements.

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NAVISITE, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Years Ended July 31,		
	2002	2001	2000
		(In thousands)	
Cash flows from operating activities:			
Net loss	$ (121,693)	$ (122,996)	$ (57,970)
Adjustments to reconcile net loss to net cash used for operating activities:			
Depreciation and amortization	20,649	15,154	9,081
Amortization of beneficial conversion feature to interest expense	5,163		
Interest on debt paid in stock	3,695		
Impairment of long-lived assets	68,317		
Impairment of goodwill	186		
Writedown of assets held for sale	524		
(Gain) loss on disposal of assets	1,363	(133)	
(Gain)/ loss on sale of Streaming Media Assets	(524)		
Provision for bad debts	3,490	11,948	1,069
Amortization of deferred compensation		1,051	827
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	3,600	(6,373)	(12,898)
Due from CMGI and affiliates	(266)	1,623	(5,908)
Prepaid expenses and other current assets, net	178	1,016	(1,738)
Due to CMGI	7,218	9,511	5,310
Deposits	(379)	(58)	(2,660)
Accounts payable	(8,537)	(3,116)	11,049
Customer deposits	(19)	218	
Accrued expenses and deferred revenue	(11,172)	(2,945)	23,618
Net cash used for operating activities	(27,035)	(88,800)	(30,220)
Cash flows from investing activities:			
Net cash acquired in acquisition			7
Purchases of property and equipment	(4,182)	(25,515)	(66,328)
Proceeds from the sale of Streaming Media Division assets	1,600		
Proceeds from the sale of equipment	1,440	13,884	
Restricted cash	1,201	(5,051)	
Other assets	577	(747)	
Net cash provided by (used for) investing activities	636	(17,429)	(66,321)
Cash flows from financing activities:			
	0.41	$ 0.52	$ 0.98
Diluted weighted average common shares outstanding	11,155,249	11,428,201	11,384,155

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

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Anika Therapeutics, Inc. and Subsidiary
Consolidated Statements of Stockholders Equity

	Common Stock			Treasury Stock		Retained	
	Number of Shares	$.01 Par Value	Additional Paid-in Capital	Number of Shares	Cost	Earnings (Accumulated Deficit)	Total Stockholders Equity
Balance, December 31, 2003	9,991,943	$ 99,919	$ 31,480,005	5,538	$ (26,868)	$ (13,569,093)	$ 17,983,963
Exercise of common stock options	265,529	2,656	548,635	(5,538)	26,868		578,159
Tax benefit related to stock options			609,866				609,866
Net income						11,189,869	11,189,869
Balance, December 31, 2004	10,257,472	102,575	32,638,506			(2,379,224)	30,361,857
Exercise of common stock options	242,921	2,429	553,762				556,191
Tax benefit related to stock options			1,080,613				1,080,613
Net income						5,892,538	5,892,538
Balance, December 31, 2005	10,500,393	105,004	34,272,881			3,513,314	37,891,199
Exercise of common stock options	272,261	2,723	1,216,751				1,219,474
Tax benefit related to stock options			505,931				505,931
FAS 123R stock option expense			1,267,205				1,267,205
Net income						4,604,216	4,604,216
Balance, December 31, 2006	10,772,654	$ 107,727	$ 37,262,768		$	$ 8,117,530	$ 45,488,025

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

Anika Therapeutics, Inc. and Subsidiary
Consolidated Statements of Cash Flows

	For the Years Ended December 31, 2006	2005	2004
Cash flows from operating activities:			
Net income	$ 4,604,216	$ 5,892,538	$ 11,189,869
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation	384,055	459,906	709,504
Stock-based compensation expense	1,267,205		
Deferred income taxes	659,976	1,911,270	(11,180,836)
Provision for inventory reserve	56,380	49,452	3,079
Tax benefit from exercise of stock options	(505,931)	1,080,613	609,866
Changes in operating assets and liabilities:			
Accounts receivable	(1,443,268)	287,440	(932,570)
Inventories	(2,181,298)	906,653	(603,284)
Prepaid expenses	805,036	313,037	(1,257,661)
Long-term deposits and other	(49,990)		
Accounts payable	(312,602)	486,771	442,219
Accrued expenses	(145,081)	(322,099)	743,769
Deferred revenue	(1,725,235)	(4,613,654)	24,165,724
Income taxes payable	523,184		(64,883)
Other long-term liabilities	64,525		
Net cash provided by operating activities	2,001,172	6,451,927	23,824,796
Cash flows from investing activities:			
Restricted cash			817,960
Purchase of property and equipment	(1,305,801)	(1,600,821)	(473,664)
Net cash (used in) provided by investing activities	(1,305,801)	(1,600,821)	344,296
Cash flows from financing activities:			
Proceeds from exercise of stock options	1,219,474	556,191	578,159
Tax benefit from exercise of stock options	505,931		
Net cash provided by financing activities	1,725,405	556,191	578,159
Increase in cash and cash equivalents	2,420,776	5,407,297	24,747,251
Cash and cash equivalents at beginning of year	44,746,656	39,339,359	14,592,108
Cash and cash equivalents at end of year	$ 47,167,432	$ 44,746,656	$ 39,339,359
Supplemental disclosure of cash flow information:			
Cash paid for income taxes	$ 1,077,506	$ 637,199	$ 7,156,053

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

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Anika Therapeutics, Inc. and Subsidiary
Notes to Consolidated Financial Statements

1. Nature of Business

Anika Therapeutics, Inc. (Anika, the Company, we, us, or our) develops, manufactures and commercializes therapeutic products for tissue protection, healing and repair. These products are based on hyaluronic acid (HA), a naturally occurring, biocompatible polymer found throughout the body. Due to its unique biophysical and biochemical properties, HA plays an important role in a number of physiological functions such as the protection and lubrication of soft tissues and joints, the maintenance of the structural integrity of tissues, and the transport of molecules to and within cells. The Company s currently manufactured and marketed products consist of ORTHOVISC®, which is an HA product used in the treatment of some forms of osteoarthritis in humans; AMVISC®, AMVISC® Plus, STAARVISC -II, and ShellGel™, each an injectable ophthalmic viscoelastic HA product; and HYVISC®, which is an HA product used in the treatment of equine osteoarthritis, and INCERT®, which is an HA based anti-adhesive for surgical applications currently marketed in three countries outside of the U.S. In the U.S. ORTHOVISC is marketed by DePuy Mitek, Inc., a subsidiary of Johnson & Johnson, under the terms of a licensing, distribution, supply and marketing agreement. Outside the U.S., ORTHOVISC has been approved for sale since 1996 and is marketed by distributors in approximately 20 countries. HYVISC is marketed in the U.S. through Boehringer Ingelheim Vetmedica, Inc. We developed and manufacture AMVISC® and AMVISC® Plus for Bausch & Lomb Incorporated under a multiyear supply agreement. Products in development include, ELEVESSTM, an HA based dermal filler used for cosmetic tissue augmentation applications and next generation osteoarthritis / joint health related products. In June 2006, we entered into a license and development agreement and a supply agreement with Galderma Pharma S.A. and Galderma S.A. for exclusive worldwide development and commercialization of ELEVESS.

The Company is subject to risks common to companies in the biotechnology and medical device industries including, but not limited to, development by the Company or its competitors of new technological innovations, dependence on key personnel, protection of proprietary technology, commercialization of existing and new products, and compliance with FDA government regulations and approval requirements as well as the ability to grow the Company s business.

2. Summary of Significant Accounting Policies

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles 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.

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of Anika Therapeutics, Inc. and its wholly owned subsidiary, Anika Securities, Inc. (a Massachusetts Securities Corporation). All intercompany balances and transactions have been eliminated in consolidation.

Cash and Cash Equivalents

Cash and cash equivalents consists of cash and highly liquid investments with original maturities of 90 days or less.

Financial Instruments

SFAS No. 107, Disclosures About Fair Value of Financial Instruments , requires disclosure about fair value of financial instruments. Financial instruments consist of cash equivalents, accounts receivable, and accounts payable. The estimated fair values of the Company s financial instruments approximate their carrying values.

Revenue Recognition

The Company s revenue recognition policies are in accordance with the Securities and Exchange Commission s (SEC) Staff Accounting Bulletin No. 101, *Revenue Recognition in Financial Statements*, as amended by SEC Staff Accounting Bulletin No. 104, *Revenue Recognition,* and Emerging Issues Task Force Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables*.

Product Revenue

The Company recognizes revenue from the sales of products it manufactures upon confirmation of regulatory compliance and shipment to the customer as long as there is (1) persuasive evidence of an arrangement, (2) delivery has occurred and risk of loss has passed, (3) the sales price is fixed or determinable and (4) collection of the related receivable is reasonably assured. Amounts billed or collected prior to recognition of revenue are classified as deferred revenue. When determining whether risk of loss has transferred to customers on product sales or if the sales price is fixed or determinable the Company evaluates both the contractual terms and conditions of its distribution and supply agreements as well as its business practices. Product revenue also includes royalties. Royalty revenue is based on our distributor s sales and recognized in the same period our distributor records their sale of the product.

License, Milestone and Contract Revenue

On June 30, 2006, the Company entered into a License and Development Agreement with Galderma Pharma S.A., a joint venture between Nestlé and L Oréal, and a Supply Agreement with Galderma Pharma S.A. and Galderma S.A., an affiliate of Galderma Pharma S.A., for the exclusive worldwide development and commercialization of hyaluronic acid based CTA products. Galderma Pharma S.A. and Galderma S.A. are jointly referred to as Galderma. Under the agreements, the Company is responsible for the development and manufacturing of the CTA products, and Galderma is responsible for the commercialization, including distribution and marketing, of the CTA products worldwide. The agreements include an upfront payment, milestones upon achievement of predefined regulatory goals, funding of certain ongoing development activities, payments for the supply of CTA products, royalties on sales and sales threshold achievement payments for meeting certain net sales targets. The Company accounts for the agreements in accordance with the Emerging Issues Task Force Issue No. 00-21, Revenue Arrangements with Multiple Deliverables (EITF 00-21). Under EITF 00-21, in order to account for an element as a separate unit of accounting, the element must have stand-alone value and there must be objective and reliable evidence of fair value of the undelivered elements. Based on the review of the agreements, the Company believes that two separate units of accounting exist: a combined license and development unit and a manufacturing and supply unit. Milestone payments related to achieving regulatory goals under the license and development unit are subject to certain refund clauses, which are expected to expire by June 2007. Pursuant to this model, the Company will recognize payments received under the license and development unit upon expiration of refund contingencies, over the period in which the Company performs its obligations, which approximates the contractual term of 10 years. Using the contingency-adjusted performance model, the intial and subsequent milestone payments, once earned, are recognized as contract and license fee revenue. Payments from the manufacturing and supply unit will be recognized post commercialization as product is delivered.

Under the terms of the agreements, the Company received on June 30, 2006 a non-refundable, upfront payment of $1,000,000, which the Company will recognize over a 10 year period. Milestone payments under the agreements are related to regulatory approvals of the CTA products in the United States and Europe. Achievements of both regulatory approvals would entitle the Company to aggregate milestone payments of up to $5,000,000 for the initial CTA product. The Company would also receive up to an additional $1,500,000 upon regulatory approvals in the United States and Europe for each additional CTA product that the parties agree to develop and market. In addition, the agreements contain payment terms for supplying Galderma with CTA products and royalties based on sales of the Company s CTA products by Galderma to its customers. The agreements provide for sales threshold achievement payments of up to $14,500,000 if CTA product net sales exceed certain net sales targets. Under the terms of the agreements, Galderma will support the development of the Company s CTA products, including reimbursement for certain clinical development costs for the enhancement of the initial CTA product, line extensions and clinical trial support, and the Company will make appropriate regulatory filings with the U.S. Food and Drug Administration and regulators in the European Union to enhance features of its initial CTA product. The agreements have an initial term of ten years, unless earlier terminated pursuant to any one of several early termination rights of each party. In certain circumstances, an early termination of the agreements will require the Company to refund to Galderma certain product development milestone payments and reimbursements of development costs. Following the initial term, the agreements will automatically renew for an additional three year period if a certain net sales target has been exceeded, unless terminated by Galderma prior to the expiration of the initial term.

The Company entered into an exclusive worldwide development and commercialization agreement (the OrthoNeutrogena Agreement) in July 2004, for the Company s CTA products with the OrthoNeutrogena, a division of Ortho-McNeil Pharmaceuticals, Inc., an affiliate of Johnson & Johnson. On September 1, 2005, the Company announced that it had mutually agreed with OrthoNeutrogena to terminate its development and commercialization agreement. The Company received a payment of $3,115,000 from OrthoNeutrogena including a $2,300,000 contract termination fee. Given that there were no continuing performance obligations with respect to the development and commercialization agreement or the related termination agreement, all amounts were recognized during the third quarter of 2005, including approximately $251,000 of previously deferred revenue under the performance-based model. Total contract revenue recognized during 2005 related to the agreements with OrthoNeutrogena was $6,537,094.

In December 2003 the Company entered into a ten-year licensing and supply agreement (the JNJ Agreement) with Ortho Biotech Products, L.P., a member of the Johnson & Johnson family of companies, to market ORTHOVISC in the U.S. In mid-2005, the agreement was assigned to DePuy Mitek, Inc., a subsidiary of Johnson & Johnson. Under the JNJ Agreement, DePuy Mitek performs sales, marketing and distribution functions and licensed the right to further develop and commercialize ORTHOVISC as well as other new products for the treatment of pain associated with osteoarthritis based on the Company s viscosupplementation technology. In support of the license, the JNJ Agreement provides that DePuy Mitek will fund post-marketing clinical trials for new indications of ORTHOVISC. The Company received an initial payment of $2,000,000 upon entering into the JNJ Agreement, a milestone payment of $20,000,000 in February 2004, as a result of obtaining FDA approval of ORTHOVISC and a milestone payment of $5,000,000 in December 2004 for planned upgrades to our manufacturing operations. The Company evaluated the terms of the JNJ Agreement and determined that the upfront fee and milestone payments did not meet the conditions to be recognized separately from the supply agreement, therefore, the Company have deferred non refundable payments received of $27,000,000 which we are recognizing ratably over the expected ten year term of the JNJ Agreement. Under the JNJ Agreement, we are the exclusive supplier of ORTHOVISC to Johnson & Johnson. The JNJ Agreement provides for additional sales-based milestone payments to us contingent upon achieving specified sales targets, in addition to royalty and transfer fees. The JNJ Agreement is subject to early termination in certain circumstances and is otherwise renewable by DePuy Mitek for consecutive five-year terms.

Accounts Receivable and Allowance for Doubtful Accounts

Trade accounts receivable are recorded at the invoiced amount and do not bear interest. The allowance for doubtful accounts is the Company s best estimate of the amount of probable credit losses in its existing accounts receivable. The Company determines the allowance based on specific identification. The Company reviews its allowance for doubtful accounts at least quarterly. Past due balances over 90 days are reviewed individually for collectibility. Account balances are charged off against the allowance when the Company feels it is probable the receivable will not be recovered. The Company does not have any off-balance-sheet credit exposure related to its customers.

Inventories

Inventories are stated at the lower of cost or market, with cost being determined using the first-in, first-out (FIFO) method. Work-in-process and finished goods inventories include materials, labor, and manufacturing overhead.

Property and Equipment

Property and equipment are carried at cost less accumulated depreciation. Costs of major additions and betterments are capitalized; maintenance and repairs that do not improve or extend the life of the respective assets are charged to operations. On disposal, the related accumulated depreciation or amortization is removed from the accounts and any resulting gain or loss is included in results of operations. Depreciation is computed using the straight-line method over the estimated useful lives of the assets as follows:

Machinery and equipment	3 8 years
Furniture and fixtures	3 5 years
Leasehold improvements	Shorter of lease term or estimated useful life

The Company accounts for impairment of long-lived assets in accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. SFAS No. 144 establishes a uniform accounting model for long-lived assets to be disposed of. This Statement also requires that long-lived assets be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by comparing the carrying amount of an asset to estimated undiscounted future net cash flows expected to be generated by the asset. If the carrying amount of the asset exceeds its estimated future cash flows, an impairment charge is recognized by the amount by which the carrying amount of the asset exceeds the fair value of the asset. As of December 31, 2006 and 2005, long-lived assets consisted of machinery, equipment and leasehold improvements.

During the years ended December 31, 2006, 2005, and 2004 the Company did not record losses on impairment.

Research and Development

Research and development costs consists primarily of salaries and related expenses for personnel and fees paid to outside consultants and outside service providers, including costs associated with licensing, milestone and contract revenue. Research and development costs are expensed as incurred.

Income Taxes

The Company provides for income taxes in accordance with SFAS No. 109, Accounting for Income Taxes. SFAS No. 109 requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of temporary differences between the financial reporting and tax basis of assets and liabilities.

Stock-Based Compensation

Effective January 1, 2006, the Company adopted the provisions of Statement of Financial Accounting Standards No. 123R, (SFAS 123R), Share-Based Payment, which establishes accounting for equity instruments exchanged for employee services. Under the provisions of SFAS No. 123R, share-based compensation cost is measured at the grant date, based on the calculated fair value of the award, and is recognized as an expense over the employee s requisite service period (generally the vesting period of the equity grant). Prior to January 1, 2006, the Company accounted for share-based compensation to employees in accordance with Accounting Principles Board Opinion No. 25 (APB 25 ,) Accounting for Stock Issued to Employees, and related interpretations. The Company also followed the disclosure requirements of SFAS No. 123, Accounting for Stock-Based Compensation, as amended by SFAS 148, Accounting for Stock-Based Compensation Transition and Disclosure. The Company elected to adopt the modified prospective transition method as provided by SFAS 123R and, accordingly, financial statement amounts for the prior periods presented in this Annual Report on Form 10-K have not been restated to reflect the fair value method of expensing share-based compensation. See Note 9 for additional disclosures.

Concentration of Credit Risk and Significant Customers

SFAS No. 105, Disclosure of Information About Financial Instruments with Off-Balance-Sheet-Risk and Financial Instruments with Concentrations of Credit Risk requires disclosure of any significant off-balance-sheet-risk, or concentrations of credit risk. The Company has no significant off-balance sheet or concentrations of credit risk such as foreign exchange contracts, option contracts or other foreign hedging arrangements. The Company, by policy, limits the amount of credit exposure to any one financial institution, and routinely assesses the financial strength of its customers. As a result, the Company believes that its accounts receivable credit risk exposure is limited and has not experienced significant write-downs in its accounts receivable balances. As of December 31, 2006, Bausch & Lomb, Boehringer Ingelheim Vetmedica, JNJ, and Staar Surgical combined, represented 89% of the Company s accounts receivable balance. As of December 31, 2005, Bausch & Lomb, Boehringer Ingelheim Vetmedica, Pharmaren, JNJ, Staar Surgical and Ferrer Grupo combined, represented 91% of the Company s accounts receivable balance.

Reporting Comprehensive Income

SFAS No. 130, Reporting Comprehensive Income establishes standards for reporting and display of comprehensive income and its components in the financial statements. Comprehensive income is the total of net income and all other non-owner changes in equity including such items as unrealized holding gains/losses on securities, foreign currency translation adjustments and minimum pension liability adjustments. The Company had no such items for the years ended December 31, 2006, 2005, and 2004 and as a result, comprehensive income is the same as reported net income for all periods presented.

Disclosures About Segments of an Enterprise and Related Information

Operating segments are identified as components of an enterprise about which separate discrete financial information is available for evaluation by the chief operating decision maker, or decision-making group, in making decisions regarding how to allocate resources and assess performance. The Company s chief operating decision maker is its Chief Executive Officer. Based on the criteria established by SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information, the Company has one reportable operating segment, the results of which are disclosed in the accompanying consolidated financial statements. All of the operations and assets of the Company have been derived from and are located in the United States.

Recent Accounting Pronouncements

On July 13, 2006, FASB Interpretation (FIN) No. 48, *Accounting for Uncertainty in Income Taxes An Interpretation of FASB Statement No. 109*, was issued. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes.* FIN 48 also prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The new FASB standard also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition and is effective for fiscal years beginning after December 15, 2006. We are currently evaluating the impact of adopting FIN 48 on our financial statements.

On September 15, 2006, the FASB issued SFAS No. 157, Fair Value Measurements (SFAS 157). This Statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. This Statement applies under other accounting pronouncements that require or permit fair value measurements, the Board having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. Accordingly, this Statement does not require any new fair value measurements. SFAS 157 is effective for the Company as of January 1, 2008. The Company is currently evaluating the potential impact of adopting SFAS 157.

On September 13, 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements*, or SAB 108. SAB 108 provides guidance on how prior year misstatements should be taken into consideration when quantifying misstatements in current year financial statements for the purposes of determining whether the current year s financial statements are materially misstated. SAB 108 becomes effective for accounting years ending after November 15, 2006. The adoption of this SAB did not have any impact on our financial statements.

3. Net Income per Common Share

The Company reports earnings per share in accordance with SFAS No. 128, Earnings per Share, which establishes standards for computing and presenting earnings per share. Basic earnings per share is computed by dividing net income by the weighted average number of common shares outstanding during the period. Diluted earnings per share is computed by dividing net income by the weighted average number of common shares outstanding and the number of dilutive potential common share equivalents during the period. Under the treasury stock method, unexercised in-the-money stock options are assumed to be exercised at the beginning of the period or at issuance, if later. The assumed proceeds are then used to purchase common shares at the average market price during the period.

Shares used in calculating basic and diluted earnings per share for each of the years ended December 31, 2006, 2005 and 2004, are as follows:

	2006	2005	2004
Net income	$ 4,604,216	$ 5,892,538	$ 11,189,869
Basic weighted average common shares outstanding	10,639,028	10,410,920	10,103,835
Dilutive potential common shares	516,221	1,017,281	1,280,320
Diluted weighted average common and potential common shares outstanding	11,155,249	11,428,201	11,384,155

Options to purchase approximately 193,075, 85,341, and 14,000 shares were outstanding at December 31, 2006, 2005 and 2004, respectively, but not included in the computation of diluted earnings per share because the options exercise prices were greater than the average market price during the period.

4. Allowance for Doubtful Accounts

A summary of the allowance for doubtful account activity is as follows:

	December 31, 2006	2005	2004
Balance, beginning of the year	$ 22,558	$ 22,558	$ 28,750
Amounts provided	27,166		
Amounts written off			(6,192)
Balance, end of the year	$ 49,724	$ 22,558	$ 22,558

5. Inventories

Inventories consist of the following:

	December 31, 2006	2005
Raw Materials	$ 2,935,075	$ 1,594,313
Work-in-Process	2,132,665	1,506,565
Finished Goods	327,856	169,800
Total	$ 5,395,596	$ 3,270,678

6. Property & Equipment

Property and equipment is stated at cost and consists of the following:

	December 31, 2006	2005
Machinery and equipment	$ 6,581,394	$ 6,407,333
Furniture and fixtures	736,824	736,824
Leasehold improvements	3,510,875	3,449,469
Construction in progress	2,426,147	1,355,813
	13,255,240	11,949,439
Less accumulated depreciation	(10,237,232)	(9,853,177)
Total	$ 3,018,008	$ 2,096,262

Depreciation expense was $384,055, $459,906 and $709,504 for the years ended December 31, 2006, 2005 and 2004, respectively.

7. Accrued Expenses

Accrued expenses consist of the following:

	December 31, 2006	2005
Payroll and benefits	$ 979,939	$ 1,006,760
Professional fees	217,500	346,970
Clinical trial	113,860	150,522
Other	262,536	214,664
Total	$ 1,573,835	$ 1,718,916

8. Commitments and Contingencies

Operating Leases. The Company s corporate headquarters is located in Woburn, Massachusetts, where it leases approximately 10,000 square feet of administrative and research and development space. The lease on this facility terminates in December 2007. The Company also leases approximately 37,000 square feet of space at a separate location in Woburn, Massachusetts, for its manufacturing facility and warehouse. The lease for this facility terminates in February 2009. Rental expense in connection with the leases, totaled $791,137, $723,707, and $699,970, for the years ended December 31, 2006, 2005, and 2004, respectively.

Future minimum lease payments under noncancelable operating leases, including facilities and office equipment leases, at December 31, 2006 are as follows:

	Amount
2007	$ 801,948
2008	679,686
2009	135,270
2010	26,387
2011	13,193
Thereafter	
Total	$ 1,656,484

On January 4, 2007, we entered into a new lease, pursuant to which we will lease a new headquarters facility (the Lease), consisting of approximately 134,000 square feet of general office, research and development and manufacturing space located in Bedford, Massachusetts. The Lease has an initial term of ten and a half years, and is expected to commence on approximately May 1, 2007 once certain agreed upon landlord improvements are completed. We have an option under the Lease to extend its terms for up to four periods beyond the original expiration date subject to the condition that we notify the landlord that we are exercising each option at least one year prior to the expiration of the original or current term thereof. The first three renewal options each extend the term an additional five years with the final renewal option extending the term six years. We currently expect our administrative, research and development personnel to begin occupying the Bedford facility by the end of 2007, and for the buildout and validation for the new manufacturing space to be completed by late 2008. Assuming a lease commencement date of May 1, 2007, future minimum lease payments related to this lease are as follows:

	Amount
2007	$ 208,334
2008	479,167
2009	562,500
2010	677,083
2011	837,500
Thereafter	5,298,583
Total	$ 8,063,167

Guarantor Arrangements. In certain of its contracts, the Company warrants to its customers that the products it manufactures conform to the product specifications as in effect at the time of delivery of the product. The Company may also warrant that the products it manufactures do not infringe, violate or breach any U.S. patent or intellectual property rights, trade secret or other proprietary information of any third party. On occasion, the Company contractually indemnifies its customers against any and all losses arising out of or in any way connected with any claim or claims of breach of its warranties or any actual or alleged defect in any product caused by the negligence or acts or omissions of the Company. The Company maintains a products liability insurance policy that limits its exposure. Based on the Company s historical activity in combination with its insurance policy coverage, the Company believes the estimated fair value of these indemnification agreements is minimal. The Company has no accrued warranties and has no history of claims paid.

9. Stock Option Plan

Effective January 1, 2006, the Company adopted the provisions SFAS 123R, which established accounting for equity instruments exchanged for employee services. The Company estimates the fair value of stock options and stock appreciation rights using the Black-Scholes valuation model. Fair value of restricted stock is measured by the grant-date price of the Company s shares. Key input assumptions used to estimate the fair value of stock options and stock appreciation rights include the exercise price of the award, the expected option term, the expected volatility of the Company s stock over the option s expected term, the risk-free interest rate over the option s expected term, and the Company s expected annual dividend yield. The Company uses historical data on exercise of stock options and other factors to estimate the expected term of share-based awards. The expected volatility assumption is based on the unadjusted historical volatility of the Company s common stock. The risk-free interest rate assumption is based on U.S. Treasury interest rates at the time of grant. The fair value of each stock option and stock appreciation rights award during 2006, 2005 and 2004 was estimated on the grant date using the Black-Scholes option-pricing model with the following assumptions:

	Twelve Months Ended December 31, 2006	December 31, 2005	December 31, 2004
Risk-free interest rate	4.32% 5.03%	3.54% 4.53%	2.35% 3.54%
Expected volatility	63.92% 65.82%	68.45% 71.38%	72.9% 100.14%
Expected lives (years)	4	4	4
Expected dividend yield	0.00%	0.00%	0.00%

The Company recorded $1,267,205 of share-based compensation expense for the twelve months ended December 31, 2006 for stock options, stock appreciation rights and restricted stock awards. The Company presents the expenses related to stock-based compensation awards in the same expense line items as cash compensation paid to the same employees. Prior to 2006, the Company granted stock options to employees and members of the Board of Directors. During 2006, the Company granted 262,050 shares of share-based stock appreciation to members of its Board of Directors and company officers. The Company also granted 12,500 shares of stock options and 27,200 shares of restricted stock to non-officer employees during 2006. These awards were granted under the Stock Option and Incentive Plan approved by the Board of Directors on April 4, 2003. The Company did not recognize compensation expense for employee share-based awards for the twelve months ended December 31, 2005 and 2004, when the exercise price of the Company s employee stock awards equaled the market price of the underlying stock on the date of grant.

The Company had previously adopted the provisions of Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation, (SFAS 123), as amended by SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure through disclosure only. The following table illustrates the effects on net income and earnings per share for the twelve months ended

December 31, 2005 and 2004 as if the Company had applied the fair value recognition provisions of SFAS 123 to share-based employee awards.

	December 31, 2005	2004
Net income		
As reported	$ 5,892,538	$ 11,189,869
Add: Stock-based employee compensation expense included in reported net income		
Deduct: Total stock-based employee compensation under the fair-value-based method for all awards, net of tax	(697,191)	(481,466)
Proforma net income	$ 5,195,347	$ 10,708,403
Basic net income per share		
As reported	$ 0.57	$ 1.11
Proforma	$ 0.50	$ 1.06
Diluted net income per share		
As reported	$ 0.52	$ 0.98
Proforma	$ 0.45	$ 0.94

For the twelve months ended December 31, 2006, the adoption of SFAS 123R had the following effect on the Company s consolidated statements of operations:

Cost of product revenue	$ 252,098
Research & development	40,964
Selling, general & administrative	974,143
Income from operations	1,267,205
Income tax benefits	(312,524)
Net stock-based compensation expense	$ 954,681
Effect on basic net income per share	$ 0.09
Effect on diluted net income per share	$ 0.09

The Company had reserved 3,485,000 shares of common stock for the grant of stock options to employees, directors, consultants and advisors under the Anika Therapeutics, Inc. 1993 Stock Option Plan, as amended (the 1993 Plan). In addition, the Company also established the Directors Stock Option Plan (the Directors Plan) and reserved 40,000 shares of the Company s common stock for issuance to the Board of Directors. On March 3, 2003, the 1993 Plan expired in accordance with its terms and approximately 662,000 shares reserved under the plan were released. On April 4, 2003 the Board of Directors approved the 2003 Anika Therapeutics, Inc. Stock Option and Incentive Plan (the 2003 Plan). The Company has reserved 1,500,000 shares of common stock for grant of stock options to employees, directors, consultants and advisors under the 2003 Plan, which was approved by stockholders on June 4, 2003. The Company issues new shares upon share option exercise from its authorized shares. Stock-based awards are granted with an exercise price equal to the market price of the Company s stock on the date of grant. Awards contain service condition and generally vest over 4 years with 25% of the shares vesting on each of the four anniversary dates from the grant date. Awards have 10-year contractual terms.

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Combined stock options and stock appreciation rights activity under the three plans is summarized as follows for the years end December 31, 2006, 2005, and 2004:

	2006		2005		2004	
	Number of Shares	Weighted Average Exercise Price per Share	Number of Shares	Weighted Average Exercise Price per Share	Number of Shares	Weighted Average Exercise Price per Share
Outstanding at beginning of year	1,795,394	$ 5.80	1,707,305	$ 4.16	2,072,297	$ 3.51
Granted	274,550	$ 11.54	409,525	$ 10.46	207,000	$ 12.60
Cancelled	(249,604)	$ 9.85	(78,515)	$ 5.47	(275,925)	$ 7.73
Expired	(667)	$ 4.75			(25,000)	$ 2.63
Exercised	(272,261)	$ 4.48	(242,921)	$ 2.29	(271,067)	$ 2.13
Outstanding at end of year	1,547,412	$ 6.39	1,795,394	$ 5.80	1,707,305	$ 4.16
Options exercisable at end of year	1,022,262	$ 4.55	1,030,507	$ 3.90	1,015,055	$ 3.32
Weighted average fair value of options granted at fair value		$ 6.05		$ 5.76		$ 7.45

The restricted stock activity for the year ended December 31, 2006 is as follows:

	Restricted Stock Twelve Months Ended December 31, 2006	
	Number of Shares	Weighted Average Grant Date Fair Value
Outstanding at beginning of year		
Granted	27,200	$ 11.65
Cancelled	(3,300)	$ 10.51
Exercised		
Expired		
Outstanding at end of year	23,900	$ 11.80
Shares exercisable at end of period		

The aggregate intrinsic value of stock options and stock appreciation rights fully vested and outstanding at December 31, 2006 was $8,921,023 and $10,653,459, respectively. The total intrinsic value of options and stock appreciation rights exercised was $2,130,816, $2,880,654, and $2,498,613 for the years ended December 31, 2006, 2005 and 2004, respectively. The total fair value of options and stock appreciation rights vested during the years ended December 31, 2006, 2005 and 2004 was $1,125,195, $716,757 and $681,606, respectively. Total tax benefits realized from stock option exercises were $505,931 and $1,080,613 for the years ended December 31, 2006 and 2005, respectively. The Company received $1,219,474 and $556,191 for exercises of stock options during the years ended December 31, 2006 and 2005, respectively.

A summary of the activity for nonvested stock options and stock appreciation rights awards as of December 31, 2006 and changes during the twelve month period is presented below:

	Number of Shares	Weighted Average Grant Date Fair Value per Share
Nonvested at January 1, 2006	766,838	$ 4.92
Granted	274,550	$ 6.04
Vested	(266,634)	$ 4.22
Cancelled	(249,604)	$ 5.68
Nonvested at December 31, 2006	525,150	$ 5.50

Generally, stock-based awards vest in equal, annual installments up to four years after the date of grant and have an expiration date no later than ten years after the date of grant. There are 572,365 options available for future grant at December 31, 2006.

The following table summarizes significant ranges of outstanding options and stock appreciation rights under the three plans at December 31, 2006:

	Options Outstanding			Options Exercisable		
Range of Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Number Exercisable	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price
\$0.90 - \$1.05	272,838	5.59	$ 1.02	235,901	5.52	$ 1.02
\$1.06 - \$4.75	313,602	4.55	$ 1.42	308,600	4.73	$ 1.38
\$4.76 - \$9.21	326,262	4.57	$ 7.13	224,300	2.95	$ 6.42
\$9.22 - \$10.69	332,385	7.55	$ 9.61	186,073	6.99	$ 9.31
\$10.70 - \$15.45	302,325	9.30	$ 12.06	67,388	8.76	$ 12.11
	1,547,412	6.31	$ 6.39	1,022,262	5.20	$ 4.55

As of December 31, 2006, the weighted average fair value per share for options and stock appreciation rights for shares outstanding and vested were \$3.81 and \$2.95, respectively. As of December 31, 2006, there was approximately \$3.2 million, net of forfeiture assumptions, of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the Company s stock plans. That cost is expected to be recognized over a weighted average period of 2.59 years.

10. Shareholder Rights Plan

On April 6, 1998, the Board of Directors adopted a shareholder rights agreement (the Rights Plan) which was subsequently amended as of November 5, 2002. In connection with the adoption of the Rights Plan, the Board of Directors declared a dividend distribution of one preferred stock purchase right (a Right) for each outstanding share of common stock to stockholders of record as of the close of business on April 23, 1998. Currently, these Rights are not exercisable and trade with the shares of the Company s Common Stock.

Under the Rights Plan, the Rights generally become exercisable if: (1) a person becomes an Acquiring Person by acquiring 15% or more of the Company s Common Stock, (2) a person commences a tender offer that would result in that person owning 15% or more of the Company s Common Stock, or (3) the Board of Directors deems a person to be an Adverse Person, as defined under the Rights Plan. In the event that a person becomes an Acquiring Person, or an Adverse Person, each holder of a Right (other than the Acquiring Person or Adverse Person) would be entitled to acquire such number of units of preferred stock (which are equivalent to shares of the Company s Common Stock) having a value of twice the exercise price of the Right. If, after any such event, the Company enters into a merger or other business combination transaction with another entity, each holder of a Right would then be entitled to purchase, at the then-current exercise price, shares of the acquiring company s common stock having a value of twice the exercise price of the Right. The current exercise price per Right is $45.00.

The Rights will expire at the close of business on April 6, 2008 (the Expiration Date), unless previously redeemed or exchanged by the Company as described below. The Rights may be redeemed in whole, but not in part, at a price of $0.01 per Right (payable in cash, shares of the Company s Common Stock or other consideration deemed appropriate by the Board of Directors) by the Board of Directors only until the earlier of (1) the time at which any person becomes an Acquiring Person or an Adverse Person , or (2) the Expiration Date. At any time after any person becomes an Acquiring Person or an Adverse Person , the Board of Directors may, at its option, exchange all or any part of the then outstanding and exercisable Rights for shares of the Company s Common Stock at an exchange ratio specified in the Rights Plan. Notwithstanding the foregoing, the Board of Directors generally will not be empowered to affect such exchange at any time after any person becomes the beneficial owner of 50% or more of the Company s Common Stock.

Until a Right is exercised, the holder will have no rights as a stockholder of the Company (beyond those as an existing stockholder), including the right to vote or to receive dividends.

In connection with the establishment of the Rights Plan, the Board of Directors approved the creation of Preferred Stock of the Company designated as Series B Junior Participating Cumulative Preferred Stock with a par value of $0.01 per share. The Board also reserved 150,000 shares of preferred stock for issuance upon exercise of the Rights.

11. Stock Repurchase Plan

In October 1998, the Board of Directors approved a stock repurchase plan under which the Company is authorized to purchase up to $4,000,000 of the Company s Common Stock, with the total number of shares repurchased not to exceed 9.9% of the total number of shares issued and outstanding. Under the plan, shares may be repurchased from time to time and in such amounts as market conditions warrant, subject to regulatory considerations. To date, the Company had repurchased a total of 762,100 shares at a net cost of approximately $3,873,000 and has reissued all shares upon exercise of employee stock options. No shares were purchased in 2006, 2005, and 2004.

12. Employee Benefit Plan

Employees are eligible to participate in the Company s 401(k) savings plan. Employees may elect to contribute a percentage of their compensation to the plan, and the Company will make matching contributions up to a limit of 5% of an employee s compensation. In addition, the Company may make annual discretionary contributions. For the years ended December 31, 2006, 2005, and 2004, the Company made matching contributions of $223,185, $202,081 and $176,604 respectively.

13. Revenue by Product Group, by Significant Customer and by Geographic Region

Product revenue by product group is as follows:

	Years Ended December 31, 2006	2005	2004
Ophthalmic Products	$ 10,748,765	$ 10,521,914	$ 11,532,671
ORTHOVISC	11,340,433	7,938,333	8,698,826
HYVISC	1,820,617	2,073,642	2,054,488
INCERT	43,470		
	$ 23,953,285	$ 20,533,889	$ 22,285,985

Product revenue by significant customers as a percent of product revenues is as follows:

	Percent of Product Revenue Years Ended December 31, 2006	2005	2004
Bausch & Lomb Incorporated	40.8 %	45.6 %	38.3 %
Depuy Mitek / Ortho Biotech	21.8 %	8.0 %	21.0 %
Pharmaren AG / Biomeks	16.7 %	23.2 %	13.6 %
Boehringer Ingelheim Vetmedica	7.6 %	10.1 %	9.2 %
Advanced Medical Optics		1.2 %	9.9 %
	86.9 %	88.1 %	92.0 %

Revenues by geographic location in total and as a percentage of total revenues are as follows:

	Years Ended December 31, 2006		2006		2006	
	Revenue	Percent of Revenue	Revenue	Percent of Revenue	Revenue	Percent of Revenue
Geographic location:						
United States	$ 17,743,274	66.1 %	$ 21,090,250	70.7 %	$ 19,767,337	74.7 %
Europe	3,668,479	13.7 %	3,166,728	10.6 %	3,115,086	11.8 %
Turkey	3,998,226	14.9 %	4,763,509	16.0 %	3,024,246	11.4 %
Other	1,430,635	5.3 %	814,125	2.7 %	558,376	2.1 %
Total	$ 26,840,614	100.00 %	$ 29,834,612	100.00 %	$ 26,465,045	100.00 %

Substantially all licensing, milestone and contract revenue was derived in the United States for 2006, 2005 and 2004.

14. Income Taxes

Income tax expense (benefit) was $2,924,006, $3,899,104 and ($4,413,161) for the years ended December 31, 2006, 2005, and 2004, respectively. Prepaid taxes of $663,338 was included in the prepaid expenses at December 31, 2005.

The components of the provision for income taxes and benefit from release of valuation allowance are as follows:

	Years Ended December 31, 2006	2005	2004
Current:			
Federal	$ 1,991,829	$ 1,787,165	$ 5,845,304
State	272,201	200,915	922,371
	2,264,030	1,988,080	6,767,675
Deferred:			
Federal	580,694	1,298,303	(3,680,232)
State	79,282	612,721	(461,812)
	659,976	1,911,024	(4,142,044)
Provision for income taxes	2,924,006	3,899,104	2,625,631
Benefit from release of valuation allowance:			
Federal			(5,759,759)
State			(1,279,033)
			(7,038,792)
Tax expense (benefit)	$ 2,924,006	$ 3,899,104	$ (4,413,161)

The Company receives a tax deduction upon the exercise of nonqualified stock options and disqualifying dispositions by employees for the difference between the exercise price and the market price of the underlying common stock on the date of exercise. The benefit of the related tax deduction in the amounts of $505,931, $1,080,613 and $609,866 were not recorded through the tax provision; rather, they were credited directly to additional paid in capital in 2006, 2005 and 2004, respectively.

The Company s effective tax rate varied from the U.S. federal statuatory rate due, principally, to the impact of research and development and other credits, and nondeductible compensation expenses related to SFAS 123R. A reconciliation of the U.S. federal statutory tax rate to the effective tax rate for the periods ending December 31 is as follows:

	Years ended December 31, 2006	2005	2004
Computed expected tax expense	34.0 %	34.0 %	34.0 %
State tax expense (net of federal benefit)	3.8 %	4.3 %	2.8 %
State deferred tax assets rate change		4.5 %	
Permanent items, including nondeductible expenses	1.8 %	-0.9 %	0.9 %
Federal and state research and development, and other credits	-1.6 %	-1.4 %	-1.8 %
Other	0.8 %	-0.7 %	
Federal rate difference			2.9 %
Change in valuation allowance related to income tax benefit			-103.9 %
Tax (benefit) expense	38.8 %	39.8 %	-65.1 %

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The Company records a deferred tax asset or liability based on the difference between the financial statement and tax bases of assets and liabilities, as measured by the enacted tax rates assumed to be in effect when these differences reverse. The approximate income tax effect of each type of temporary difference and carryforward is as follows:

	Years ended December 31, 2006	2005
Deferred tax assets:		
Depreciation	$ 755,442	$ 653,708
FAS 123R expense	248,680	
Accrued expenses and other	257,490	143,274
Inventory reserve	23,336	84,354
Deferred revenue	7,324,642	8,388,230
Deferred tax asset	$ 8,609,590	$ 9,269,566

As of December 31, 2006 and 2005, management determined that it is more likely than not that the deferred tax assets will be realized and, therefore, a valuation allowance has not been recorded. As of December 31, 2004, based on management s expectations regarding future profitability, the Company released the valuation allowance previously established against its deferred tax assets and recorded a one-time income tax benefit of $7,038,792.

In 2004, the Company achieved milestones under the JNJ Agreement and received payments totaling $27,000,000 which the Company recognized as taxable income in 2004. As a result, the Company has determined that it will be able to utilize all of its net operating loss and credit carry-forwards in 2004 to offset part of its taxable income. In accordance with the Company s revenue recognition policy, for financial statement purposes, the milestone payments totaling $27,000,000 were deferred and are being recognized ratably over the expected ten-year term of the JNJ Agreement. The Company recorded a deferred tax asset of approximately $7,300,000 representing the approximate income tax effect of the timing difference of revenue recognition for financial statement purposes and for tax purposes related to these milestone payments as of December 31, 2006.

The Company has a pending IRS audit related to its 2004 tax return. The Company is currently in the process of finalizing the audit results with the IRS. It is expected that the outcome of the IRS audit will not be material to the Company s financial statements.

15. Quarterly Financial Data (Unaudited)

Year 2006	Quarter ended December 31,	Quarter ended September 30,	Quarter ended June 30,	Quarter ended March 31,
Product revenue	$ 5,077,561	$ 5,494,407	$ 7,115,484	$ 6,265,833
Total revenue	5,888,956	6,200,657	7,798,041	6,952,960
Cost of product revenue	3,054,111	2,125,028	2,890,904	3,047,818
Gross profit on product revenue	2,023,450	3,369,379	4,224,580	3,218,015
Net income	$ 1,046,762	$ 1,324,640	$ 1,352,065	$ 880,749
Per common share information				
Basic net income per share	$ 0.10	$ 0.12	$ 0.13	$ 0.08
Basic common shares outstanding	10,745,819	10,676,943	10,601,336	10,526,672
Diluted net income per share	$ 0.09	$ 0.12	$ 0.12	$ 0.08
Diluted common shares outstanding	11,196,213	11,130,225	10,955,156	11,218,360

Year 2005	Quarter ended December 31,	Quarter ended September 30,	Quarter ended June 30,	Quarter ended March 31,
Product revenue	$ 4,773,825	$ 5,998,995	$ 4,084,132	$ 5,676,937
Total revenue	5,466,026	10,057,874	7,019,425	7,291,287
Cost of product revenue	2,266,156	3,766,762	2,117,208	2,993,964
Gross profit on product revenue	2,507,669	2,232,233	1,966,924	2,682,973
Net income	$ 822,302	$ 2,531,507	$ 1,336,489	$ 1,202,240
Per common share information				
Basic net income per share	$ 0.08	$ 0.24	$ 0.13	$ 0.12
Basic common shares outstanding	10,496,453	10,482,850	10,391,538	10,269,389
Diluted net income per share	$ 0.07	$ 0.22	$ 0.12	$ 0.11
Diluted common shares outstanding	11,412,632	11,480,570	11,537,538	11,264,595

During the second quarter of 2005, the Company s ophthalmic sales were significantly impacted as a result of a voluntary product recall instigated by our discovery of defective vendor-supplied finished goods packaged with our HA viscoelastic product. This voluntary recall resulted in a decrease of $1,359,000 in sales of ophthalmic product for the three months ended June 30, 2005 and a corresponding similar increase in third quarter sales as we completed restocking of our customers, with very little impact on revenue from the recall for the nine and twelve months ended September 30 and December 31, 2005, respectively.

On September 1, 2005, the Company announced that it had mutually agreed with OrthoNeutrogena to terminate its development and commercialization agreement. Under the terms of the termination agreement, we received a termination payment of $3,115,000 from OrthoNeutrogena including $815,000 for all outstanding clinical study costs incurred and committed to by the Company at the termination date. Given there are no continuing performance obligations with respect to the development and commercialization agreement or the related termination agreement, all amounts were recognized as contract revenue during the third quarter of 2005 under the performance-based model. See Notes 2.

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

None.

ITEM 9A. CONTROLS AND PROCEDURES

(a) Evaluation of disclosure controls and procedures.

As required by Rule 13a-15 under the Securities Exchange Act of 1934 (Exchange Act), we carried out an evaluation under the supervision and with the participation of the our management, including our chief executive officer and chief financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this report. Based upon that evaluation, the chief executive officer and principal financial officer have concluded that our disclosure controls and procedures are reasonably effective to ensure that material information relating to us required to be disclosed by us in reports we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by the Company in the reports it files or submits under the Exchange Act is accumulated and communicated to the Company s management, including our chief executive officer and chief financial officer, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, our management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurances of achieving the desired control objectives, and management necessarily was required to apply its judgment in designing and evaluating the controls and procedures. On an on-going basis, we review and document our disclosure controls and procedures, and our internal control over financial reporting, and may from time to time make changes aimed at enhancing their effectiveness and to ensure that our systems evolve with our business.

(b) Changes in internal controls over financial reporting.

There were no changes in our internal control over financial reporting during the fourth quarter of fiscal year 2006 that have materially affected, or that are reasonably likely to materially affect, our internal controls over financial reporting.

Management s Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934. Our internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

Because of its inherent limitations, internal control over financial reporting can provide only reasonable assurance and may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Our management assessed the effectiveness of our internal control over financial reporting as of December 31, 2006. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control-Integrated Framework.

Based on our assessment and those criteria, our management believes that the company maintained effective internal control over financial reporting as of December 31, 2006.

Our management s assessment of the effectiveness of our internal control over financial reporting as of December 31, 2006 has been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm, as stated in their report which is included herein.

ITEM 9B. OTHER INFORMATION

None.

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The information required by Item 10 is hereby incorporated by reference to the Registrant s Proxy Statement (the Proxy Statement) for the Annual Meeting of Stockholders to be held on June 1, 2007.

ITEM 11. EXECUTIVE COMPENSATION

The information required by Item 11 is hereby incorporated by reference to the Proxy Statement for the Annual Meeting of Stockholders to be held on June 1, 2007.

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

The information required by Item 12 is hereby incorporated by reference to the Proxy Statement for the Annual Meeting of Stockholders to be held on June 1, 2007. and Item 5 of this Annual Report on Form 10-K under the heading Equity Compensation Plan Information.

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

The information required by Item 13 is hereby incorporated by reference to the Proxy Statement for the Annual Meeting of Stockholders to be held on June 1, 2007.

ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

The information required by Item 14 is hereby incorporated by reference to the Proxy Statement for the Annual Meeting of Stockholders to be held on June 1, 2007.

PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a) Documents filed as part of Form 10-K.

(1) Financial Statements

(2) Schedules

Schedules have been omitted as all required information has been disclosed in the financial statements and related footnotes.

(3) Exhibits

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The list of Exhibits filed as a part of this Annual Report on Form 10-K are set forth on the Exhibit Index (b) below.

(b) Exhibit No.	**Description**
(3) Articles of Incorporation and Bylaws:	
3.1	The Amended and Restated Articles of Organization of the Company, incorporated herein by reference to Exhibit 3.1 to the Company s Registration Statement on Form 10 (File no. 000-21326), filed with the Securities and Exchange Commission on March 5, 1993.
3.2	Certificate of Vote of Directors Establishing a Series of Convertible Preferred Stock, incorporated herein by reference to Exhibits to the Company s Registration Statement on Form 10 (File no. 000-21326), filed with the Securities and Exchange Commission on March 5, 1993.
3.3	Amendment to the Amended and Restated Articles of Organization of the Company, incorporated herein by reference to Exhibit 3.1 to the Company s quarterly report on Form 10-QSB for the period ended November 30, 1996, (File no. 000-21326), filed with the Securities and Exchange Commission on January 14, 1997.
3.4	Certificate of Vote of Directors Establishing a Series of a Class of Stock, incorporated herein by reference to Exhibit 3.1 of the Company s Registration Statement on Form 8-AB12 (File no. 001-14027), filed with the Securities and Exchange Commission on April 7, 1998.
3.5	Amendment to the Amended and Restated Articles of Organization of the Company, incorporated herein by reference to Exhibit 3.3 of the Company s quarterly report on Form 10-Q for the quarterly period ending June 30, 2002 (File no. 000-21326), filed with the Securities and Exchange Commission on August 14, 2002.
3.6	The Amended and Restated Bylaws of the Company, incorporated herein by reference to Exhibit 3.6 to the Company s quarterly report on Form 10-Q for the quarterly period ended June 30, 2002 (File no. 000-21326), filed with the Securities and Exchange Commission on August 14, 2002.
(4) Instruments Defining the Rights of Security Holders	
4.1	Shareholder Rights Agreement dated as of April 6, 1998 between the Company and Firstar Trust Company, incorporated herein by reference to Exhibit 4.1 to the Company s Registration Statement on Form 8-A12B (File no. 001-14027), filed with the Securities and Exchange Commission on April 7, 1998.
4.2	Amendment to Shareholder Rights Agreement dated as of November 5, 2002 between the Company and American Stock Transfer and Trust Company, as successor to Firstar Trust Company incorporated herein by reference to Exhibit 4.2 to the Company s quarterly report on Form 10-Q for the quarterly period ended September 30, 2002 (File no. 000-21326), filed with the Securities and Exchange Commission on November 13, 2002.
(10) Material Contracts	
10.1	1993 Stock Option Plan, as amended, incorporated herein by reference to Annex A of the Company s Proxy Statement (File no. 001-14027), filed with the Securities and Exchange Commission on April 28, 2000.

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10.2	Lease dated March 10, 1995 between the Company and Cummings Properties, incorporated herein by reference to Exhibit 10.8 to the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 2000 (File no. 001-14027), filed with the Securities Exchange Commission on April 2, 2001.
10.3	First Amendment to Lease dated December 11, 1997 between the Company and Cummings Properties, incorporated herein by reference to Exhibit 10.9 to the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 2000 (File no. 001-14027), filed with the Securities Exchange Commission on April 2, 2001.
10.4	Extension of Lease dated November 23, 1999 between the Company and Cummings Properties, incorporated herein by reference to Exhibit 10.10 to the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 2000 (File no. 001-14027), filed with the Securities Exchange Commission on April 2, 2001.
10.5	Second Amendment to Lease dated November 23, 1998 between the Company and Cummings Properties, incorporated herein by reference to Exhibit 10.11 to the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 2000 (File no. 001-14027), filed with the Securities Exchange Commission on April 2, 2001.
10.6	Lease dated September 23, 1999 between the Company and Cummings Properties, incorporated herein by reference to Exhibit 10.12 to the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 2000 (File no. 001-14027), filed with the Securities Exchange Commission on April 2, 2001.
10.7	Letter Agreement dated April 15, 1998 between the Company and Charles H. Sherwood, incorporated herein by reference to Exhibit 10.3 to the Company s quarterly report on Form 10-Q for the quarterly period ended June 30, 2000 (File no. 001-14027), filed with the Securities and Exchange Commission on August 14, 2000.
10.8	Non-Disclosure and Non-Competition Agreement dated May 5, 1998 between the Company and Charles H. Sherwood, incorporated herein by reference to Exhibit 10.26 to the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 2000 (File no. 001-14027), filed with the Securities Exchange Commission on April 2, 2001.
10.9	Stipulation and Agreement of Compromise, Settlement and Release dated May 25, 2001 in connection with In Re Anika Therapeutics, Inc. Securities Litigation, incorporated herein by reference to Exhibit 10.2 to the Company s quarterly report on Form 10-Q for the quarterly period ended June 30, 2001 (File no. 001-14027), filed with the Securities and Exchange Commission on August 14, 2001.
10.10	Amendment to Lease #3 dated November 1, 2001 by and between the Company and Cummings Properties, incorporated herein by reference to Exhibit 10.1 to the Company s quarterly report on Form 10-Q for the quarterly period ended September 30, 2001 (File no. 001-14027), filed with the Securities and Exchange Commission on November 14, 2001.
10.11	Sublease effective as of November 2001, between MedChem Products, Inc. and the Company, incorporated herein by reference to Exhibit 10.1 to the Company s quarterly report on Form 10-Q for the quarterly period ended March 31, 2002 (File no. 000-21326), filed with the Securities and Exchange Commission on May 14, 2002.

10.12	Amended and Restated Change in Control, Bonus and Severance Agreement dated July 8, 2002 by and between the Company and Charles H. Sherwood incorporated herein by reference to Exhibit 10.4 to the Company s quarterly report on Form 10-Q for the quarterly period ended June 30, 2002 (File no. 000-21326), filed with the Securities and Exchange Commission on August 14, 2002.
10.13	Change in Control, Bonus and Severance Agreement dated June 9, 2003 by and between the Company and Francesco J. Luppino, incorporated herein by reference to Exhibit 10.35 to the Company s quarterly report on Form 10-Q for the quarterly period ended June 30, 2003 (File no. 000-21326), filed with the Securities and Exchange Commission on August 14, 2003.
10.14	Lease Extension dated October 8, 2003 by and between the Company and Cummings Properties, LLC, incorporated herein by reference to Exhibit 10.36 to the Company s quarterly report on Form 10-Q for the quarterly period ended September 30, 2003 (File no. 000-21326), filed with the Securities and Exchange Commission on November 14, 2003.
10.15	Lease Amendment dated October 8, 2003 by and between the Company and MedChem Products, Inc., incorporated herein by reference to Exhibit 10.36 to the Company s quarterly report on Form 10-Q for the quarterly period ended September 30, 2003 (File no. 000-21326), filed with the Securities and Exchange Commission on November 14, 2003.
10.16	License Agreement dated as of December 20, 2003 by and between the Company and Ortho Biotech Products, L.P., incorporated herein by reference to Exhibit 10.38 to the Company s annual report on Form 10-K for the year ended December 31, 2003 (File no. 000-21326), filed with the Securities and Exchange Commission on March 29, 2004.
10.17	Letter Agreement dated October 6, 2004 by and between the Company and Carol A. Toth, Ph.D., incorporated herein by reference to the Company s current report on Form 8-K (File no. 000-21326), filed with the Securities and Exchange Commission on November 19, 2004.
**10.18	Supply Agreement dated as of December 15, 2004 by and between the Company and Bausch & Lomb, Incorporated, incorporated by reference to the Company s current report on Form 8-K (File no. 001-14027), filed with the Securities and Exchange Commission on December 20, 2004.
10.19	Lease Amendment dated October 13, 2004 by and between the Company and MedChem Products, Inc., incorporated herein by reference to the Company s annual report on Form 10-K for the period ended December 31, 2004 (File no. 001-14027), filed with the Securities and Exchange Commission on March 16, 2005.
10.20	Letter Agreement dated June 30, 2005, as amended, by and between the Company and Kevin W. Quinlan, incorporated herein by reference to the Company s current report on Form 8-K (File no. 001-14027), filed with the Securities and Exchange Commission on July 12, 2005.
10.21	Change in Control, Bonus and Severance Agreement, dated as of July 11, 2005, by and between the Company and Kevin W. Quinlan, incorporated herein by reference to the Company s current report on Form 8-K (File no. 001-14027), filed with the Securities and Exchange Commission on July 12, 2005.

10.22	2003 Stock Option and Incentive Plan, as amended, incorporated herein by reference to Exhibit A of the Company s Proxy Statement (File no. 001-14027), filed with the Securities and Exchange Commission on April 30, 2003.
10.23	First Amendment to the Company s 2003 Stock Option and Incentive Plan incorporated herein by reference to Exhibit 4.9 of the Company s Form S-8 (File no. 333-110326), filed with the Securities and Exchange Commission on November 7, 2003.
10.24	Form of Incentive Stock Option Agreement under the Company s 2003 Stock Option and Incentive Plan, incorporated herein by reference to Exhibit 10.3 to the Company s current report on Form 8-K (File no. 001-14027), filed with the Securities and Exchange Commission on October 5, 2004.
10.25	Form of Non-Qualified Stock Option Agreement under the Company s 2003 Stock Option and Incentive Plan, incorporated herein by reference to Exhibit 10.4 to the Company s current report on Form 8-K (File no. 001-14027), filed with the Securities and Exchange Commission on October 5, 2004.
10.26	Form of Stock Appreciation Right Agreement for Employees under the Company s 2003 Stock Option and Incentive Plan, incorporated herein by reference to Exhibit 10.1 to the Company s quarterly report on Form 10-Q for the quarterly period ended March 31, 2006 (File no. 001-14027), filed with the Securities and Exchange Commission on May 9, 2006.
10.27	Form of Stock Appreciation Right Agreement for Non-Employee Directors under the Company s 2003 Stock Option and Incentive Plan, incorporated herein by reference to Exhibit 10.2 to the Company s quarterly report on Form 10-Q for the quarterly period ended March 31, 2006 (File no. 001-14027), filed with the Securities and Exchange Commission on May 9, 2006.
10.28	License and Development Agreement between Anika Therapeutics, Inc. and Galderma Pharma S.A., dated as of June 30, 2006, incorporated herein by reference to Exhibit 10.1 to the Company s quarterly report on Form 10-Q for the quarterly period ended June 30, 2006 (File no. 001-14027), filed with the Securities and Exchange Commission on August 7, 2006.
10.29	Supply Agreement among Galderma S.A, Galderma Pharma S.A, and Anika Therapeutics, Inc., dated as of June 30, 2006., incorporated herein by reference to Exhibit 10.2 to the Company s quarterly report on Form 10-Q for the quarterly period ended June 30, 2006 (File no. 001-14027), filed with the Securities and Exchange Commission on August 7, 2006.
10.30	Lease dated January 4, 2007, between the Company and Farley White Wiggins, incorporated herein by reference to Exhibit 10.1 to the Company s current report on Form 8-K (File no. 001-14027), filed with the Securities and Exchange Commission on January 10, 2007.
(11)	Statement Regarding the Computation of Per Share Earnings
11.1	See Note 3 to the Financial Statements included herewith.
(21)	Subsidiaries of the Registrant
*21.1	List of Subsidiaries of the Registrant.
(23)	Consent of Experts
*23.1	Consent of PricewaterhouseCoopers LLP.

*31.1	Certification of Charles H. Sherwood, Ph.D. pursuant to Rules 13a-15(e) and 15d-15(e), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
*31.2	Certification of Kevin W. Quinlan pursuant to Rules 13a-15(e) and 15d-15(e), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
***32.1	Certification of Charles H. Sherwood, Ph.D. and Kevin W. Quinlan, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
(99)	Additional Exhibits None

* Filed herewith

** Certain portions of this document have been omitted pursuant to a confidential treatment request filed with the Commission. The omitted portions have been filed separately with the Commission.

*** Furnished herewith.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, as amended, the registrant has duly caused this report to be signed on its behalf by the undersigned.

		ANIKA THERAPEUTICS, INC.
Date: March 13, 2007	By:	/s/ CHARLES H. SHERWOOD, PH.D.
		Charles H. Sherwood, Ph.D.
		Chief Executive Officer

SIGNATURES

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

Signature	Title	Date
/s/ CHARLES H. SHERWOOD, PH.D. Charles H. Sherwood, Ph.D.	Chief Executive Officer and Director *(Principal Executive Officer)*	March 13, 2007
/s/ KEVIN W. QUINLAN Kevin W. Quinlan	Chief Financial Officer *(Principal Accounting Officer)*	March 13, 2007
/s/ JOSEPH L. BOWER Joseph L. Bower	Director	March 13, 2007
/s/ EUGENE A. DAVIDSON, PH.D. Eugene A. Davidson, Ph.D.	Director	March 13, 2007
/s/ RAYMOND J. LAND Raymond J. Land	Director	March 13, 2007
/s/ JOHN C. MORAN John C Moran	Director	March 13, 2007
/s/ STEVEN E. WHEELER Steven E. Wheeler	Director	March 13, 2007