NAVISITE INC
Form PRER14C
November 26, 2004

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

Check the appropriate box:

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

NAVISITE, INC.

(Name of Registrant as Specified in Charter)

Payment of Filing Fee (Check the appropriate box):

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

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

2) Aggregate number of securities to which transaction applies:

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

4) Proposed maximum aggregate value of transaction:

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

1) Amount Previously Paid:

2) Form Schedule or Registration Statement No.:

____

3) Filing Party:

____

4) Date Filed:

____

Preliminary Copy

NAVISITE, INC.

400 Minuteman Road
Andover, Massachusetts 01810

NOTICE OF ACTION TAKEN PURSUANT TO WRITTEN CONSENT OF STOCKHOLDERS

To the stockholders of NaviSite, Inc.:

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

1. The issuance of (i) 3,000,000 shares of the Company s Common Stock to Surebridge, Inc., and (ii) the shares of the Company s Common Stock issuable upon the conversion of convertible promissory notes made by the Company to Surebridge, Inc.; and

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

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

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

By Order of the Board of Directors,

KENNETH DRAKE
Secretary

Andover, Massachusetts
December [ ], 2004

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Preliminary Copy

NAVISITE, INC.

400 Minuteman Road
Andover, Massachusetts 01810

INFORMATION STATEMENT

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

General

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

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

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

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

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

Reason for the Written Consent

The Surebridge Acquisition

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

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

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

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

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

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

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

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

The Stock Plan Amendment

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

The Written Consent

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

Voting and Vote Required

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

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

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

Notice Pursuant to Section 228

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

Dissenters Rights of Appraisal

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

Householding of Stockholder Materials

Some banks, brokers and other nominee record holders may be participating in the practice of householding stockholder materials, such as proxy statements, information statements and annual reports. This means that only one copy of this Information Statement may have been sent to multiple stockholders in your household. The Company will promptly deliver a separate copy of this Information Statement to you if you write or call us at the following address or telephone number: Investor Relations Department, NaviSite, Inc., 400 Minuteman Road, Andover, Massachusetts 01810, telephone: (978) 682-8300. If you want to receive separate copies of stockholder materials in the future, or if you are receiving multiple copies and would like to receive only one copy for your household, you should contact your bank, broker, or other nominee record holder, or you may contact NaviSite at the above address and telephone number.

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

The Surebridge Acquisition

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

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

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

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

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

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

Nasdaq Stockholder Approval Requirements

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

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

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

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

APPROVAL OF THE STOCK PLAN AMENDMENT

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

Summary of the 2003 Plan

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

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As of May 6, 2004, approximately 397 persons were eligible to receive Awards under the 2003 Plan, including the Company s five executive officers and three non-employee directors. As of October 31, 2004, approximately 517 persons were eligible to receive Awards under the 2003 Plan, including the Company s five executive officers and three non-employee directors. The granting of Awards under the 2003 Plan is discretionary, and the Company cannot now determine the number or type of Awards to be granted in the future to any particular person or group of persons. The following table summarizes options awarded under the 2003 Plan (excluding the Stock Plan Amendment) and under the Stock Plan Amendment as of October 31, 2004 to designated individuals and groups since the adoption of the 2003 Plan in July 2003:

Name and Principal Position	Number of Options Granted under the 2003 Plan	Number of Options Granted under the Stock Plan Amendment
Arthur P. Becker		
Chief Executive Officer and President	460,000	0
Gabriel Ruhan		
Chief Operating Officer	460,000	0
James Pluntze		
Former Chief Financial Officer	43,125	16,875
Kenneth Drake		
General Counsel and Secretary	60,000	0
Current Executive Officers, as a group	1,230,000	0
Current Non-Executive Officer Directors, as a group	170,000	0
Current Non-Executive Officer Employees, as a group	1,679,525	1,700,375

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

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

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

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

Exercise of Options. Each option granted under the 2003 Plan shall either be fully exercisable at the time of grant or shall become exercisable in such installments as the Board may specify. Once an installment becomes exercisable it shall remain exercisable until expiration or termination of the option, unless otherwise specified by the Board. Each option or installment may be exercised at any time or from

time to time, in whole or in part, for up to the total number of shares with respect to which it is then exercisable. During the Participant s lifetime, Awards may be exercised only by the Participant.

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

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

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

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

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

Effect of Termination, Disability or Death. The Board determines the effect on an Award of the disability, death, retirement, authorized leave of absence or other change in the employment or other status of a Participant and the extent to which, and the period during which, the Participant, or the

Participant s legal representative, conservator, guardian or designated beneficiary, may exercise rights under the Award.

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

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

United States Federal Income Tax Consequences

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

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

1. In general, an optionee will not recognize any taxable income upon the grant of an ISO or upon the issuance of shares to him or her upon the exercise of an ISO, and NaviSite will not be entitled to a federal income tax deduction upon either the grant or the exercise of an ISO.

2. If shares acquired upon exercise of an ISO are not disposed of within (i) two years from the date the ISO was granted or (ii) one year from the date the shares are issued to the optionee pursuant to the exercise of the ISO (the Holding Periods), the difference between the amount realized on any subsequent disposition of the shares and the exercise price generally will be treated as capital gain or loss to the optionee.

3. If shares acquired upon exercise of an ISO are disposed of and the optionee does not satisfy the Holding Periods (a Disqualifying Disposition), then in most cases the lesser of (i) any excess of the fair market value of the shares at the time of exercise of the ISO over the exercise price or (ii) the actual gain on disposition, will be treated as compensation to the optionee and will be taxed as ordinary income in the year of such disposition.

4. The difference between the amount realized by an optionee as the result of a Disqualifying Disposition and the sum of (i) the exercise price and (ii) the amount of ordinary income recognized under the above rules generally will be treated as capital gain or loss to the optionee.

5. In any year that an optionee recognizes ordinary income on a Disqualifying Disposition of shares acquired upon exercise of an ISO, NaviSite generally will be entitled to a corresponding federal income tax deduction.

6. An optionee may be entitled to exercise an ISO by delivering shares of NaviSite Common Stock to NaviSite in payment of the exercise price, if the optionee s ISO agreement so provides. If an optionee exercises an ISO in such fashion, special rules will apply.

7. In addition to the tax consequences described above, the exercise of an ISO may result in an alternative minimum tax to the optionee. In general, the amount by which the fair market value of the shares received upon exercise of the ISO exceeds the exercise price is included in the optionee s alternative minimum taxable income. A taxpayer is required to pay the greater of his regular tax liability or the alternative minimum tax. A taxpayer who pays alternative minimum tax attributable to the exercise of an ISO may be entitled to a tax credit against his or her regular tax liability in later years.

8. Capital gain or loss recognized by an optionee on a disposition of shares will be long-term capital gain or loss if the optionee s holding period for the shares exceeds one year.

9. Special rules apply if the shares acquired upon the exercise of an ISO are subject to vesting, or are subject to certain reporting requirements and restrictions on resale under federal securities laws applicable to directors, certain officers or 10% stockholders.

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

1. In general, an optionee will not recognize any taxable income upon the grant of a Non-Qualified Option, and NaviSite will not be entitled to a federal income tax deduction upon such grant.

2. An optionee generally will recognize ordinary income at the time of exercise of the Non-Qualified Option in an amount equal to the excess, if any, of the fair market value of the shares on the date of exercise over the exercise price. NaviSite may be required to withhold tax on this amount.

3. When an optionee sells the shares acquired upon the exercise of a Non-Qualified Option, he or she generally will recognize capital gain or loss in an amount equal to the difference between the amount realized upon the sale of the shares and his or her basis in the shares (generally, the exercise price plus the amount taxed to the optionee as ordinary income). If the optionee s holding period for the shares exceeds one year, such gain or loss will be a long-term capital gain or loss.

4. When an optionee recognizes ordinary income attributable to a Non-Qualified Option, NaviSite generally should be entitled to a corresponding federal income tax deduction.

5. An optionee may be entitled to exercise a Non-Qualified Option by delivering shares of NaviSite Common Stock to NaviSite in payment of the exercise price, if the optionee s option agreement so provides. If an optionee exercises a Non-Qualified Option in such fashion, special rules will apply.

6. Special rules apply if the shares acquired upon the exercise of a Non-Qualified Option are subject to vesting, or are subject to certain reporting requirements and restrictions on resale under federal securities laws applicable to directors, certain officers or 10% stockholders.

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

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

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

Equity Compensation Plan Information as of July 31, 2004

The following table sets forth certain information regarding NaviSite s equity compensation plans as of July 31, 2004. Pursuant to the rules of the Securities and Exchange Commission, the following table excludes the 3,000,000 shares subject to the Stock Plan Amendment.

Plan Category	(a) Number of Securities to Be Issued Upon Exercise of Outstanding Options, Warrants and Rights	(b) Weighted-average Exercise Price of Outstanding Options, Warrants and Rights	(c) Number of Securities Available for Future Issuance Under Equity Compensation Plans (excluding securities reflected in column (a))
Equity compensation plans approved by security holders	3,730,713	$7.10	159,634
Equity compensation plans not approved by security holders		$	
Total	3,730,713		159,634

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

SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The following table sets forth certain information as of September 30, 2004 (unless otherwise indicated), with respect to the beneficial ownership of Common Stock by the following:

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

each of the Company s directors;

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

one additional executive officer of the Company; and

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

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For purposes of the following table, beneficial ownership is determined in accordance with the rules promulgated by the Securities and Exchange Commission and the information is not necessarily indicative of beneficial ownership for any other purpose. Except as otherwise noted in the footnotes to the table, the Company believes that each person or entity named in the table has sole voting and investment power with respect to all shares of Common Stock shown as beneficially owned by them (or shares such power with his or her spouse). Under such rules, shares of Common Stock issuable under options that are currently exercisable or exercisable within 60 days after September 30, 2004 (Presently Exercisable Options) are deemed outstanding and are included in the number of shares beneficially owned by a person named in the table and are used to compute the percentage ownership of that person. These shares are not, however, deemed outstanding for computing the percentage ownership of any other person or entity. Unless otherwise indicated, the address of each person listed in the table is c/o NaviSite, Inc., 400 Minuteman Road, Andover, Massachusetts 01810.

The percentage ownership of Common Stock of each person or entity named in the following table is based on 27,928,724 shares of Common Stock outstanding as of September 30, 2004 plus any shares subject to Presently Exercisable Options held by such person.

	Amount and Nature of Beneficial Ownership	
Name and Address of Beneficial Owner	**Number of Shares**	**Percentage of Class**
5% Stockholders		
Atlantic Investors, LLC 20 East 66th Street New York, NY 10021	17,121,652(1)	61.3%
Hewlett-Packard Financial Services Company 420 Mountain Avenue Murray Hill, NJ 07974	4,416,592(2)	15.8%
Waythere, Inc.(3) c/o BG Affiliates One Beacon Street Suite 1500 Boston, MA 02108	3,000,000	10.7%
Directors and Named Executive Officers		
Andrew Ruhan	(4)	*
Arthur P. Becker	446,400(5)	1.6%
Gabriel Ruhan	233,333(6)	*
Larry Schwartz	35,554(6)	*
James Dennedy	39,721(6)	*
Thomas R. Evans	18,055(6)	*
James Pluntze	49,791(6)(7)	*
Kenneth Drake	43,333(6)	*
Other Executive Officers		
John J. Gavin, Jr.	54,166(8)	*
All current executive officers and director as a group	870,562(9)	3.0%

* Less than 1%.

(1) Based on information provided by Atlantic Investors, LLC in a Form 4 dated July 28, 2004 filed with the Securities and Exchange Commission on July 30, 2004. Atlantic Investors, LLC is controlled by two managing members, Unicorn Worldwide Holdings Limited and Madison Technology LLC. Unicorn Worldwide Holdings Limited is jointly controlled by its Board members, Simon Cooper and Simon McNally. Mr. Becker is the managing member of Madison Technology LLC. Messrs. Cooper and McNally

for Unicorn Worldwide Holdings Limited and Mr. Becker for Madison Technology LLC share voting and investment power over the securities held by Atlantic Investors, LLC. Mr. A. Ruhan holds a 10% equity interest in Unicorn Worldwide Holdings Limited, a managing member of Atlantic Investors, LLC. Atlantic Investors, LLC has informed us that the 17,121,652 shares of our common stock it holds is currently its sole investment.

(2) These shares are held of record by Hewlett-Packard Financial Services Company, a wholly owned subsidiary of Hewlett-Packard Company, a widely held publicly traded company. Hewlett-Packard Company and Hewlett-Packard Financial Services Company may each be deemed the beneficial owner of these shares.

(3) Formerly known as Surebridge, Inc.

(4) Excludes 17,121,652 shares of Common Stock owned by Atlantic Investors, LLC and 426,134 shares of Common Stock owned by Global Unicorn Worldwide Holdings S.A.R.L., a wholly owned subsidiary of Unicorn Worldwide Holdings Limited, with respect to all of which Mr. A. Ruhan disclaims beneficial ownership. Mr. A. Ruhan holds a 10% equity interest in Unicorn Worldwide Holdings Limited, a managing member of Atlantic Investors, LLC.

(5) Consists of 213,067 shares of Common Stock owned by Madison Technology LLC and 233,333 shares of Common Stock issuable upon the exercise of Presently Exercisable Options. Excludes 17,121,652 shares of Common Stock owned by Atlantic Investors, LLC with respect to which Mr. Becker disclaims beneficial ownership. Mr. Becker is the managing member of Madison Technology LLC, a managing member of Atlantic Investors, LLC.

(6) Consists of shares of Common Stock issuable upon the exercise of Presently Exercisable Options.

(7) Served as NaviSite s Chief Financial Officer until May 2004.

(8) Consists of shares of Common Stock issuable upon the exercise of Presently Exercisable Options. Mr. Gavin became our Chief Financial Officer on May 6, 2004.

(9) Consists of 213,067 shares of Common Stock owned by Madison Technology LLC and 657,495 shares of Common Stock issuable upon the exercise of Presently Exercisable Options. Excludes 17,121,652 shares of Common Stock owned by Atlantic Investors, LLC with respect to which Messrs. A. Ruhan and Becker disclaim beneficial ownership, and 426,134 shares of Common Stock owned by Global Unicorn Worldwide Holdings S.A.R.L., a wholly owned subsidiary of Unicorn Worldwide Holdings Limited, with respect to which Mr. A. Ruhan disclaims beneficial ownership. Mr. A. Ruhan holds a 10% equity interest in Unicorn Worldwide Holdings Limited, a managing member of Atlantic Investors, LLC, and Mr. Becker is the managing member of Madison Technology LLC, a managing member of Atlantic Investors, LLC.

ADDITIONAL INFORMATION ABOUT NAVISITE

Director Compensation

The Board of Directors has adopted a policy (i) to grant to future independent directors upon initial election to the Board options to purchase 50,000 shares of NaviSite Common Stock and (ii) that any independent director be paid $7,500 per year, payable in quarterly installments. The initial option grant of 50,000 shares of NaviSite Common Stock will vest monthly over three years (1/36th of the number of shares vest monthly). Additionally, upon re-election to the Board of Directors, independent directors of the Board of Directors will be granted an annual option to purchase 15,000 shares of NaviSite Common Stock. The annual option grant of 15,000 shares vests monthly over a period of 12 months. The Chairperson of each of the Audit Committee and the Compensation Committee also will receive, upon re-election to the Board of Directors at each annual meeting of stockholders, an option to purchase 10,000 shares of NaviSite Common Stock. This annual option grant of 10,000 shares of NaviSite Common Stock vests monthly over a period of 12 months.

During the 2004 fiscal year, Messrs. A. Ruhan, G. Ruhan and Becker were not paid for service on the Board of Directors. In October 2004 Messrs. Dennedy, Evans and Schwartz each received $5,625 for service on the Board of Directors since December 9, 2003, of which approximately $4,700 was for service

during the 2004 fiscal year. On December 9, 2003, each of Messrs. Dennedy and Schwartz was granted an option to purchase 50,000 shares of Common Stock at an exercise price of $2.55 per share and an option to purchase 10,000 shares of Common Stock at an exercise price of $8.40 per share. On December 9, 2003, Mr. Evans was granted an option to purchase 50,000 shares of Common Stock at an exercise price of $3.53 per share. On December 9, 2003, Messrs. G. Ruhan and Becker were each granted an option to purchase 60,000 shares of Common Stock at an exercise price of $2.55 per share, and on January 30, 2004, Messrs. G. Ruhan and Becker were each granted an option to purchase 400,000 shares of Common Stock at an exercise price of $5.41 per share.

Apart from the arrangements discussed above, NaviSite does not pay any cash compensation to members of its Board of Directors for their services as members of the Board of Directors, although directors are reimbursed for their reasonable travel expenses incurred in connection with attending Board of Directors and committee meetings. Directors who are also NaviSite officers or employees are eligible to participate in the 2003 Plan.

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

Executive Compensation

Summary Compensation

The following table sets forth certain summary information with respect to the compensation paid during the fiscal years ended July 31, 2004 and 2003 earned by each of (i) all individuals who served as the Chief Executive Officer during the fiscal year ended July 31, 2004, (ii) one former executive officer who would have been among the most highly compensated executive officers during fiscal year 2004 had he remained as an executive officer as of July 31, 2004, and (iii) two other executive officers who were serving as executive officers on July 31, 2004 whose total annual salary and bonuses for fiscal year 2004 exceeded $100,000 (collectively, the Named Executive Officers). None of the Named Executive Officers served with NaviSite prior to fiscal year 2003. Mr. Drake commenced employment with NaviSite in September 2003. In the table below, columns required by the regulations of the SEC have been omitted where no information was required to be disclosed under those columns.

SUMMARY COMPENSATION TABLE

		Annual Compensation		Long-Term Compensation Awards	
Name and Principal Position	Year	Salary ($)	Bonus ($)	Securities Underlying Options	All Other Compensation ($)
Arthur P. Becker	2004	275,000		460,000	
Chief Executive Officer and President	2003	121,635		40,000	
Gabriel Ruhan	2004	250,000		460,000	40,799(1)
Chief Operating Officer	2003	205,769		40,000	
James Pluntze	2004	166,058		43,125	
Former Chief Financial Officer	2003	48,075	4,850	40,000	
Kenneth Drake	2004	155,769		80,000	
General Counsel and Secretary					

(1) Amount represents housing expenses, including the rent for a residential real estate lease, and the taxes owed by Mr. G. Ruhan on such benefit.

Option Grants During the Fiscal Year Ended July 31, 2004

The following table sets forth information regarding options to purchase NaviSite Common Stock granted to the Named Executive Officers during the fiscal year ended July 31, 2004. NaviSite has never granted any stock appreciation rights.

STOCK OPTION GRANTS IN THE FISCAL YEAR ENDED JULY 31, 2004

	Individual Grants				Potential Realizable Value at Assumed Annual Rates of Stock Price Appreciation for Option Term ($)(1)	
Name	Number of Securities Underlying Options Granted (#)	Percent of Total Options Granted to Employees in Fiscal Year (%)	Exercise Price (Per Share) ($)	Expiration Date	5%	10%
Arthur P. Becker	60,000(2)	3.0	2.55	07/10/2013	651,451	1,103,377
	400,000(3)	19.9	5.41	01/30/2014	1,360,928	3,448,859
Gabriel Ruhan	60,000(2)	3.0	2.55	07/10/2013	651,451	1,103,377
	400,000(3)	19.9	5.41	01/30/2014	1,360,928	3,448,859
James Pluntze	40,000(4)	2.0	2.55	07/10/2013	434,301	735,584
	3,125(5)	0.2	2.55	01/30/2014	19,570	35,882
Kenneth Drake	40,000(6)	2.0	3.53	10/03/2013	88,769	224,941
	40,000(7)	2.0	3.53	10/03/2013	401,229	715,183

(1) Amounts reported in these columns represent hypothetical amounts that may be realized upon exercise of the options immediately prior to the expiration of their term assuming the specified compounded rates of appreciation (5% and 10%) on the underlying common stock over the term of the options. These numbers are calculated based on rules promulgated by the Securities and Exchange Commission and do not reflect NaviSite s estimate of future stock price growth. Actual gains, if any, on stock option exercises and Common Stock holdings are dependent on the timing of such exercise and the future performance of the underlying common stock. There can be no assurance that the

rates of appreciation assumed in this table can be achieved or that the amounts reflected will be received by the optionholder.

(2) On December 9, 2003, this option was granted under the 2003 Plan. The option is exercisable as to 10,000 shares on July 10, 2004. Thereafter, the option vests and becomes excisable as to 2,084 shares on each monthly anniversary date of July 10, 2004 until fully vested on July 10, 2006.

(3) On January 30, 2004, this option was granted under the 2003 Plan. The option is exercisable as to 100,000 shares on the date of grant. Thereafter, the option vests and becomes excisable in 36 equal monthly installments on each monthly anniversary date of the date of grant until fully vested on third anniversary of the date of grant.

(4) On January 30, 2004, this option was granted under the 2003 Plan. The option is exercisable as to 1/24th the number of shares subject to the option on each monthly anniversary date of July 10, 2004 until fully vested on July 10, 2006.

(5) Mr. Pluntze served as a member of the Board of Directors of NaviSite from January 27, 2003 through May 5, 2003. During this time, NaviSite did not have an existing stock option plan pursuant to which Mr. Pluntze was eligible to participate and receive a stock option grant. On December 9, 2003, the stockholders of NaviSite approved the 2003 Plan. On January 30, 2004, the Board of Directors determined to grant to Mr. Pluntze an option to purchase these shares under such plan at an exercise price of $2.55 per share, consistent with grants made to certain similarly situated directors on December 9, 2003.

(6) On October 3, 2003, Mr. Drake was granted this option under the 1998 Equity Incentive Plan. The option was vested and exercisable as to 50% of the shares underlying the option on the date of grant. Thereafter, the option vested and became exercisable in 12 equal monthly installments on each monthly anniversary date of the date of grant until fully vested on October 3, 2004.

(7) On December 9, 2003, Mr. Drake was granted this option under the 2003 Plan. This option is exercisable as to 1/24th number of shares underlying the option on each monthly anniversary date of September 8, 2004 until fully vested on September 8, 2006.

Options Exercised During Fiscal Year Ended July 31, 2004

The following table sets forth the number of exercisable and unexercisable options to purchase NaviSite Common Stock held by the Named Executive Officers as of July 31, 2004. No stock options to purchase NaviSite Common Stock were exercised by any Named Executive Officer during the fiscal year ended July 31, 2004 and no such options were in-the-money as of July 31, 2004.

AGGREGATED OPTION EXERCISES IN LAST FISCAL YEAR AND

FISCAL YEAR-END OPTION VALUES

	Number of Securities Underlying Unexercised Options at July 31, 2004	
Name	**Exercisable**	**Unexercisable**
Arthur P. Becker	200,000	300,000
Gabriel Ruhan	200,000	300,000
James Pluntze	43,125	40,000
Kenneth Drake	35,000	45,000

Compensation Committee Report

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

Compensation Philosophy. NaviSite s executive compensation program has three objectives: (i) to align the interests of its executive officers with the interests of NaviSite s stockholders by basing a significant portion of an executive s compensation on NaviSite s performance; (ii) to attract and retain highly talented and productive executives; and (iii) to provide incentives for superior performance by NaviSite s executives. To achieve these objectives, the Compensation Committee has crafted a program

that consists of base salary, short-term incentive compensation in the form of a bonus, and long-term incentive compensation in the form of stock options. These compensation elements are in addition to the general benefit programs that are offered to all of NaviSite s employees. The Compensation Committee has determined that, in light of NaviSite s current cash position, awarding cash bonuses at this time is not appropriate.

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

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

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

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

Mr. Becker has served as a director of NaviSite since September 2002 and became its Chief Executive Officer and President in February 2003. Mr. Becker s base salary for the last fiscal year was $275,000. In December 2003, Mr. Becker also received an option to acquire 60,000 shares of NaviSite Common Stock at an exercise price of $2.55 per share, and in January 2004, Mr. Becker received an option to acquire 400,000 shares of NaviSite Common Stock at an exercise price of $5.41 per share. Mr. Becker s compensation was designed to align his interests with those of NaviSite s stockholders by tying the value of the stock option award and his eligibility for periodic cash bonuses to the success of his efforts towards building NaviSite s management team, business and infrastructure and improving the operating and financial performance of NaviSite. The Compensation Committee believes that Mr. Becker s compensation has been consistent with the Compensation Committee s compensation philosophy.

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

COMPENSATION COMMITTEE

Larry Schwartz, Chairman
James Dennedy
Thomas R. Evans

Stock Performance Graph

The following graph compares the cumulative total return to stockholders of NaviSite Common Stock for the period from October 22, 1999, the date NaviSite Common Stock was first traded on The Nasdaq National Market, through July 31, 2004, with the cumulative total return over the same period of (i) the Nasdaq Composite Index and (ii) a peer group index of publicly traded companies that provide similar services to those of NaviSite (the Peer Group Index). The graph assumes the investment of $100 in NaviSite Common Stock (at the closing price on the date of NaviSite s initial public offering) and in each of such indices (and the reinvestment of all dividends, if any) on October 22, 1999. The performance shown is not necessarily indicative of future performance.

Comparison of Cumulative Total Return

Assumes Initial Investment of $100
October 22, 1999 Through July 31, 2004

Measurement Period (Fiscal Year Covered)	NaviSite, Inc.	Nasdaq Composite Index	Peer Group Index(1)
October 22, 1999	$100.00	$100.00	$100.00
July 31, 2000	$234.30	$143.06	$ 93.93
July 31, 2001	$ 4.33	$ 77.20	$ 80.16
July 31, 2002	$ 0.69	$ 50.76	$ 46.63
July 31, 2003	$ 1.14	$ 66.63	$ 48.21
July 31, 2004	$ 0.78	$ 72.83	$ 51.49

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

Notwithstanding anything to the contrary set forth in any of NaviSite s filings under the Securities Act or the Exchange Act that might incorporate other filings with the SEC, including this Proxy

Statement, in whole or in part, the Compensation Committee Report and the Stock Performance Graph shall not be deemed incorporated by reference into any such filings.

Employment Agreements and Severance and Change of Control Arrangements

Arthur Becker

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

- a base salary, currently $275,000 per year, which is reviewed by our Board of Directors annually (but no more frequently than annually);
- an annual bonus upon NaviSite s achievement of various financial and/or other goals established by the Board; and
- fringe benefits, including stock options and health insurance and other benefits available to our employees.

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

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

Mr. Becker and NaviSite have also entered into an indemnification agreement pursuant to which he will be indemnified by NaviSite, subject to certain limitations, for any liabilities incurred by him in connection with his role as a director and officer of NaviSite.

John J. Gavin, Jr.

On May 6, 2004, Mr. Gavin and NaviSite entered into an employment agreement pursuant to which Mr. Gavin is employed as NaviSite s Chief Financial Officer. Mr. Gavin s agreement is for a continuous term, but subject to the provisions described below, may be terminated by either party at any time. Pursuant to this agreement, Mr. Gavin is entitled to receive:

- a base salary, currently $250,000 per year, which is reviewed by our Board of Directors annually (but no more frequently than annually); and
- fringe benefits, including stock options and health insurance and other benefits available to our employees.

If Mr. Gavin s employment is terminated (i) by reason of death or disability, (ii) by NaviSite with Cause (as defined) or (iii) due to his voluntary resignation without Good Reason (as defined), then he will receive no additional salary or benefits other than what has accrued through the date of termination.

If Mr. Gavin s employment is terminated by NaviSite without Cause or by Mr. Gavin with Good Reason, and he signs a general release of known and unknown claims in a form satisfactory to NaviSite, Mr. Gavin will receive severance payments at his final base salary rate, less applicable withholding, and continuation of medical benefits until the earlier of (i) six or twelve months after the date of his termination (depending on the reason, date of severance and amount of time served with NaviSite) and (ii) the date on which Mr. Gavin commences other employment.

Kenneth Drake

We entered into an employment agreement with Kenneth Drake as of July 15, 2003, pursuant to which he is employed as NaviSite s General Counsel. Pursuant to this agreement, Mr. Drake is entitled to receive:

- a base salary, currently $180,000 per year, which is reviewed by our Board of Directors annually (but no more frequently than annually); and

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

Mr. Drake is also eligible for an annual discretionary bonus based in part upon NaviSite s achievement of various goals set by Mr. Drake and NaviSite s President and Chief Executive Officer.

If Mr. Drake s employment is terminated (i) by reason of death or disability, (ii) by NaviSite with Cause (as defined) or (iii) due to his voluntary resignation without Good Reason (as defined), then he will receive no additional salary or benefits other than what has accrued through the date of termination.

If Mr. Drake s employment is terminated by NaviSite without Cause or by Mr. Drake with Good Reason, and he signs a general release of known and unknown claims in a form satisfactory to NaviSite, Mr. Drake will receive severance payments at his final base salary rate, less applicable withholding, and continuation of medical benefits until six months after the date of his termination.

James Pluntze

We entered an employment agreement and a severance agreement with James Pluntze as of March 25, 2003, pursuant to which he was employed as NaviSite s VP of Finance and Acting CFO. Mr. Pluntze served as NaviSite s Chief Financial Officer until May 5, 2004, at which point he assumed the role of Senior Vice President of Finance and Mr. Gavin assumed the role of Chief Financial Officer. Pursuant to Mr. Pluntze s employment agreement, Mr. Pluntze was entitled to receive a base salary of $140,000 per year.

Pursuant to Mr. Pluntze s severance agreement, in the event Mr. Pluntze s employment is terminated (i) by NaviSite for a reason other than for Cause (as defined) or (ii) by Mr. Pluntze for Good Reason (as defined), then Mr. Pluntze shall be eligible for severance pay equal to six (6) months base wages, less applicable taxes and withholding.

Financial and Other Information

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

By Order of the Board of Directors,

KENNETH DRAKE
Secretary

December [ ], 2004

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Stockholders

NaviSite, Inc. and Subsidiaries:

We have audited the accompanying consolidated balance sheets of NaviSite, Inc. and Subsidiaries as of July 31, 2004 and 2003, 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, 2004. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of NaviSite, Inc. and Subsidiaries as of July 31, 2004 and 2003, and the results of their operations and their cash flows for each of the years in the three-year period ended July 31, 2004, in conformity with accounting principles generally accepted in the United States of America.

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

/s/ KPMG LLP

Boston, Massachusetts

November 1, 2004

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NAVISITE, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

	July 31,	
	2004	2003
	(In thousands, except par value)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 3,195	$ 3,862
Accounts receivable, less allowance for doubtful accounts of $2,498 and $2,030 at July 31, 2004 and 2003, respectively	16,584	14,741
Unbilled accounts receivable	1,854	58
Due from related party	101	
Prepaid expenses and other current assets	4,113	3,953
Total current assets	25,847	22,614
Property and equipment, net	20,794	22,165
Customer lists, less accumulated amortization of $7,875 and $3,724 at July 31, 2004 and 2003, respectively	23,151	12,052
Goodwill	45,920	3,206
Other assets	6,316	6,280
Restricted cash	1,836	3,054
Total assets	$ 123,864	$ 69,371
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts receivable financing line, net	$ 20,240	$ 6,358
Notes payable, current portion	1,551	1,211
Note payable to related party	3,000	3,000
Capital lease obligations, current portion	2,921	3,268
Accounts payable	8,285	4,371
Accrued expenses	18,890	15,044
Accrued lease abandonment costs, current portion	4,269	2,536
Deferred revenue	2,670	2,736
Customer deposits	732	391
Total current liabilities	62,558	38,915
Capital lease obligations, less current portion	469	1,907
Accrued lease abandonment costs, less current portion	2,782	3,476
Other long-term liabilities	1,349	2,194
Note to the AppliedTheory Estate	6,000	6,000
Note payable, less current portion	1,157	
Convertible notes payable to Surebridge	38,467	
Total liabilities	112,782	52,492
Commitments and contingencies (Note 12)		

Stockholders equity:		
Preferred stock, $0.01 par value; Authorized 5,000 shares; Issued and outstanding: no shares at July 31, 2004 and 2003		
Common stock, $0.01 par value; Authorized 395,000 shares; Issued and outstanding: 27,924 and 23,412 at July 31, 2004 and 2003	279	235
Deferred compensation	(1,514)	
Accumulated other comprehensive income (loss)	15	(16)
Additional paid-in capital	452,156	432,399
Accumulated deficit	(439,854)	(415,739)
Total stockholders equity	11,082	16,879
Total liabilities and stockholders equity	$ 123,864	$ 69,371

See accompanying notes to consolidated financial statements.

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NAVISITE, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

	Years Ended July 31,		
	2004	2003	2002
	(In thousands, except per share data)		
Revenue	$ 91,126	$ 75,281	$ 40,968
Revenue, related parties	46	1,310	18,453
Total revenue	91,172	76,591	59,421
Cost of revenue	68,379	70,781	67,000
Impairment, restructuring and other	917		68,317
Total cost of revenue	69,296	70,781	135,317
Gross profit (loss)	21,876	5,810	(75,896)
Operating expenses:			
Product development	1,075	950	5,281
Selling and marketing	9,567	5,960	9,703
General and administrative	24,714	20,207	19,272
Impairment, restructuring and other	5,286	8,882	(2,633)
Total operating expenses	40,642	35,999	31,623
Loss from operations	(18,766)	(30,189)	(107,519)
Other income (expense):			
Interest income	126	851	1,060
Interest expense	(3,181)	(43,403)	(14,718)
Other income (expense), net	468	(733)	(516)
Loss before income tax expense	(21,353)	(73,474)	(121,693)
Income tax expense	(1)	(153)	
Net loss	$ (21,354)	$ (73,627)	$ (121,693)
Basic and diluted net loss per common share	$ (0.85)	$ (6.32)	$ (22.30)
Basic and diluted weighted average number of common shares outstanding	25,160	11,654	5,457

See accompanying notes to consolidated financial statements.

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NAVISITE, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY (DEFICIT)

	Common Stock		Deferred	Accumulated Other Comprehensive	Additional Paid-In	Accumulated	Stockholders Equity
	Shares	Amount	Compensation	Income (Loss)	Capital	Deficit	(Deficit)
				(In thousands)			
Balance at July 31, 2001	4,125	$ 41	$	$	$ 208,642	$ (215,645)	$ (6,962)
Issuance of common stock pursuant to employee stock purchase plan and exercise of stock options	35	0			36		36
Conversion of CMGI convertible debt and other amounts due to CMGI	1,624	16			87,137		87,153
Issuance of common stock in connection with the interest on convertible debt	464	5			2,980		2,985
Beneficial conversion feature of debt issued to CMGI and HPFS					42,561		42,561
Net settlement of debt to CMGI					4,464		4,464
Net loss						(121,693)	(121,693)
Balance at July 31, 2002	6,248	62			345,820	(337,338)	8,544
Exercise of common stock options	2				2		2
Common control merger with CBTM	568	6			3,360	(515)	2,851
Common control merger with CBT					16,664	(4,259)	12,405
Conversion of CBT convertible debt and other amounts due to CBT	16,363	165			65,816		65,981
Issuance of common stock Avasta acquisition	231	2			367		369
Issuance of stock warrants to Silicon Valley Bank					370		370
Currency translation adjustment				(16)			(16)
Net loss						(73,627)	(73,627)
Balance at July 31, 2003	23,412	235		(16)	432,399	(415,739)	16,879
Exercise of common stock options	159	1			403		404
Deferred stock-based compensation			(1,987)		1,987		
Amortization of deferred stock-based compensation			473				473
Issuance of common stock Avasta earn-out	179	2			741		743
Issuance of stock warrants to Silicon Valley Bank					213		213
Exercise of Silicon Valley Bank stock warrants	74	1			(1)		
Issuance of common stock common control merger with CBT	1,100	10			2,794	(2,761)	43
Issuance of common stock Surebridge acquisition	3,000	30			13,620		13,650
Currency translation adjustment				31			31
Net loss						(21,354)	(21,354)
Balance at July 31, 2004	27,924	$ 279	$ (1,514)	$ 15	$ 452,156	$ (439,854)	$ 11,082

See accompanying notes to consolidated financial statements.

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NAVISITE, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Years Ended July 31,		
	2004	**2003**	**2002**
		(In thousands)	
Cash flows from operating activities:			
Net loss	$(21,354)	$(73,627)	$(121,693)
Adjustments to reconcile net loss to net cash used for operating activities:			
Depreciation and amortization	12,902	14,148	20,649
Amortization of beneficial conversion feature to interest expense		37,398	5,163
Interest on debt paid in stock		2,098	3,695
Impairment of long-lived assets	1,145	1,190	68,317
Impairment of goodwill and intangibles		1,831	186
Write-down of assets held for sale			524
Loss on disposal of assets	6	250	1,363
Gain on sale of Streaming Media assets			(524)
Costs associated with abandoned leases	5,058	6,127	
Amortization of warrants	358	66	
Non-cash stock compensation	473		
Provision for bad debts	2,568	1,583	3,490
Accretion of debt discount			1,172
Changes in operating assets and liabilities, net of impact of acquisitions			
Accounts receivable	586	(1,371)	3,600
Unbilled accounts receivable	(360)	45	
Due from CMGI and affiliates		(22)	(266)
Due to CMGI		(3,241)	7,218
Due from CBT	(101)		
Prepaid expenses and other current assets	(79)	1,775	178
Long-term assets	498	675	(379)
Accounts payable	(814)	(2,614)	(8,537)
Customer deposits	(1)	192	(19)
Long-term liabilities	(844)	163	
Accrued expenses and deferred revenue	(4,687)	(1,215)	(11,172)
Net cash used for operating activities	(4,646)	(14,549)	(27,035)

(Continued)

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	Years Ended July 31,		
	2004	2003	2002
		(In thousands)	
Cash flows from investing activities:			
Net cash acquired in acquisitions	6	3,981	
Cash used to acquire Interliant assets		(5,830)	
Purchase of property and equipment	(4,269)	(1,067)	(4,182)
Proceeds from the sale of equipment	95	475	1,440
Purchase of debt securities		(1,963)	
Loan to related party		(1,596)	
Proceeds from repayment of loan to related party		200	
Proceeds from the sale of Streaming Media assets			1,600
Other assets			577
Net cash used for investing activities	(4,168)	(5,800)	(565)
Cash flows from financing activities:			
Restricted cash	1,676	3,878	1,201
Issuance of convertible notes payable to CMGI and HPFS			30,000
Proceeds from exercise of stock options and employee stock purchase plan	404		35
Proceeds from sale leaseback	120		
Proceeds from note payable	450		
Repayment of note payable	(2,055)		(1,874)
Debt repayment to the AppliedTheory estate		(6,100)	
Borrowing under note to affiliate		5,850	
Net borrowings (repayments) under accounts receivable line	(6,874)	6,359	
Net proceeds from modified accounts receivable line	20,400		
Payments under note to affiliates	(30)	(2,600)	
Payoff of Surebridge line of credit and term note	(3,865)		
Payments on capital lease obligations	(2,079)	(5,018)	(1,218)
Payments of software vendor obligations			(916)
Net cash provided by financing activities	8,147	2,369	27,228
Net decrease in cash	(667)	(17,980)	(372)
Cash and cash equivalents, beginning of year	3,862	21,842	22,214
Cash and cash equivalents, end of year	$ 3,195	$ 3,862	$ 21,842
Supplemental disclosure of cash flow information:			
Cash paid for interest	$ 1,898	$ 2,263	$ 3,553

See accompanying notes to consolidated financial statements.

NAVISITE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(1) Description of Business

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

(2) Summary of Significant Accounting Policies

(a) Basis of Presentation

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

We completed a business combination with CBT, an entity under common control, on August 8, 2003, which was after our fiscal year ending July 31, 2003 and disclosed as a subsequent event in the notes to our 2003 financial statements. As our fiscal 2004 operating results include the results of CBT, our fiscal year 2003 financial statements, as previously filed in our 2003 Form 10-K, have been restated herein to account for this business combination in a manner similar to a pooling of interests from September 11, 2002, which was the common control effective date.

One-for-fifteen Reverse Stock Split

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

Change in Controlling Ownership

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

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

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

On December 12, 2002, ClearBlue Finance, Inc., a wholly-owned subsidiary of ClearBlue (ClearBlue Finance), (i) converted in full the $10.0 million note formerly held by CMGI and (ii) converted $10.0 million of the $55.0 million notes formerly held by HPFS. We issued 5,128,205 shares of our common stock to ClearBlue Finance upon the conversion and partial conversion, respectively, of the

NAVISITE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

$10.0 million note formerly held by CMGI and $10.0 million of the $55.0 million notes formerly held by HPFS and issued 458,943 shares of our common stock for payments of interest due under the convertible notes. A new note (New Note) in the amount of $45.0 million was issued to ClearBlue Finance with respect to the portion of the outstanding principal and interest due under the note formerly held by HPFS that was not converted.

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

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

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

On June 16, 2003, we repaid approximately $3.9 million of the $45.0 million outstanding New Note to ClearBlue Finance, Inc. by offsetting amounts due to us by ClearBlue. On June 17, 2003, we received written notice from ClearBlue Finance, Inc. stating its election to convert the remaining approximately $41.1 million of the New Note into 10,559,248 shares of common stock effective June 19, 2003. As of July 31, 2003 ClearBlue Technologies Equity, Inc., ClearBlue Finance, ClearBlue and ClearBlue Atlantic beneficially owned 19,284,994 shares of our common stock, representing approximately 78.6% of the outstanding shares of common stock on a fully converted basis. As a result of these changes in ownership since September 11, 2002 involving ClearBlue and its affiliates, the utilization of our federal and state tax net operating loss carryforwards will be severely limited pursuant to Internal Revenue Code Section 382.

Impact of Acquisitions

During fiscal year 2004, we completed the acquisition of substantially all of the assets of Surebridge, Inc. (Surebridge) through our wholly-owned subsidiary, Lexington Acquisition Corp. (Lexington). This acquisition was accounted for using the purchase method of accounting. The results of operations and cash flows from Surebridge are included in our Consolidated Statement of Operations and Consolidated

NAVISITE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Statement of Cash Flows for the twelve-month period ended July 31, 2004, from its acquisition date of June 10, 2004. See Note 8 for further discussion of this fiscal year 2004 acquisition.

In addition to the acquisition of CBTM, as discussed above, during fiscal year 2003, we acquired Avasta, Inc. (Avasta), Conxion Corporation (Conxion), and substantially all of the assets of Interliant, Inc. (Interliant Assets) through our wholly-owned subsidiary, Intrepid Acquisition Corp. (Intrepid). Each of these acquisitions was accounted for using the purchase method of accounting. The results of operations and cash flows from Avasta, Conxion, and Intrepid are included in our Consolidated Statements of Operations and Consolidated Statements of Cash Flows for the twelve-month period ended July 31, 2003 from their respective dates of acquisition, February 5, 2003, April 2, 2003, and May 16, 2003 and for all subsequent periods. See Note 8 for further discussion of our fiscal year 2003 acquisitions.

On August 8, 2003, we completed the acquisition of certain assets and the assumption of certain liabilities of ClearBlue Technologies, Inc. (CBT) pursuant to a Stock and Asset Acquisition Agreement (the CBT Agreement). We acquired all outstanding shares of six (6) wholly-owned subsidiaries of CBT with data centers located in Chicago, Las Vegas, Los Angeles, Milwaukee, Oak Brook and Vienna. In addition, we assumed the revenue and expense, as of the date of acquisition, of four (4) additional wholly-owned subsidiaries of CBT with data centers located in Dallas, New York, San Francisco and Santa Clara (collectively the Four Subsidiaries or the Deferred Entities). Ownership of these subsidiaries transferred to NaviSite for no additional consideration in April 2004, as described below. The operational results of the Four Subsidiaries have been included herein since NaviSite exercised effective control over these subsidiaries as of August 8, 2003.

As Atlantic Investors, LLC had a controlling interest in both NaviSite and CBT at the time of the combination, the transaction was accounted for as a combination of entities under common control (i.e., as if pooling) whereby the assets and liabilities of CBT and NaviSite were combined at their historical amounts. Accordingly, our consolidated financial statements have been restated for all periods prior to the business combination to include CBT s financial results beginning on September 11, 2002, the date on which CBT acquired the controlling interest in NaviSite, after the elimination of intercompany balances. See Note 8 for further discussion of our fiscal year 2003 and 2004 acquisitions.

On February 6, 2004, we entered into an amendment to the CBT Agreement (the Amendment) by and among NaviSite, CBT and certain of CBT s wholly-owned subsidiaries. The Amendment amended the CBT Agreement dated August 8, 2003 to extend the date by which we are able to cause the transfer to us of the Deferred Entities, from February 8, 2004 to anytime on or prior to August 8, 2005 (the Transfer Date), under certain conditions and for no additional consideration. In consideration for such Amendment, we agreed to operate and manage the Deferred Entities in a manner consistent with the CBT Agreement. On April 12, 2004, pursuant to the Amendment, NaviSite exercised its right to acquire from CBT all of the outstanding shares of the Deferred Entities, for no additional consideration.

(b) Principles of Consolidation

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

NAVISITE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(c) Use of Estimates

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

(d) Cash and Cash Equivalents and Restricted Cash

The Company considers all highly liquid securities with original maturities of three months or less to be cash equivalents. The Company had restricted cash of $1.8 million and $3.1 million at July 31, 2004 and 2003, respectively, which represents a cash collateral requirement for standby letters of credit associated with several of the Company s facility and equipment leases. Restricted cash declined during the year ended July 31, 2004, as the result of letters of credit that have expired, been drawn down or canceled due to lease modifications.

(e) Revenue Recognition

Revenue consists of monthly fees for Web site and Internet application management, hosting, colocations and professional services. The Company also derives revenue from the sale of software and related maintenance contracts. Reimbursable expenses charged to clients are included in revenue and cost of revenue. Application management, hosting and colocation revenue (other than installation fees) is billed and recognized over the term of the contract, generally one to three years, based on actual usage. Payments received in advance of providing services are deferred until the period such services are provided. Revenue from professional services, application management, hosting and colocation revenue is recognized on either a time-and material basis as the services are performed or under the percentage of completion method for fixed-price contracts. We generally sell our professional services under contracts with terms ranging from one to five years. When current contract estimates indicate that a loss is probable, a provision is made for the total anticipated loss in the current period. Contract losses are determined to be the amount by which the estimated service costs of the contract exceed the estimated revenue that will be generated by the contract. Unbilled accounts receivable represents revenue for services performed that have not been billed. Billings in excess of revenue recognized are recorded as deferred revenue until the applicable revenue recognition criteria are met. Revenue from the sale of software is recognized when persuasive evidence of an arrangement exists, the product has been delivered, the fees are fixed and determinable and collection of the resulting receivable is reasonably assured. In instances where the Company also provides application management and hosting services in conjunction with the sale of software, software revenue is deferred and recognized ratably over the expected customer relationship period. If we determine that collection of a fee is not reasonably assured, we defer the fee and recognize revenue at the time collection becomes reasonably assured, which is generally upon receipt of cash.

(f) Concentration of Credit Risk

Our financial instruments include cash, accounts receivable, obligations under capital leases, software agreements, accounts payable, and accrued expenses. As of July 31, 2004, the carrying cost of these instruments approximated their fair value. The financial instruments that potentially subject us to concentration of credit risk consist primarily of accounts receivable. Concentration of credit risk with respect to trade receivables is limited due to the large number of customers across many industries that comprise our customer base. One third-party customer accounted for 12% and 21% of our total revenue for

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NAVISITE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

the fiscal year ended July 31, 2004 and 2003, respectively. During 2002, no third party customer accounted for 10% or more of our total revenue. Accounts receivable included approximately $1.5 million and $2.3 million due from this third-party customer at July 31, 2004 and 2003, respectively.

(g) Comprehensive Income (Loss)

Comprehensive income (loss) is defined as the change in equity of a business enterprise during a period of time from transactions and other events and circumstances from non-owner sources. The Company reports accumulated other comprehensive income (loss), resulting from foreign currency translation adjustments, in the Consolidated Statements of Stockholders Equity.

(h) Property and Equipment

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

Renewals and betterments, which materially extend the life of assets, are capitalized and depreciated. Upon disposal, the asset cost and related accumulated depreciation are removed from their respective accounts and any gain or loss is reflected within Other income (expense), net in our Consolidated Statements of Operations.

(i) Long-Lived Assets, Goodwill and Other Intangibles

The Company follows the provisions of Statement of Financial Accounting Standards (SFAS) No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. This statement requires that long-lived assets and certain indentifiable intangibles 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 a comparison of the carrying amount of an asset to undiscounted future net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value less cost to sell.

The Company reviews the valuation of goodwill in accordance with SFAS No. 142 Goodwill and Other Intangible Assets. Under the provisions of SFAS No. 142, goodwill is required to be tested for impairment annually in lieu of being amortized. This testing is done in the fourth quarter of each year. Furthermore, goodwill is required to be tested for impairment on an interim basis if an event or circumstance indicates that it is more likely than not an impairment loss has been incurred. An impairment loss shall be recognized to the extent that the carrying amount of goodwill exceeds its implied fair value. Impairment losses shall be recognized in operations. The Company s valuation methodology for assessing impairment requires management to make judgments and assumptions based on historical experience and projections of future operating performance. Management predominantly uses third party valuation reports to assist in its determination of the fair value. If these assumptions differ materially from future results, the Company may record impairment charges in the future.

NAVISITE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(j) Income Taxes

We account for income taxes under the asset and liability method in accordance with SFAS No. 109, Accounting for Income Taxes . Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

(k) Advertising Costs

We recognize advertising costs as incurred. Advertising expense was approximately $20,000, $0 and $4,000 for the fiscal years ended July 31, 2004, 2003, and 2002, respectively, and is included in the accompanying consolidated statements of operations as a component of selling and marketing expenses.

(l) Stock-Based Compensation Plans

We account for our stock option plans under the recognition and measurement principles of Accounting Principles Board Opinion No. 25 (APB), Accounting for Stock Issued to Employees, and Related Interpretations. We recorded stock compensation expense of approximately $473,000, $0 and $0 during the fiscal years ended July 31, 2004, 2003 and 2002, respectively (see Note 12). The following table illustrates the effect on net loss and net loss per common share if we had applied the fair value recognition provisions of Financial Accounting Standards Board (FASB) Statement No. 123, Accounting for Stock-Based Compensation , to stock based compensation.

	2004	2003	2002
	(In thousands, except per share data)		
Net loss, as reported	$ (21,354)	$ (73,627)	$ (121,693)
Add: Stock-based employee compensation expense from the Amended and Restated 2003 Stock Incentive Plan included in reported net loss	473		
Deduct: Total stock based employee compensation expense determined under fair value based method for all awards	(5,702)	(8,062)	(24,778)
Net loss, as adjusted	$ (26,583)	$ (81,689)	$ (146,471)
Net loss per common share:			
Basic and diluted as reported	$ (0.85)	$ (6.32)	$ (22.30)
Basic and diluted as adjusted	$ (1.06)	$ (7.01)	$ (26.84)

The fair value of each stock option grant has been estimated on the date of grant using the Black-Scholes option-pricing model, assuming no expected dividends and the following weighted average assumptions:

NaviSite:			
Risk-free interest rate	2.68%	1.93%	2.23%
Expected volatility	137.34%	160.16%	250.00%
Expected life (years)	2.08	3.07	2.12

Weighted average fair value of options granted during the period	$ 4.58	$ 2.23	$ 4.01

NAVISITE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

For fiscal years ended July 31, 2004, 2003, and 2002, net loss per basic and diluted share is based on weighted average common shares and excludes any common stock equivalents, as they would be anti-dilutive due to the reported losses. There were 970,748, 2,741 and 29,503 of diluted shares related to employee stock options that were excluded as they have an anti-dilutive effect due to the loss for fiscal years 2004, 2003 and 2002, respectively.

(n) Segment Reporting

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

(o) New Accounting Pronouncements

In November 2002, the Emerging Issues Task Force (EITF) reached a consensus on EITF Issue 00-21, Accounting for Revenue Arrangements with Multiple Deliverables. EITF Issue 00-21 provides guidance on how to determine when an arrangement that involves multiple revenue-generating activities or deliverables should be divided into separate units of accounting for revenue recognition purposes, and if this division is required, how the arrangement consideration should be allocated among the separate units of accounting. The guidance in the consensus is effective for revenue arrangements entered into on or after January 1, 2004. The adoption of EITF Issue 00-21 did not have a material effect on the Company s financial position or results of operations.

In January 2003, FASB Interpretation No. (FIN) 46, Consolidation of Variable Interest Entities, was issued. FIN 46 requires certain variable interest entities (VIE) to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. FIN 46 is effective for all new VIEs created or acquired after January 31, 2003. During December 2003, the FASB issued a new revision to FIN 46 (FIN 46R).

Under the revised provisions, public entities are required to apply the guidance if the entity has interests in VIEs commonly referred to as special-purpose entities for the periods ending after December 15, 2003. The adoption of FIN 46 and 46R did not have a material effect on our consolidated financial statements.

In May 2003, the FASB issued SFAS No. 150, Accounting For Certain Financial Instruments with Characteristics of Both Liabilities and Equity , which establishes standards for how an issuer of financial instruments classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances) if, at inception, the monetary value of the obligation is based solely or predominantly on a fixed monetary amount known at inception, variations in something other than the fair value of the issuer s equity shares or variations inversely related to changes in the fair value of the issuer s equity shares. This Statement is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003.

NAVISITE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

On November 7, 2003, the FASB deferred the classification and measurement provisions of SFAS No. 150 as they apply to certain mandatory redeemable non-controlling interests. This deferral is expected to remain in effect while these provisions are further evaluated by the FASB. We have not entered into or modified any financial instruments covered by this statement after May 31, 2003 and the application of this standard is not expected to have a material impact on our financial position or results of operations.

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

(p) Foreign Currency

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

(q) Reclassifications

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

(3) Liquidity

As of July 31, 2004, our principal sources of liquidity included cash and cash equivalents and our financing agreement with Silicon Valley Bank. We had a working capital deficit of $36.7 million, including cash and cash equivalents of $3.2 million at July 31, 2004, as compared to a working capital deficit of $16.3 million, including cash and cash equivalents of $3.9 million, at July 31, 2003.

The total net change in cash and cash equivalents for the fiscal year ended July 31, 2004 was a decrease of $0.7 million. The primary uses of cash during fiscal year 2004 included $4.6 million of cash used for operating activities, $4.3 million for purchases of property and equipment and $8.0 million in repayments on notes payable and capital lease obligations. Our primary sources of cash during fiscal year 2004 were a $1.7 million decrease in restricted cash, $0.4 million in proceeds associated with the exercise of stock options under the employee stock option plans, $13.5 million in net proceeds from our financing agreements and $0.6 million in proceeds from sale-leaseback and note payable transactions. Net cash used for operating activities of $4.6 million during the fiscal year ended July 31, 2004, resulted primarily from our $21.4 million net loss, partially offset by $22.6 million in non-cash charges, and $5.8 million used by net changes in operating assets and liabilities. At July 31, 2004, we had an accumulated deficit of $439.9 million, and have reported losses from operations since incorporation. At July 31, 2003, we had an accumulated deficit of $415.7 million.

Prior to May 2003, our primary sources of cash to fund our operations were sales of equity and convertible debt securities. Since May 2003, our primary source of cash to fund our operations and meet our contacted obligations and commitments has been our accounts receivable financing agreement with

NAVISITE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Silicon Valley Bank. On January 30, 2004, we amended this agreement to, among other things, allow for future borrowing to be based on monthly recurring revenue, increase the maximum borrowings level from $10.0 million to $12.8 million, and extend the term until January 29, 2006. On April 29, 2004, we amended this agreement, among other things, to increase the maximum borrowing level from $12.8 million to $20.4 million, and extend the term until April 29, 2006. Under the amended agreement, borrowings are based on monthly recurring revenue. We are required to prepare and deliver a written request for an advance of up to three times the value of total monthly recurring revenue, calculated to be monthly revenue (including revenue from New York State Department of Labor) less professional services revenue. The bank may then provide an advance of 85% of such value (or such other percentage as the bank may determine). The interest rate under the agreement is variable and is currently calculated at the bank s published prime rate plus four percent. Following completion of certain equity or debt financings, and provided we continue to meet certain ratios under the amended agreement, the interest rate shall be reduced to the bank s prime rate plus one percent. In no event, however, will the prime rate be less than 4.25%. On July 31, 2004, we had an outstanding balance under the amended agreement of $20.4 million.

At July 31, 2004, the Company had $1.8 million in outstanding standby letters of credit, issued in connection with facility and equipment lease agreements, which are 100% cash collateralized. Cash subject to collateral requirements has been recorded as restricted cash and is classified as non-current on our balance sheet at July 31, 2004.

We anticipate that we will continue to incur net losses in the future. We have taken several actions we believe will allow us to continue as a going concern through July 31, 2005, including the closing and integration of strategic acquisitions, the changes to our senior management and bringing costs more in line with projected revenue. Additionally, we will need to find sources of financing in order to remain a going concern. Potential sources include our financing agreement with Silicon Valley Bank and public or private sales of equity or debt securities. We are obligated to use a significant portion of any proceeds raised in an equity or debt financing to make payments on the Surebridge notes, depending on the total net proceeds received by us in the financing (see Note 11(f)). We may also consider sales of assets to raise additional cash. If we use a significant portion of the net proceeds from an offering to acquire a company, technology or product, we will need to raise additional debt or equity capital.

Our operating forecast incorporates material trends, such as our acquisitions, reductions in workforce, loss of related party revenue and closings of facilities. Our forecast also incorporates the future cash flow benefits expected from our continued efforts to increase efficiencies and reduce redundancies. Nonetheless, our forecast includes the need to raise additional funds. Our cash flow estimates are based upon attaining certain levels of sales, maintaining budgeted levels of operating expenses, collections of accounts receivable and maintaining our current borrowing line with Silicon Valley Bank among other assumptions, including the improvement in the overall macroeconomic environment. However there can be no assurance that we will be able to meet such assumptions. Our sales estimate includes revenue from new and existing customers, which may not be realized, and we may be required to further reduce expenses if budgeted sales are not attained. We may be unsuccessful in reducing expenses in proportion to any shortfall in projected sales and our estimate of collections of accounts receivable may be hindered by our customers ability to pay. In addition, we are currently involved in various pending and potential legal proceedings. While we believe that the allegations against us in each of these matters are without merit, and that we have a meritorious defense in each, we are not able to predict the final outcomes of any of these matters and the effect, if any, on our business, financial condition, results of operations or cash flows. If we are ultimately unsuccessful in any of these matters, we could be required to pay substantial amounts of cash and/or shares of our common stock to the other parties. The amount and timing of any such payments could adversely affect our business, financial condition, results of operations or cash flows.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(4) Impairment of Long-Lived Assets

During fiscal year 2004, the Company recorded a $1.1 million impairment charge including, a $0.6 million impairment charge for furniture and fixtures related to abandoned leases in Houston, Syracuse and San Jose; a $0.2 million charge for capital improvements to our impaired space at 400 Minuteman Road in Andover, MA; and a $0.3 million charge related to the impairment of furniture and fixtures in our facility at 55 Francisco Street, San Francisco, CA.

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

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

During fiscal 2003, CBT evaluated the net realizable value of its long-lived assets and recorded an impairment charge of approximately $2.0 million.

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

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

During fiscal year 2002, the Company finalized agreements with various equipment lessors whereby the Company purchased equipment previously held under operating lease for approximately $42.0 million, less amount owed under capital leases at that time. The fair market value of the equipment at the time of purchase, based on third party appraisal, was approximately $13.1 million. As the aggregate fair market value of the equipment, based on third party appraisal, was less than the aggregate consideration given, the Company recorded an asset impairment charge of $24.9 million, as a separate component of cost of revenue, in fiscal year 2002.

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

Based on these factors and their impact on current and future projected cash flows, the Company performed an assessment of the carrying value of its long-lived assets pursuant to SFAS No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of. The conclusion of this assessment was that the decline in market conditions within the Company s industry were significant and other than temporary. In this assessment, the Company reviewed its long-lived assets,

NAVISITE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

which included property and equipment and goodwill. The carrying amount of goodwill, which totaled $186,000, was considered unrecoverable and was written-off as of July 31, 2002 and was included as a component of general and administration expense.

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

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

In addition, approximately $3.0 million of other impairment charges were recorded throughout fiscal year 2002.

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

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

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

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

NAVISITE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(5) Property and Equipment

Property and equipment are stated at cost. Depreciation is computed using the straight-line method over the estimated useful lives of the assets. Leasehold improvements and assets acquired under capital leases are amortized using the straight-line method over the shorter of the lease term or estimated useful life of the asset. Assets acquired under capital leases in which title transfers to us at the end of the agreement are amortized over the useful life of the asset. Expenditures for maintenance and repairs are charged to expense as incurred. Property and equipment at July 31, 2004 and 2003 are summarized as follows:

	July 31,	
	2004	2003
	(In thousands)	
Office furniture and equipment	$ 3,625	$ 2,613
Computer equipment	35,117	28,368
Software licenses	10,405	9,308
Leasehold improvements	10,245	12,549
	59,392	52,838
Less: Accumulated depreciation and amortization	(38,598)	(30,673)
Property and equipment, net	$ 20,794	$ 22,165

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

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

	July 31,	
	2004	2003
	(In thousands)	
Cost	$ 6,797	$ 6,349
Accumulated depreciation and amortization	(4,644)	(2,181)
	$ 2,153	$ 4,168

(6) Intangible Assets

Intangible assets consist of customer lists resulting from our acquisitions of Avasta, Interliant and Surebridge and the as if poolings of CBTM and CBT. The gross carrying amount and accumulated amortization as of July 31, 2004 and 2003 for customer lists are as follows:

July 31,

	2004	2003
	(In thousands)	
Gross carrying amount	$31,026	$15,776
Accumulated amortization	7,875	3,724
Customer lists, net	$23,151	$12,052

NAVISITE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Intangible asset amortization expense for the years ended July 31, 2004, 2003 and 2002 aggregated $3.8 million, $2.8 million and $0, respectively. Amortization expense related to intangible assets for the next five years is as follows:

Year Ending July 31,	(In thousands)
2005	$5,630
2006	$5,133
2007	$4,189
2008	$3,292
2009	$2,064

Customer lists are being amortized over estimated useful lives ranging from five to eight years.

(7) Goodwill

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

	Fiscal 2004	Fiscal 2003	Fiscal 2002
		(In thousands)	
Goodwill as of August 1,	$ 3,206	$	$ 394
Goodwill common control merger with CBTM		3,206	
Goodwill acquired	42,714		
Goodwill amortization			(208)
Goodwill impairment			(186)
Goodwill as of July 31,	$45,920	$3,206	$

We perform our annual impairment analysis in our fiscal fourth quarter. No goodwill impairment has been recorded during fiscal year 2004 or 2003. As part of our impairment analysis performed at July 31, 2002, it was determined that the unamortized goodwill at July 31, 2002 of $186,000 was fully impaired and was included in the accompanying consolidated statements of operations as a component of general and administrative expense.

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

	2004	2003	2002
		(In thousands)	
Net loss	$(21,354)	$(73,627)	$(121,693)
Add back: goodwill amortization expense, net of tax			208
Adjusted net loss available to common stockholders	$(21,354)	$(73,627)	$(121,485)
Basic and diluted earnings per share:			
Net loss	$ (0.85)	$ (6.32)	$ (22.30)

Goodwill amortization expense, net of tax			0.05
Adjusted net loss	$ (0.85)	$ (6.32)	$ (22.25)

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(8) Acquisitions

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

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

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

Avasta, Inc. On February 5, 2003, we acquired Avasta, a provider of remote hosting and managed service operations in an all-stock transaction valued at approximately $370,000. The acquisition was made to enhance our ability to be a full service provider of applications management services and technology to our customers. The purchase price consisted of 231,039 shares of common stock at a per share value of $1.60. The purchase price of $442,000 consists of the issuance of common stock for approximately $370,000 and approximately $72,000 in acquisition costs. The Agreement and Plan of Merger provided that up to an additional 1,004,518 shares of common stock could be issued in the event certain revenue targets are achieved through June 2003. As a result of the earnout calculation, in September 2003, we issued 179,353 shares of our common stock at a per share value of $4.14. During the third quarter of 2004, we finalized our purchase accounting for this acquisition, which resulted in the reclassification from leasehold improvements to an intangible asset allocated to customer lists in the amount of approximately $1.5 million, which is being amortized over the remaining four years.

Subsequent to our fiscal 2004 year end, and pursuant to an arbitration decision (see Note 12(b)) whereby the arbitrator found that we breached our obligations under the Agreement and Plan of Merger and ordered us to issue to the former Avasta shareholders, or their designee, an aggregate of 321,880 shares of our common stock and reimburse related attorneys fees, costs and disbursements, we have recorded, as of July 31, 2004, approximately $2.4 million related to this arbitration decision in general and administrative expense.

Conxion Corporation. On April 2, 2003, we completed the acquisition of Conxion, a provider of software distribution services and network/server security expertise for its customers, pursuant to an Agreement and Plan of Merger, dated as of March 26, 2003 (Conxion Agreement), by and between us, Union Acquisition Corp., a Delaware corporation and our wholly-owned subsidiary and Conxion. Pursuant to the Conxion Agreement, the shareholders of Conxion received an aggregate of $1.9 million in cash. The acquisition was made to enhance our ability to be a full service provider of applications management services and technology to our customers. The source of funds used for the acquisition of Conxion was our

NAVISITE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

cash on hand. The acquisition price was based on the parties determination of the fair value of Conxion and the terms of the Conxion Agreement were derived from arms-length negotiation among the parties. The purchase price of $2.0 million consisted of the $1.9 million paid to the Conxion shareholders and approximately $106,000 in acquisition costs. The negative goodwill of approximately $2.2 million reduced the recorded basis of property and equipment. This acquisition was accounted for using the purchase method of accounting.

Interliant. On May 16, 2003, we completed the acquisition of substantially all of the assets relating to the managed infrastructure solutions business, encompassing messaging and collaboration, managed hosting, bundled-in managed security, and integrated and related professional services in the United States and in Europe of Interliant, Inc., a Delaware corporation, and several of its subsidiaries (Debtors) in the bankruptcy proceedings of the Debtors under Chapter 11 of Title 11 of the United States Bankruptcy Code pending in the Southern District of New York (White Plains), pursuant to an Asset Purchase Agreement, dated as of May 15, 2003 (the Agreement), by and between our subsidiary, Intrepid Acquisition Corp. and the Debtors, approved by order of the Bankruptcy Court on May 15, 2003. Pursuant to the Agreement, the aggregate purchase price for the Interliant assets, excluding certain assumed liabilities, was approximately $7.2 million after adjustments, based upon the Debtors adjusted net worth, comprised of approximately $5.8 million in cash, $0.6 million in the form of a credit of future distributions to be paid on the Interliant Notes, $0.6 million in principal amount of a non-interest bearing, 180-day promissory note, secured by the Interliant Notes and the accounts receivable acquired as part of the Interliant Assets and approximately $0.2 million in acquisition-related costs. On May 16, 2003, we closed on the purchase of all of the Interliant Assets, other than the Debtors accounts receivable. On June 6, 2003, we closed on the purchase of the accounts receivable. The source of funds used for the initial closing was our cash on hand combined with the funds provided from and through financing of our accounts receivable with Silicon Valley Bank (SVB), as discussed below, cash acquired with the Interliant assets, and cash receipts from the purchased accounts receivable. The acquisition price was determined through arms-length negotiations and competitive bidding for the Interliant Assets at an auction conducted under the auspices of the Bankruptcy Court. On March 8, 2004, the court approved an approximate $0.3 million net worth adjustment in favor of Intrepid and we adjusted our purchase accounting to reflect this resolution. In conjunction with this resolution, Intrepid s approximate $0.6 million promissory note in favor of Interliant was satisfied out of the net worth adjustment and the remaining balance of $0.2 million was paid from funds Intrepid had placed in escrow (see Note 11). The acquisition was accounted for under the purchase method of accounting.

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

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

In exchange for these subsidiaries and certain assets and contracts relating to them, we: (i) issued 1.1 million shares of our common stock, to CBT; (ii) released CBT from certain inter-company advances

NAVISITE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

in an amount up to $300,000; (iii) assumed all of CBT s obligations under certain assets and contracts relating to these subsidiaries; and (iv) released CBT from certain payment obligations owed to us pursuant to the Outsourcing Agreement in an amount not to exceed $263,000.

As Atlantic Investors, LLC had a controlling interest in both NaviSite and CBT at the time of the CBT Agreement, the transaction was accounted for as a combination of entities under common control (i.e., as if pooling) whereby the assets and liabilities of CBT and NaviSite were combined at their historical amounts. Accordingly, the Company s consolidated financial statements have been restated for all periods prior to the business combination to include CBT s financial results beginning on September 11, 2002, the date on which CBT acquired the controlling interest in the Company.

On April 14, 2004, pursuant to the Amendment, NaviSite exercised its right to acquire from CBT all of the outstanding shares of the Deferred Entities, for no additional consideration.

Surebridge. On June 10, 2004, we completed the acquisition of substantially all of the assets and liabilities of Surebridge, Inc., or Surebridge, a privately held provider of managed application services for mid-market companies, in exchange for two promissory notes (see Note 11) in the aggregate principal amount of approximately $39.3 million, three million shares of our common stock and the assumption of certain liabilities of Surebridge at closing. The primary reasons for the acquisition included the addition of service offerings, specific contractual relationships with PeopleSoft and Microsoft, and established contractual revenue base, as well as potential operational savings. As the primary reasons for the acquisition were not related to the tangible net assets of Surebridge, the purchase price was significantly in excess of the fair value of the net assets acquired. The acquisition was accounted for under the purchase method of accounting. The final purchase accounting is subject to final resolution of the net worth calculation. We have included the financial results of Surebridge in our consolidated financial statements beginning June 10, 2004, the date of acquisition.

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

	Surebridge
	(In thousands)
Accounts receivable	$ 5,201
Other current assets	1,745
Long-term assets	560
Property and equipment	5,725
Goodwill	42,714
Customer lists	14,000
Total assets acquired	69,945
Accounts payable and accrued expenses	9,030
Other current liabilities	6,496
Long-term liabilities	1,002
Total liabilities assumed	16,528
Net assets acquired	$53,417

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following unaudited pro forma results for the years ended July 31, 2004, 2003 and 2002 give effect to our 2004 acquisition of Surebridge as if it had taken place at the beginning of fiscal year 2003 and our 2003 acquisitions of Avasta, Conxion, Interliant and common control mergers of CBTM and CBT as if they had taken place at the beginning of fiscal year 2002. The pro forma information does not necessarily reflect the results of operations that would have occurred had the acquisitions taken place at the beginning of the fiscal periods indicated and is not necessarily indicative of results that may be obtained in the future:

	Year Ended July 31,		
	2004	2003	2002
	Pro Forma (Unaudited)		
	(In thousands, except for per share amounts)		
Revenue	$ 129,764	$ 147,802	$ 197,726
Net loss	$ (27,481)	$ (98,520)	$ (286,962)
Net loss per share	$ (0.99)	$ (6.72)	$ (52.59)

(9) Investment in Debt Securities

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

On May 16, 2003, the Bankruptcy Court confirmed us as the successful bidder for the purchase of the Interliant Assets (see Note 8). We used $624,000 of the first projected distributions to be made on our Interliant Notes as partial payment for the assets acquired. As such, we have reduced the carrying value of the Interliant Notes by this amount. On September 30, 2004, the Third Amended Plan of Liquidation of Interliant and its affiliated debtors became effective. The final amount and timing of distributions we will receive on our Interliant Notes has not been determined. It may be greater or less than the remaining carrying value, however, we have estimated the value to approximate the $1.4 million carrying value included in other assets on our Consolidated Balance Sheet.

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(10) Accrued Expenses

Accrued expenses consist of the following:

	July 31,	
	2004	2003
	(In thousands)	
Accrued payroll, benefits and commissions	$ 6,580	$ 3,088
Accrued legal	3,098	551
Accrued accounts payable	2,727	3,694
Due to AppliedTheory Estate	1,464	1,461
Accrued interest	659	351
Accrued contract termination fees	984	2,096
Accrued other	3,378	3,803
	$ 18,890	$ 15,044

(11) Debt

Debt consists of the following:

	July 31,	
	2004	2003
Accounts receivable financing line, net	$ 20,240	$ 6,358
Notes payable to Atlantic Investors	3,000	3,000
Note to the AppliedTheory Estate	6,000	6,000
Notes payable to landlord	1,908	
Convertible notes payable to Surebridge	39,267	
Notes payable to the Interliant Estate		550
Other notes payable		661
Total	$ 70,415	$ 16,569
Less current portion	24,791	10,569
Long-term debt	45,624	6,000

(a) Silicon Valley Bank Financing Arrangements

On May 27, 2003, we entered into an Accounts Receivable Financing Agreement (Financing Agreement), by and among Silicon Valley Bank (SVB), us and our wholly owned subsidiaries, ClearBlue Technologies Management, Inc., Avasta, Inc., Conxion Corporation and Intrepid Acquisition Corp., whereby we can finance up to a maximum of $12.5 million of our eligible accounts receivables with an 80% advance rate.

Under the Financing Agreement, we are required to repay advances upon the earlier of our receipt of payment on the financed accounts receivables from our customers, or the financed accounts receivable being aged greater than ninety days from date of service. The Financing Agreement has a one-year term and bears an annual interest rate of prime rate plus 4.0%, with a minimum $10,000 monthly finance charge. The Financing Agreement also contains certain affirmative and negative covenants and is secured by substantially all of our assets, tangible and intangible. As part of the Financing Agreement, on May 27, 2003 we issued to SVB a warrant to purchase up to 165,000 shares of NaviSite common stock with an exercise price of $2.50 per share, the closing price of our stock on the last business day before the issuance of the warrant. We fair valued the warrants at $370,000 using the Black-Scholes option-pricing model. The value of the warrants was amortized into interest expense over the one-year term of the

NAVISITE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Financing Agreement. Under the conversion rights of the warrant, on May 19, 2004, SVB exercised its warrant to purchase 165,000 shares of our common stock, which resulted in a net issuance of 73,738 shares.

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

On April 29, 2004, we entered into a Second Loan Modification Agreement with SVB. The agreement amended our account receivable financing agreement, with SVB to, among other things: (i) increase our maximum borrowing level from $12.8 million to $20.4 million; and (ii) extend the term until April 29, 2006. On July 31, 2004, we had an outstanding balance under the amended agreement of $20.4 million.

Under the amended agreement, borrowings are based on monthly recurring revenue. We are required to prepare and deliver a written request for an advance of up to three times the value of total recurring monthly revenue, calculated to be monthly revenue (including revenue from The New York State Department of Labor) less professional services revenue. SVB may then provide an advance of 85% of such value (or such other percentage as the bank may determine). The interest rate under the amended agreement is variable and is currently calculated at the bank s published prime rate plus 4.0%. Following the completion of certain equity or debt financings, and provided we continue to meet certain ratios under the amended agreement, the interest rate shall be reduced to the bank s prime rate plus 1.0%. In no event, however, will the bank s prime rate be less than 4.25%. The accounts receivable financing line at July 31, 2004 and 2003 is reported net of the remaining value ascribed to the related warrants of $0.2 million and $0.3 million, respectively.

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

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

NAVISITE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

On January 16, 2004, the Atlantic Loan was amended to extend any and all Credit Advances under the Atlantic Loan made prior to, or following, January 16, 2004, to be due on or before the earlier of (i) August 1, 2004 or (ii) five (5) business days following the closing of a financing transaction or disposition pursuant to which the Borrower receives gross proceeds of $13.0 million. On July 13, 2004, the Atlantic Loan was amended to extend any and all Credit Advances under the Atlantic Loan made prior to, or following, July 13, 2004, to be due on or before the earlier of (i) November 1, 2004 or (ii) five (5) business days following the closing of a financing transaction or disposition pursuant to which the Borrower receives net proceeds of $13.0 million after satisfying the mandatory prepayment obligation under those certain Notes due to Surebridge, Inc. On October 12, 2004, the Atlantic Loan was amended to extend any and all Credit Advances under the Atlantic Loan made prior to, or following, October 12, 2004, to be due on or before the earlier of (i) February 1, 2005 or (ii) five (5) business days following the closing of a financing transaction or disposition pursuant to which the Borrower receives net proceeds of $13.0 million after satisfying the mandatory prepayment obligation under those certain Notes due to Surebridge, Inc.

(c) Note Payable to the AppliedTheory Estate

As part of CBTM s acquisition of certain AppliedTheory assets, CBTM entered into two unsecured promissory notes totaling $6.0 million (Estate Liability) due to the AppliedTheory Estate on June 10, 2006. The Estate Liability bears interest at 8% per annum, which is due and payable annually. At July 31, 2004, we had approximately $80,000 in accrued interest related to this note, which is reflected within accrued expenses on our Consolidated Balance Sheet.

(d) Notes Payable to the Interliant Estate

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

(e) Notes Payable to Landlord

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

In addition, during fiscal year 2004, we paid $120,000 and we entered into a separate $150,000 note (Second Landlord Note) with the landlord for additional leasehold improvements to facilitate a subleasing transaction involving a specific section of the 400 Minuteman location. The Second Landlord Note bears

NAVISITE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

interest at an annual rate of 11% and calls for 36 equal monthly payments of principal and interest, with the final payment due on March 1, 2007.

(f) Notes Payable to Surebridge

On June 10, 2004, in connection with our acquisition of the Surebridge business, we issued two convertible promissory notes in the aggregate principal amount of approximately $39.3 million. Interest shall accrue on the unpaid balance of the notes at the annual rate of 10%, provided that if an event of default shall occur and be continuing, the interest rate shall be 15%. Notwithstanding the foregoing, no interest shall accrue or be payable on any principal amounts repaid on or prior to the nine-month anniversary of the issuance date of the notes. We must repay the outstanding principal of the notes with all interest accrued thereon, no later than June 10, 2006. In addition, if at any time during the first six months after the date of issuance of the notes we complete certain equity or debt financings, including our proposed public offering, we are obligated to use a significant portion of the proceeds to make payments on the notes, depending on the total net proceeds received by us in the financing. If we receive net proceeds of less than $20.0 million in a debt or equity financing, then we would be obligated to make a payment on the notes equal to 75% of the net proceeds. If we receive net proceeds of between $20.0 million and $30.0 million, then we would be obligated to make a payment on the notes equal to $15.0 million. If we receive net proceeds in excess of $30.0 million, then we would be obligated to make a payment on the notes equal to 50% of the net proceeds. Pursuant to the terms of the acquisition agreement, $0.8 million of the primary note is callable at anytime for a period of one year from June 10, 2004, the date of closing, and is included in Notes payable, current portion on our July 31, 2004 Consolidated Balance Sheet.

In addition, if we realize net proceeds in excess of $1.0 million from certain equity or debt financings or sales of assets at any time after six months from the date the notes were issued, we are obligated to use a significant portion of the proceeds to make payments on the notes, depending on the total payments, if any, made on the notes during the first six months after the notes were issued. If the amount we paid on the notes during the first six months the notes were outstanding is less than $10.0 million, we would be obligated to make a payment on the notes equal to 75% of the net proceeds. If the amount we paid on the notes during the first six months the notes were outstanding was greater than $15.0 million, we would be obligated to make a payment on the notes equal to 50% of the net proceeds. If the amount we paid on the notes during the first six months the notes were outstanding is between $10.0 million and $15.0 million, we would be obligated to make a payment on the notes equal to a percentage between 50% and 75% of the net proceeds received in the financing calculated in accordance with a formula set forth in the notes.

It shall be deemed an event of default under the notes if, among other things, we fail to pay when due any amounts under the notes, if we fail to pay when due or experience an event of default with respect to any debts having an outstanding principal amount of $500,000 or more, if we are delisted from the Nasdaq SmallCap Market, or if we are acquired and the acquiring party does not expressly agree to assume the notes. In addition, certain bankruptcy, reorganization, insolvency, dissolution and receivership actions would be deemed an event of default under the notes. If an event of default under the notes occurs, the holder shall be entitled to declare the notes immediately due and payable in full.

The notes provide that we shall not incur any indebtedness in excess of $20.5 million in the aggregate, unless such indebtedness is unsecured and expressly subordinated to the notes, is otherwise permitted under the notes, or the proceeds are used to make payments on the notes.

Finally, the outstanding principal of and accrued interest on the notes are convertible into shares of NaviSite common stock at a conversion price of $4.642 at the election of the holder:

- at any time following the first anniversary of the closing if the aggregate principal outstanding under the notes at such time is greater than or equal to $20.0 million;

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

at any time following the 18-month anniversary of the closing if the aggregate principal outstanding under the notes at such time is greater than or equal to $10.0 million;

at any time following the second anniversary of the closing; and

at any time following an event of default thereunder.

(12) Commitments and Contingencies

(a) Leases

Abandoned Leased Facilities During fiscal year 2003, we abandoned our administrative space on the second floor of our 400 Minuteman Road, Andover, MA leased location. We continue to maintain and operate our Data Center on the first floor of the building. While we remain obligated under the terms of the lease for the rent and other costs associated with the second floor of the building, we ceased to use the space on January 31, 2003. Therefore, in accordance with SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities, issued in July 2002, we recorded a charge to our earnings in fiscal year 2003 of approximately $5.4 million to recognize the costs of exiting the space. The liability is equal to the total amount of rent and other direct costs for the period of time the second floor of the building was expected to remain unoccupied plus the present value of the amount by which the rent paid by us to the landlord exceeds any rent paid to us by a tenant under the terms of a sublease over the remainder of the initial lease term, which is January 2012. During fiscal year 2004 we amended our existing agreement with the landlord of our 400 Minuteman Road facility. As a result of the amendment $2.2 million of our future payments to the landlord were transferred into a note payable (see Note 11). Additionally we incurred charges totaling approximately $0.7 million related primarily to changes in common area maintenance, property taxes and other estimates in our initial calculation.

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

During the third quarter of fiscal year 2003, in conjunction with the Conxion acquisition, we impaired data center and office leases in Chicago, IL, Herndon, VA, and Amsterdam, as these leases provided no economic benefit to the combined company.

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

During the third quarter of fiscal year 2004, we recorded a $206,000 net impairment charge resulting from the write-off of $300,000 in property and equipment, net of $94,000 in recovery of impairment charges, triggered by the termination and settlement of the abandoned lease at 55 Francisco,

NAVISITE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

San Francisco, CA. Additional net adjustments of $69,000 were during the third quarter of fiscal year 2004 in conjunction with the final purchase accounting for Conxion.

During the fourth quarter of fiscal year 2004, we abandoned administrative office spaces in Houston, TX, San Jose, CA and Syracuse, NY. While we remain obligated under the terms of these leases for the rent and other costs associated with these leases, we made the decision to cease using these spaces during the fourth quarter of fiscal year 2004 and have no foreseeable plans to occupy them in the future. Therefore, in accordance with SFAS No. 146, we recorded a charge to our current earnings in the fourth quarter of fiscal year 2004 of approximately $2.7 million to recognize the costs of exiting these spaces. The liability is equal to the total amount of rent and other direct costs for the period of time the spaces are expected to remain unoccupied plus the present value of the amount by which the rent paid by us to the landlord exceeds any rent paid to us by a tenant under a sublease over the remainder of the lease terms, which expire in October 2008 for Houston, TX, November 2006 for San Jose, CA and December 2007 for Syracuse, NY.

During the fourth quarter of fiscal year 2004, we recorded a $284,000 net impairment charge to cost of revenue triggered by a change in the expected recovery from a sublease arrangement at the abandoned lease in Vienna, VA.

Additionally, the Company recorded a $0.4 million net impairment charge related to its LaJolla, CA and Amsterdam facilities during the fourth quarter of fiscal year 2004. This net charge is primarily due to changes in sublease assumptions for the LaJolla space and the impact of a favorable settlement agreement for the Amsterdam lease.

Also during the fourth quarter of fiscal year 2004, in conjunction with the Surebridge acquisition, we impaired administrative space in office leases in Bedford, NH and two leases in Atlanta, GA as these spaces provided no economic benefit to the combined company.

All impairment expense amounts recorded are included in the caption Impairment, restructuring and other in the accompanying Consolidated Statements of Operations.

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

Lease Abandonment Costs for:	Balance at July 31, 2002	Expense	Transfers/ Reclasses	Purchase Accounting Adjustments	Payments, Less Accretion of Interest	Balance at July 31, 2003
400 Minuteman	$	$5,409	$	$	$(2,069)	$3,340
La Jolla, CA		1,431			(322)	1,109
Chicago, IL				1,332(a)	(240)	1,092
Herndon, VA				368(a)	(61)	307
Amsterdam				164(a)		164
	$	$6,840(b)	$	$1,864	$(2,692)	$6,012

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Details of activity in the lease exit accrual for the year ended July 31, 2004 were as follows:

Lease Abandonment Costs for:	Balance at July 31, 2003	Expense	Transfers/ Reclasses	Purchase Accounting Adjustments	Payments, Less Accretion of Interest	Balance at July 31, 2004
400 Minuteman	$3,340	$ 661	$(2,200)(c)	$	$ (761)	$1,040
La Jolla, CA	1,109	516			(489)	1,136
Chicago, IL	1,092		(48)(d)	100(a)	(222)	922
Herndon, VA	307		(67)(d)	(58)(a)	(182)	
Amsterdam	164	(130)	115(d)	27(a)	(56)	120
Vienna, VA		917			(369)	548
San Francisco, CA		362			(114)	248
Houston, TX		946			(41)	905
Syracuse, NY		453			(95)	358
Syracuse, NY		132			(21)	111
San Jose, CA		1,201			(182)	1,019
Atlanta, GA				247(e)	(17)	230
Atlanta, GA				323(e)	(48)	275
Bedford, NH				340(e)	(201)	139
	$6,012	$5,058(f)	$(2,200)	$979	$(2,798)	$7,051

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

(b) Impairment, restructuring and other totaled $8.9 million for fiscal year 2003, consisting of $6.8 million related to the abandonment of leased facilities and $2.1 million related to the impairment long-lived assets (see Note 4).

(c) Transfer of future payments to landlord into a note payable (see Note 11)

(d) Reclassifications made between the Conxion accrued lease abandonments

(e) Recorded in purchase accounting for the acquisition of Surebridge

(f) Impairment, restructuring and other totaled $6.2 million for fiscal year 2004, consisting of $5.1 million related to the abandonment of leased facilities and $1.1 million related to the impairment long-lived assets (see Note 4).

Minimum annual rental commitments under operating leases and other commitments are as follows as of July 31, 2004:

Description	Total	Less than 1 Year	Year 2	Year 3	Year 4	Year 5	After Year 5
				(In thousands)			
Short/Long-term debt	$ 70,575	$24,951	$45,305	$ 319	$	$	$
Interest on debt(a)	9,591	1,164	8,419	8			
Capital leases	3,551	1,845	1,482	224			
Operating leases	629	558	47	24			
Minimum bandwidth commitments	7,821	3,781	2,569	1,267	204		
Maintenance for hardware/software	1,051	731	160	160			
Property leases(b)	63,880	13,528	11,903	9,520	8,225	6,072	14,632

$157,098	$46,558	$69,885	$11,522	$8,429	$6,072	$14,632

NAVISITE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(a) Amounts do not include interest on the accounts receivable financing line, as interest rate is variable.

(b) Amounts exclude certain common area maintenance and other property charges that are not included within the lease payment.

Total rent expense for property leases was $10.5 million, $11.6 million and $5.2 million for fiscal years ended July 31, 2004, 2003 and 2002, respectively.

With respect to the property lease commitments listed above, certain cash is restricted pursuant to terms of lease agreements with landlords. At July 31, 2004, this restricted cash of $1.8 million on the balance sheet consisted of certificates of deposit and a treasury note and are recorded at cost, which approximates fair value.

(b) Legal Matters

IPO Securities Litigation

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

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

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NAVISITE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

defendants in the offering, including the lead underwriters, had solicited and received excessive and undisclosed commissions from certain investors. The suit seeks unspecified monetary damages and certification of a plaintiff class consisting of all persons who acquired shares of our common stock between October 22, 1999 and June 12, 2001.

Those five cases, along with lawsuits naming more than 300 other issuers and over 50 investment banks which have been sued in substantially similar lawsuits, have been assigned to the Honorable Shira A. Scheindlin (the Court) for all pretrial purposes (the IPO Securities Litigation). On September 6, 2001, the Court entered an order consolidating the five individual cases involving us and designating Werman v. NaviSite, Inc., et al., Civil Action No. 01-CV-5374 as the lead case. A consolidated, amended complaint was filed thereafter on April 19, 2002 (the Class Action Litigation) on behalf of plaintiffs Arvid Brandstrom and Tony Tse against underwriter defendants Robertson Stephens (as successor-in-interest to BancBoston), BancBoston, J.P. Morgan (as successor-in-interest to Hambrecht & Quist), Hambrecht & Quist and First Albany and against us and Messrs. Rosen, Hale and Eisenberg (collectively, the NaviSite Defendants). Plaintiffs uniformly allege that all defendants, including the NaviSite Defendants, violated the federal securities laws (i.e., Sections 11 and 15 of the Securities Act, Sections 10(b) and 20(a) of the Exchange Act and Rule 10b-5) by issuing and selling our common stock pursuant to the October 22, 1999, initial public offering, without disclosing to investors that some of the underwriters of the offering, including the lead underwriters, had solicited and received extensive and undisclosed agreements from certain investors to purchase aftermarket shares at pre-arranged, escalating prices and also to receive additional commissions and/or other compensation from those investors. At this time, plaintiffs have not specified the amount of damages they are seeking in the Class Action Litigation.

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

On June 30, 2003, our Board of Directors considered and authorized us to negotiate a settlement of the pending Class Action Litigation substantially consistent with a memorandum of understanding negotiated among class plaintiffs, the issuer defendants and the insurers for such issuer defendants. Among other contingencies, any such settlement would be subject to approval by the Court. Plaintiffs filed on June 14, 2004, a motion for preliminary approval of the Stipulation And Agreement Of Settlement With Defendant Issuers And Individuals (the Preliminary Approval Motion). As of August 13, 2004, the Preliminary Approval Motion has been fully briefed but the Court has not ruled upon or set a date for oral argument, if any, on the Preliminary Approval Motion. If completed and then approved by the Court, the settlement is expected to be covered by our existing insurance policies and is not expected to have a material effect on our business, financial condition, results of operations or cash flows.

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Joseph Cloonan

On or about September 27, 2002, we received a demand for a wage payment of $850,000 from our former Procurement Director, Joseph Cloonan. We rejected the demand, alleging that Mr. Cloonan s claim is based, among other things, on a potentially fraudulent contract. Mr. Cloonan also claimed $40,300 for allegedly unpaid accrued vacation and bonuses and that he may be statutorily entitled to treble damages and legal fees. On October 11, 2002, NaviSite filed a civil complaint with the Massachusetts Superior Court, Essex County, seeking a declaratory judgment and asserting claims against Mr. Cloonan for civil fraud, misrepresentation, unjust enrichment and breach of duty of loyalty. Mr. Cloonan asserted counter claims against NaviSite seeking the payments set forth in his September 2002 demand. The discovery phase of the case has concluded and the parties may serve dispositive motions through December 2004. We believe Mr. Cloonan s allegations are without merit and intend to vigorously defend them. Due to the inherent uncertainty of litigation, we are not able to predict the possible outcome of this matter and the effect, if any, on our business, financial condition, results of operations or cash flows.

Lighthouse International

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

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

As to the U.S. District Court matter, the exchange of written discovery and the majority of depositions of witnesses have been completed. On June 15, 2004, District Court Judge Pauley determined that both parties could proceed with their respective summary judgment motions. All motion papers were to be submitted by September 20, 2004, with oral argument scheduled for October 15, 2004.

On August 4, 2004, however, upon the application of CBTM, Bankruptcy Court Judge Gerber preliminarily enjoined Lighthouse from asserting claims or counterclaims against CBTM relating to the Lighthouse contract or any assets acquired by CBTM from AppliedTheory pursuant to the sale order, except for the purpose and to the extent necessary to setoff claims brought by CBTM against Lighthouse relating to the Lighthouse contract. As a result, Lighthouse is limited to seeking only those pre- and post- bankruptcy counterclaims that may constitute as set-offs against the claims asserted by CBTM. Subsequent to issuing the injunction order, Bankruptcy Judge Gerber held several conferences urging the parties to submit their dispute to court-ordered mediation. In conjunction with the Bankruptcy Court s request, District Court Judge Pauley ordered a stay of all remaining expert discovery and motion procedures pending the participation and completion of mediation as requested by Bankruptcy Court Judge Gerber. The matter was then transferred to mediation by order of the Courts.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

In September, 2004, the parties selected Harvey A. Stricken, Esq. as mediator to the dispute. On October 6, 2004, the mediation was held with no particular outcome. Mr. Stricken has asked for follow-up discussions with the parties on an individual basis to determine whether continued mediation is warranted.

Pursuant to an October 1, 2004 Order of Judge Pauley, the parties are to advise the District Court of any disposition of the bankruptcy proceedings. A telephone status conference on December 3, 2004 will also be held by Judge Pauley. The stay of expert discovery and motion procedures shall continue until that date. Because of the uncertain outcome of such mediation, we are unable to predict the possible outcome of this matter, if any, on our business, financial condition, results of operations or cash flows.

Avasta Earnout

On October 14, 2003, we received a letter purportedly on behalf of the former stockholders of Avasta, Inc. relating to the issuance of additional shares of common stock pursuant to the earnout calculations pursuant to the Agreement and Plan of Merger and Reorganization dated as of January 29, 2003 among Avasta Acquisition Corp., Avasta and NaviSite. On December 11, 2003, a demand for arbitration before JAMS (formerly known as Judicial Arbitration and Mediation Services) was filed by Convergence Associates, Inc. (Convergence Associates) on behalf of substantially all of the former shareholders of Avasta claiming among other things breach of contract, tortious conduct, fraud and other wrongful conduct. Damages sought included in excess of 782,790 shares of our common stock. On September 30, 2004, the arbitrator issued a decision with respect to the demand for arbitration. The arbitrator found that we breached our obligations under the Agreement and ordered us to issue to the former Avasta shareholders, or their designee, an aggregate of 321,880 shares of our common stock. In addition, the arbitrator determined that, as the prevailing party, Convergence Associates is entitled to recover from us its reasonable attorneys fees, costs and disbursements. On October 11, 2004, Convergence Associates submitted its application for reasonable attorneys fees, costs and disbursements in the range of approximately $750,957 to $957,000. We filed an objection to Convergence Associates proposed fees on October 25, 2004. Convergence Associates has until November 2, 2004 to respond to our objection. When the arbitrator makes the final award of fees, that order, together with the decision issued on September 30, 2004, will constitute the final, non-appealable award of the arbitrator. (See Note 8)

Engage Bankruptcy Trustee Claim

On September 9, 2004, Don Hoy, Craig R. Jalbert and David St. Pierre, as trustees of and on behalf of the Engage, Inc. creditor trust, filed suit against us in the United States Bankruptcy Court in the District of Massachusetts. The suit generally relates to a termination agreement, dated March 7, 2002, we entered into with Engage, Inc. (a company then affiliated with CMGI, Inc.), which terminated a services agreement between us and Engage and required Engage to pay us $3.6 million. Engage made three payments to us under the termination agreement in the aggregate amount of $3.4 million. On June 19, 2003, Engage and five of its wholly owned subsidiaries filed petitions for relief under Chapter 11 of Title 11 of the United States Bankruptcy Code. The suit generally alleges that Engage was insolvent at the time that we entered into the termination agreement with Engage and at the time Engage made the payments to us. Specifically, the suit alleges that (i) the plaintiffs are entitled to avoid and recover $1.0 million paid by Engage to us in the year prior to June 19, 2003 as a preferential transfer, (ii) the plaintiffs are entitled to avoid and recover $3.4 million (which amount includes the $1.0 million payment made prior to June 13, 2003) paid by Engage to us as a fraudulent transfer, and (iii) our acts and omissions relating to the termination agreement and the payments made by Engage to us constitute unfair and deceptive acts or practices in willful and knowing violation of Mass. Gen. Laws ch. 93A. In addition to the foregoing amounts, the plaintiffs are also seeking treble damages, attorneys fees and costs under Mass. Gen. Laws ch. 93A. As this matter is in the initial stage, we are not able to predict the possible outcome of this matter and the effect, if any, on our business, financial condition, results of operations or

NAVISITE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

cash flow, except that we believe we have certain meritorious defenses to the claims asserted in the complaint which we intend to assert vigorously.

(13) Income Taxes

Total income tax expense (benefit) for the periods ending July 31, 2004, July 31, 2003 and July 31, 2002, consisted of the following:

	July 31, 2004			July 31, 2004			July 31, 2004		
	Current	Deferred	Total	Current	Deferred	Total	Current	Deferred	Total
					(In thousands)				
Federal	$	$	$	$(513)	$513	$	$	$	$
Foreign	1		1						
State				153		153			
	$ 1	$	$ 1	$(360)	$513	$153	$	$	$

The actual income tax expense for the periods ending July 31, 2004, July 31, 2003, and July 31, 2002 differs from the expected tax expense for these periods as follows:

	July 31, 2004	July 31, 2004	July 31, 2004
		(In thousands)	
Computed expected tax expense (benefit)	$(7,260)	$(24,981)	$(41,376)
State taxes, net of federal income tax benefit		101	
Losses not benefited	7,261	25,033	41,376
Total	$ 1	$ 153	$

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

	July 31, 2004	July 31, 2004
	(In thousands)	
Deferred tax assets:		
Accruals and reserves	$ 6,422	$ 4,455
Loss carryforwards	30,943	20,709
Depreciation and amortization	25,579	33,134
Total deferred tax assets	$ 62,944	$ 58,298
Less: Valuation allowance	(62,944)	(58,298)
Net deferred tax (assets) liabilities	$	$

Valuation allowance increased by $4.6 million and decreased by $84.2 million for the years ended July 31, 2004 and 2003, respectively. Reported tax benefits related to approximately $0.2 million of the valuation allowance at July 31, 2004 will be recorded as an increase to paid-in capital, if realized, as it related to tax benefits from stock-based compensation.

The Company has recorded a full valuation allowance against its deferred tax assets since management believes that, after considering all the available objective evidence, both positive and negative, historical and prospective, with greater weight given to historical evidence, it is not more likely than not that these assets will be realized.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

As a result of the transaction on September 11, 2002, the Company experienced a change in ownership as defined in Section 382 of the Internal Revenue Code. As a result of the change in ownership, the utilization of its federal and state tax net operating losses generated prior to the transaction is subject to an annual limitation of approximately $1.2 million. As a result of this limitation, the Company expects that a substantial portion of its federal and state net operating loss carryforwards will expire unused.

The Company has net operating loss carryforwards for federal and state tax purposes of approximately $78.4 million, after taking into consideration net operating losses expected to expire unused due to the Section 382 limitation. The federal net operating loss carryforwards will expire from fiscal year 2011 to fiscal year 2024 and the state net operating loss carryforwards will expire from fiscal year 2008 to fiscal year 2024. The utilization of these net operating loss carryforwards may be further limited if the Company experiences additional ownership changes as defined in Section 382 of the Internal Revenue Code.

(14) Stockholders Equity

Issuance of Common Stock

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

We have accounted for the 567,978 shares issued to CBT on December 31, 2002, in connection with the acquisition of CBTM, as a dividend distribution to CBT because CBT and its affiliates were considered to have controlling interest over both CBTM and NaviSite. As a result, we reported an increase to accumulated deficit of $1.3 million, which represents the number of common shares issued at the then current market value of $2.25 per share.

On February 5, 2003, we issued 231,039 shares of our common stock at a per share value of $1.60 in connection with the acquisition of Avasta (see Note 8). In September 2003, we issued 179,353 shares of our common stock at a per share value of $4.14 (representing the market value of our common stock the day preceding the issuance of the additional shares) for the attainment of certain revenue targets in conjunction with the Avasta acquisition.

On August 8, 2003, we issued 1,100,000 shares of our common stock to CBT at a per share value of $2.55 in connection with the acquisition of certain assets of CBT (see Note 8). The issuance of these shares has been accounted for as a dividend distribution because Atlantic Investors, LLC and its affiliates are considered to have controlling interest in both CBT and NaviSite. As a result, we reported a reduction of retained earnings of $2.8 million, which represents the number of common shares issued at the then current market value of $2.55 per share.

During 2003, we had an insufficient number of stock options remaining within our existing shareholder approved stock option plans for grants to our independent Board of Directors and members of management. At our 2003 annual meeting of stockholders, held on December 9, 2003, our stockholders approved our Amended and Restated 2003 Stock Incentive Plan and we granted stock options to members of our independent Board of Directors and certain members of management at that time. These stock options were granted to the independent members of our Board of Directors and management at strike prices similar to the period that the stock options would have been granted had sufficient shareholder approved stock options been available for grant at that time. Because the strike price of these stock options represented a discount from the market value of our stock on the date of grant, we recorded approximately $2.0 million of deferred compensation expense, which will be amortized into compensation expense over the vesting period of the stock options. During the year ended July 31, 2004, the Company reported compensation expense of approximately $473,000 for these options. The remaining unamortized compensation charge of $1.5 million is recorded as deferred compensation, which is a component of stockholders equity.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

As part of the Silicon Valley Bank Financing Agreement, on May 27, 2003 we issued to SVB a warrant to purchase up to 165,000 shares of NaviSite common stock with an exercise price of $2.50 per share, the closing price of our stock on the last business day before the issuance of the warrant. We fair valued the warrants at $370,000 using the Black-Scholes option-pricing model. The value of the warrants was amortized into interest expense over the term of the Financing Agreement. Pursuant to the terms of the warrant, on May 19, 2004, SVB fully exercised its warrant, which resulted in a net issuance of 73,738 shares (see Note 11).

In connection with our amended Silicon Valley Bank Financing Agreement, on January 30, 2004, we issued a warrant to SVB for the purchase of 50,000 shares of common stock at an exercise price of $5.75 per share. We fair valued the warrant at $213,426 using the Black-Scholes option-pricing model. The value of the warrant is being amortized into interest expense over the term of the modified Financing Agreement. The warrant is exercisable at any time on or after September 1, 2004. Pursuant to the terms of a Registration Rights Agreement, dated as of January 30, 2004, we also granted certain registration rights to SVB with respect to the shares of common stock issuable upon exercise of the warrant (see Note 11).

On June 10, 2004, we issued 3,000,000 shares of our common stock at a per share value of $4.55, in connection with the acquisition of certain assets and liabilities of Surebridge (see Note 8).

(15) Stock Option Plans

(a) 1999 Employee Stock Purchase Plan

The 1999 Employee Stock Purchase Plan (the Stock Purchase Plan) was adopted by NaviSite s Board of Directors and Stockholders in October 1999. The Stock Purchase Plan provides for the issuance of a maximum of 16,666 shares of our Common Stock. The Plan allows participants to purchase shares at 85% of the closing price of Common Stock on the first business day of the Plan period or the last business day of the Plan period, whichever closing price is less.

During fiscal year 2004, no additional shares were issued under this plan. We issued a total of 16,657 shares since the plan s inception.

(b) NaviSite 2000 Stock Option Plan

In November 2000, NaviSite s Board of Directors approved the 2000 Stock Option Plan (the Plan). Under the Plan, nonqualified stock options or incentive stock options may be granted to NaviSite s employees, other than those who are also officers or directors, and our consultants and advisors, as defined, up to a maximum number of shares of Common Stock not to exceed 66,666 shares. The board of directors administers this plan, selects the individuals who are eligible to be granted options under the Plan and determines the number of shares and exercise price of each option. Options granted under the Plan have a five-year maximum term and typically vest over a one-year period. On December 9, 2003, the NaviSite Stockholders approved the 2003 Stock Incentive Plan and will grant no additional options under the Plan.

NAVISITE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table reflects stock option activity under the Plan for the years ended July 31, 2004, 2003 and 2002, respectively:

	2004		2003		2002	
	Number of Shares	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price
Options outstanding, beginning of year	4,872	$128.44	16,266	$128.44	32,157	$128.44
Granted						
Exercised						
Cancelled	(1,164)	$128.44	(11,394)	$128.44	(15,891)	$128.44
Options outstanding, end of year	3,708	$128.44	4,872	$128.44	16,266	$128.44
Options exercisable, end of year	3,708		4,872		16,266	
Options available for grant, end of year			61,794		50,400	

(c) NaviSite 1998 Equity Incentive Plan

In December 1998, NaviSite s Board of Directors and Stockholders approved the 1998 Equity Incentive Plan, as amended (the 1998 Plan). The 1998 Plan replaced NaviSite Internet Services Corporation s 1997 Equity Incentive Plan (the 1997 Plan). All options outstanding under the 1997 Plan were cancelled and replaced with an equivalent amount of options issued in accordance with the 1998 Plan. Under the original 1998 Plan, nonqualified stock options or incentive stock options may be granted to NaviSite s or its affiliates employees, directors, and consultants, as defined, up to a maximum number of shares of Common Stock not to exceed 333,333 shares. In August 1999, the Board of Directors approved an increase in the number of shares authorized under the 1998 Plan to 741,628. In December 2000, the Board of Directors approved an additional increase in the number of shares authorized under the 1998 Plan to 1,000,000 shares. The Board of Directors administers this plan, selects the individuals who are eligible to be granted options under the 1998 Plan and determines the number of shares and exercise price of each option. The chief executive officer, upon authority granted by the board of directors, is authorized to approve the grant of options to purchase Common Stock under the 1998 Plan to certain persons. Options are granted at fair market value. Options granted under the 1998 Plan have a five-year maximum term and typically vest over a four year period, with 25% of options granted becoming exercisable one year from the date of grant and the remaining 75% vesting monthly for the next thirty-six (36) months. On December 9, 2003, the NaviSite stockholders approved the 2003 Stock Incentive Plan and will grant no additional options under the 1998 Plan.

NAVISITE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table reflects activity and historical exercise prices of stock options under our 1998 Plan for the three years ended July 31, 2004, 2003 and 2002, respectively:

	2004		2003		2002	
	Number of Shares	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price
Options outstanding, beginning of year	265,969	$66.14	452,801	$149.40	522,560	$276.00
Granted	40,000	$ 3.53	128,164	$ 2.57	268,397	$ 4.65
Exercised	(11,006)	$ 2.44	(1,905)	$ 1.18	(34,901)	$ 1.05
Cancelled	(62,910)	$87.61	(313,091)	$160.79	(303,255)	$256.35
Options outstanding, end of year	232,053	$52.59	265,969	$ 66.14	452,801	$149.40
Options exercisable, end of year	224,005	$54.02	175,555	$ 84.18	131,156	$294.60
Options available for grant, end of year			571,661		386,606	

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Number Outstanding	Weighted Average Exercise Price
$0.01 - 2.55	121,141	8.89	$ 2.55	120,465	$ 2.55
$2.56 - 3.75	40,166	9.15	$ 3.53	35,100	$ 3.53
$3.76 - 3.90	33,626	2.64	$ 3.90	33,626	$ 3.90
$3.91 - 15.47	7,854	1.67	$ 15.04	6,462	$ 15.14
$15.48 - 73.13	8,924	1.58	$ 34.17	8,131	$ 33.94
$73.14 - 182.82	6,127	0.36	$114.38	6,044	$113.72
$182.83 - 671.25	6,255	0.81	$615.24	6,217	$615.71
$671.26 and up	7,960	0.52	$835.33	7,960	$835.33
	232,053			224,005	

(d) NaviSite 2003 Stock Option Plan

On July 10, 2003, the 2003 Stock Incentive Plan (the 2003 Plan) was approved by the Board of Directors and was approved by the NaviSite Stockholders on December 9, 2003. The 2003 Plan provides that stock options or restricted stock awards may be granted to employees, officers, directors, consultants, and advisors or NaviSite (or any present or future parent or subsidiary corporations and any other business venture (including, without limitation, joint venture or limited liability company) in which NaviSite has a controlling interest, as determined by the

Board of Directors of NaviSite). The Board of Directors authorized 2,600,000 shares of Common Stock for issuance under the 2003 Plan. On November 11, 2003, the 2003 Plan was amended to increase the number of available shares from 2,600,000 to 3,800,000. An amendment has been filed to add an additional 3,000,000 shares to the 2003 Plan. This amendment is subject to Stockholder approval. Upon approval of this amendment, there will be 6,800,000 shares authorized under the 2003 Plan.

NAVISITE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

As of July 31, 2004, stock options to purchase 3,492,287 shares of common stock at an average exercise price of $3.85 per share were outstanding under the 2003 Plan. The options are exercisable as to 25% of the original number of shares on the six month anniversary of the optionholder and thereafter in equal amounts monthly over the three year period commencing on the six month anniversary of the optionholder. Options granted under the 2003 Plan have a maximum term of ten years.

The following table reflects activity and historical exercise prices of stock options under the 2003 Plan for the two years ended July 31, 2004, and 2003, respectively:

	2004		2003	
	Number of Shares	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price
Options outstanding, beginning of year	2,189,000	$2.55		$
Granted	1,967,375	$4.92	2,272,000	$2.55
Exercised	(148,079)	$2.55		$
Cancelled	(516,009)	$2.75	(83,000)	$2.55
Options outstanding, end of year	3,492,287	$3.85	2,189,000	$2.55
Options exercisable, end of year	1,340,969	$3.58		$
Options available for grant, end of year	159,634		411,000	

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Number Outstanding	Weighted Average Exercise Price
$0.01 - 2.55	1,835,081	8.92	$2.55	857,414	$2.55
$2.56 - 5.31	390,374	9.50	$4.52	88,448	$4.62
$5.32 - 5.42	1,004,000	9.55	$5.41	300,000	$5.41
$5.43 - 5.69	217,832	9.49	$5.69	73,550	$5.69
$5.70 and up	45,000	9.37	$7.73	21,557	$7.85

	3,492,287	1,340,969

NAVISITE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(e) Other Stock Option Grants

At July 31, 2004, we had 2,665 outstanding stock options issued outside of existing plans to certain directors at an average exercise price of $135.56. These stock options were fully vested on the grant date and have a contractual life of 10 years.

(f) Other Disclosure

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

(16) Related Party Transactions

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

The consolidated financial statements for the three and twelve-month periods ended July 31, 2003 include certain allocations from CMGI for certain general and administrative expenses, such as rent, legal services, insurance, and employee benefits. Allocations are based primarily on headcount. Management believes that the method used to allocate the costs and expenses is reasonable; however, such allocated amounts may or may not necessarily be indicative of what actual expenses would have been incurred had we operated independently of CMGI. As a result of CMGI s sale of its debt and equity interests in us to CBT, the agreement between NaviSite and CMGI whereby CMGI provided certain services to us automatically terminated. CMGI continued to provide certain services to us pursuant to a Transition Services Agreement we entered into with CMGI on November 25, 2002, as we transitioned to service offerings from CBT and other third-party suppliers. This transition agreement concluded during the second quarter of fiscal year 2003 and we have completely severed our administrative ties with CMGI; however, CMGI remains a third-party customer. During the second quarter of fiscal year 2003, we contracted with CBT and other third-party suppliers for these services. We currently rent administrative facilities from CMGI at 800 Federal Street, Andover, Massachusetts.

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

On January 29, 2003, we entered into a $10.0 million Loan and Security Agreement (Atlantic Loan) with Atlantic, a related party. The Atlantic Loan bears an interest rate of 8% per annum. Interest is payable upon demand or, at Atlantic s option, interest may be added to the outstanding balance due to Atlantic by NaviSite. Atlantic may make demand for payment of amounts in excess of the minimum Atlantic Loan amount of $2.0 million (Minimum Loan Amount), with 60 days notice. Atlantic can demand payment of the Minimum Loan Amount with 90 days notice. Under the Atlantic Loan agreement, we can require Atlantic to loan us (1) up to $2.0 million to repay an amount due from CBTM to Unicorn, a related party to NaviSite and Atlantic; (2) $1.0 million for costs associated with our

NAVISITE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

acquisition of Avasta; and (3) up to $500,000 for the post-acquisition working capital needs of Avasta. Atlantic, at its sole and absolute discretion, may advance other amounts to us such that the aggregate amount borrowed by NaviSite does not exceed the maximum loan amount, defined as the lesser of $10.0 million or 65% of our consolidated accounts receivables. At July 31, 2004 and July 31, 2003, we had $3.0 million outstanding under the Atlantic Loan. This amount is shown as a current note payable to related party on our Consolidated Balance Sheet. The Atlantic Loan is secured by all of our receivables, and is subordinate to Silicon Valley Bank. On May 30, 2003 we repaid $2.0 million of the approximate $3.0 million outstanding under the Atlantic Loan and on June 11, 2003, we borrowed $2.0 million under the Atlantic Loan (see Note 9). On January 16, 2004, the Atlantic Loan was amended to extend any and all Credit Advances under the Atlantic Loan made prior to, or following January 16, 2004 to be due on or before the earlier of (i) August 1, 2004 or (ii) five (5) business days following the closing of a financing transaction or disposition pursuant to which the Borrower receives gross proceeds of $13.0 million. On July 13, 2004, the Atlantic Loan was further amended to extend any and all Credit Advances under the Atlantic Loan to be due on or before the earlier of (i) November 1, 2004 or (ii) five (5) business days following the closing of a financing transaction or disposition pursuant to which we receive net proceeds of $13.0 million. On October 12, 2004, the Atlantic Loan was amended to extend any and all Credit Advances under the Atlantic Loan made prior to, or following, October 12, 2004, to be due on or before the earlier of (i) February 1, 2005 or (ii) five (5) business days following the closing of a financing transaction or disposition pursuant to which the Borrower receives net proceeds of $13.0 million after satisfying the mandatory prepayment obligations under those certain Notes due to Surebridge, Inc.

ClearBlue Technologies (UK) Limited Outsourcing Agreement

Beginning April 1, 2004, we entered into an Outsourcing Agreement with ClearBlue Technologies (UK) Limited (ClearBlue) whereby, the Company will provide certain management services as well as manage the day-to-day operations as required by ClearBlue s customers contracts. The Company charges ClearBlue a monthly fee of £4,700, plus 20% of gross profit (gross profit is revenue collected from ClearBlue customers, less the monthly fee), but in the event such calculation is less than $0, 100% of the gross profit shall remain with ClearBlue. During the fiscal year ended July 31, 2004, the Company charged ClearBlue approximately $46,000 under this agreement, which has been included in Revenue, related parties in the Consolidated Statements of Operations. As of July 31, 2004, there are no amounts outstanding under this agreement.

(15) Selected Quarterly Financial Data (Unaudited)

Financial information for interim periods was as follows:

	Fiscal Year Ended July 31, 2004			
	Q1	Q2	Q3	Q4
	(In thousands)			
Revenue	$23,473	$22,329	$20,185	$ 25,185
Gross profit	4,916	5,571	5,968	5,421
Net loss	(3,353)	(3,439)	(3,026)	(11,536)
Net loss per common share(a)	$ (0.14)	$ (0.14)	$ (0.12)	$ (0.43)

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NAVISITE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	Fiscal Year Ended July 31, 2003			
	Q1	Q2	Q3	Q4
	(In thousands)			
Revenue	$ 15,871	$ 18,761	$ 19,620	$ 22,339
Gross profit (loss)	(624)	1,747	2,308	2,379
Net loss	(10,005)	(20,231)	(11,304)	(32,087)
Net loss per common share(a)	$ (1.60)	$ (2.07)	$ (0.88)	$ (1.80)

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

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

ON FINANCIAL STATEMENT SCHEDULE

The Board of Directors and Stockholders

NaviSite, Inc. and Subsidiaries:

Under date of November 1, 2004, we reported on the consolidated balance sheets of NaviSite, Inc. as of July 31, 2004 and 2003 and the related consolidated statements of operations, changes in stockholders equity (deficit), and cash flows for each of the fiscal years in the three-year period ended July 31, 2004, which are included in this Form 10-K. In connection with our audits of the aforementioned consolidated financial statements, we also audited the related consolidated financial statement schedule of Valuation and Qualifying Accounts in this Form 10-K. This financial statement schedule is the responsibility of the Company s management. Our responsibility is to express an opinion on this financial statement schedule based on our audits. In our opinion, such financial statement schedule when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

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

/s/ KPMG LLP

Boston, Massachusetts

November 1, 2004

NaviSite, Inc. and Subsidiaries

Valuation and Qualifying Accounts

	Balance at beginning of year	Additions charged to expense	Other(1)	Deductions from reserve	Balance at end of year
			(In thousands)		
Year ended July 31, 2002:					
Allowance for doubtful accounts	$6,859	$3,490	$	$(9,732)	$ 617
Year ended July 31, 2003:					
Allowance for doubtful accounts	$ 617	$1,778	$3,119	$(3,484)	$2,030
Year ended July 31, 2004:					
Allowance for doubtful accounts	$2,030	$2,568	$	$(2,100)	$2,498

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

INDEPENDENT AUDITORS REPORT

The Board of Directors
NaviSite, Inc.

We have audited the accompanying consolidated balance sheet of Surebridge, Inc. and subsidiaries (the Company) as of December 31, 2003, and the related consolidated statements of operations, stockholders deficit, and cash flows for the year then ended. These consolidated financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Surebridge, Inc. and subsidiaries as of December 31, 2003, and the results of their operations and their cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

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

/s/ KPMG LLP

Providence, Rhode Island

June 10, 2004

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SUREBRIDGE, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

March 31, 2004 (Unaudited) and December 31, 2003

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

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

See accompanying notes to the consolidated financial statements

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SUREBRIDGE, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

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

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

See accompanying notes to the consolidated financial statements

SUREBRIDGE, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF STOCKHOLDERS DEFICIT

Three Months Ended March 31, 2004 (Unaudited) and Year Ended December 31, 2003

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

Net loss (unaudited)								
Balance, March 31, 2004 (unaudited)	10,861,056	$ 108,611	$ 9,486,602	$ (57,194,508)	$	883,612	$ (465,098)	$ (48,064,393)

See accompanying notes to the consolidated financial statements

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SUREBRIDGE, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

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

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

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

See accompanying notes to the consolidated financial statements

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SUREBRIDGE, INC. AND SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(1) Organization, Acquisition and Basis of Presentation

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

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

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

(2) Summary of Significant Accounting Policies

(a) Basis of Consolidation

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

(b) Use of Estimates

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

(c) Cash and Cash Equivalents and Restricted Cash

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

(d) Financial Instruments and Concentration of Credit Risk

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

SUREBRIDGE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

(e) Property and Equipment

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

(f) Impairment of Long-Lived Assets

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

(g) Goodwill and Other Intangible Assets

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

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

(h) Revenue Recognition

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

Information Technology Consulting and Software Implementation Services

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

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SUREBRIDGE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

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

Application Management and Hosting Services

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

Software Revenue

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

Maintenance Contracts

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

(i) Income Taxes

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

(j) Stock-Based Compensation

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

SUREBRIDGE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

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

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

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

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

(k) Guarantees and Indemnification Obligations

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

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

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

(I) Recent Accounting Pronouncements

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

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SUREBRIDGE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

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

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

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

SUREBRIDGE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

(3) Acquisitions

Transchannel, Inc.

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

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

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

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

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

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

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

ManagedOps.com, Inc.

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

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

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

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

SUREBRIDGE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

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

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

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

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

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SUREBRIDGE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(4) Property and Equipment

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

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

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

(5) Goodwill and Other Intangible Assets

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

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

SUREBRIDGE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

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

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

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

(6) Accrued Expenses and Other Current Liabilities

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

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

	$ 1,943,324	$ 3,006,547

(7) Commitments & Contingencies

Leases

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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