NAVISITE INC
Form 10-Q
December 14, 2005

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549
Form 10-Q

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

For the quarterly period ended October 31, 2005

Or

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

For the transition period from to

Commission file number: 000-27597

NaviSite, Inc.
(Exact name of registrant as specified in its charter)

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

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

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

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes o No þ

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

As of December 9, 2005, there were 28,487,260 shares outstanding of the registrant s common stock, par value $.01 per share.

NAVISITE, INC.
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FOR THE QUARTER ENDED OCTOBER 31, 2005

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PART I: FINANCIAL INFORMATION

Item 1. Financial Statements

NAVISITE, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited)
(In thousands, except par value)

	October 31, 2005	July 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 1,830	$ 6,816
Accounts receivable, less allowance for doubtful accounts of $2,816 and $2,887 at October 31, 2005 and July 31, 2005, respectively	11,164	10,688
Unbilled accounts receivable	533	363
Due from related party	92	101
Prepaid expenses and other current assets	2,618	2,806
Total current assets	16,237	20,774
Property and equipment, net	15,624	15,199
Customer lists, less accumulated amortization of $14,465 and $13,228 at October 31, 2005 and July 31, 2005, respectively	15,326	16,563
Goodwill	43,159	43,159
Other assets	4,395	4,383
Restricted cash	1,099	1,099
Total assets	$ 95,840	$ 101,177
LIABILITIES AND STOCKHOLDERS EQUITY (DEFICIT)		
Current liabilities:		
Accounts receivable financing line, net	$ 20,373	$ 20,347
Notes payable, current portion	1,356	1,145
Notes payable to the AppliedTheory Estate	6,000	6,000
Note payable to related party	3,000	3,000
Convertible notes payable to Waythere (formerly Surebridge)	34,611	35,361
Capital lease obligations, current portion	1,881	1,259
Accounts payable	7,089	8,122
Accrued expenses and other current liabilities	18,832	20,794
Deferred revenue, deferred other income and customer deposits	2,495	2,306
Total current liabilities	95,637	98,334
Capital lease obligations, less current portion	1,059	1,105
Accrued lease abandonment costs, less current portion	1,115	1,359
Deferred tax liability	1,631	1,338
Other long-term liabilities	1,292	1,304
Note payable, less current portion	158	409

Total liabilities	100,892	103,849
Commitments and contingencies (Note 11)		
Stockholders equity (deficit):		
Preferred stock, $0.01 par value; Authorized 5,000 shares; Issued and outstanding: no shares at October 31, 2005 and July 31, 2005		
Common stock, $0.01 par value; Authorized 395,000 shares; Issued and outstanding: 28,487 at October 31, 2005 and 28,487 at July 31, 2005	285	285
Deferred compensation		(633)
Accumulated other comprehensive income	159	156
Additional paid-in capital	453,912	453,458
Accumulated deficit	(459,408)	(455,938)
Total stockholders equity (deficit)	(5,052)	(2,672)
Total liabilities and stockholders equity (deficit)	$ 95,840	$ 101,177

See accompanying notes to condensed consolidated financial statements.

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NAVISITE, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)
(In thousands, except per share amounts)

	Three Months Ended	
	October 31, 2005	October 31, 2004
Revenue	$ 25,410	$ 28,861
Revenue, related parties	30	33
Total revenue	25,440	28,894
Cost of revenue (includes stock-based compensation expense under SFAS 123R of $250 for Q1 FY 06; $0 for Q1 FY 05)	17,677	22,820
Gross profit	7,763	6,074
Operating expenses:		
Selling and marketing (includes stock-based compensation expense under SFAS 123R of $79 for Q1 FY 06; $0 for Q1 FY 05)	3,249	3,173
General and administrative (includes stock-based compensation expense under SFAS 123R of $758 for Q1 FY 06; $0 for Q1 FY 05)	5,885	6,635
Impairment, restructuring and other		1,032
Total operating expenses	9,134	10,840
Loss from operations	(1,371)	(4,766)
Other income (expense):		
Interest income	28	13
Interest expense	(1,977)	(1,898)
Other income, net	143	75
Loss before income tax expense	(3,177)	(6,576)
Income tax expense	293	
Net loss	$ (3,470)	$ (6,576)
Basic and diluted net loss per common share	$ (0.12)	$ (0.24)
Basic and diluted weighted average number of common shares outstanding	28,481	27,927

See accompanying notes to condensed consolidated financial statements.

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NAVISITE, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)
(In thousands)

	Three Months Ended	
	October 31, 2005	October 31, 2004
Cash flows from operating activities:		
Net loss	$ (3,470)	$ (6,576)
Adjustments to reconcile net loss to net cash used for operating activities:		
Depreciation and amortization	3,078	3,764
Impairment of long-lived assets related to abandoned leases		330
Gain on disposal of assets		(13)
Costs associated with abandoned leases		702
Amortization of warrants	26	27
Non-cash stock compensation	1,087	184
Provision for bad debts	291	646
Deferred income tax expense	293	
Changes in operating assets and liabilities, net of impact of acquisitions:		
Accounts receivable	(767)	(298)
Unbilled accounts receivable	(170)	444
Due from related party	9	2
Prepaid expenses and other current assets	(384)	48
Long-term assets	(12)	127
Accounts payable	(1,034)	2,309
Long-term liabilities	(12)	1,401
Accrued expenses, deferred revenue, deferred other income, lease abandonment and customer deposits	(1,441)	(3,841)
Net cash used for operating activities	(2,506)	(744)
Cash flows from investing activities:		
Purchase of property and equipment	(1,207)	(1,439)
Proceeds from the sale of equipment		20
Net cash used for investing activities	(1,207)	(1,419)
Cash flows from financing activities:		
Restricted cash		110
Proceeds from exercise of stock options		11
Proceeds from notes payable	342	405
Repayment of notes payable	(1,132)	(237)
Net borrowings under accounts receivable line		
Payments under note to affiliates		
Payments on capital lease obligations	(483)	(297)

Net cash used for financing activities		(1,273)		(8)
Net decrease in cash		(4,986)		(2,171)
Cash and cash equivalents, beginning of period		6,816		3,195
Cash and cash equivalents, end of period	$	1,830	$	1,024
Supplemental disclosure of cash flow information:				
Cash paid for interest	$	1,325	$	618

See accompanying notes to condensed consolidated financial statements.

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NAVISITE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

(1) Description of Business

NaviSite, Inc. (NaviSite , the Company , we , us or our) provides information technology (IT) hosting, outsourc and professional services for mid- to large-sized organizations. Leveraging our set of technologies and subject matter expertise, we deliver cost-effective, flexible solutions that provide responsive and predictable levels of service for our clients business. Over 900 companies across a variety of industries rely on NaviSite to build, implement and manage their mission-critical systems and applications. NaviSite is a trusted advisor committed to ensuring the long-term success of our customers business applications and technology strategy. NaviSite has 15 state-of-the art data centers and 8 major office locations across the U.S., U.K. and India. Substantially all revenue is generated from customers in the United States.

(2) Summary of Significant Accounting Policies

(a) Basis of Presentation and Principles of Consolidation

The accompanying unaudited condensed consolidated financial statements include the accounts and operations of NaviSite, Inc. and its wholly-owned subsidiaries and have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission regarding interim financial reporting. Accordingly, they do not include all of the information and notes required by U.S. generally accepted accounting principles for complete financial statements and thus should be read in conjunction with the audited consolidated financial statements included in our Annual Report on Form 10-K filed on October 31, 2005. In the opinion of management, the accompanying unaudited condensed consolidated financial statements contain all adjustments, consisting only of those of a normal recurring nature, necessary for a fair presentation of the Company s financial position, results of operations and cash flows at the dates and for the periods indicated. The results of operations for the three months ended October 31, 2005 are not necessarily indicative of the results expected for the remainder of the fiscal year ending July 31, 2006.

All significant intercompany accounts and transactions have been eliminated in consolidation.

The preparation of financial statements in conformity with U.S. generally accepted accounting principles 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 revenue and expenses during the reported period. 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, the collectability of receivables and other assumptions for sublease and lease abandonment reserves.

(b) Revenue Recognition

Revenue consists of monthly fees for Web site and Internet application management, hosting, colocation 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

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NAVISITE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

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.

(c) 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 $1.2 million, including $0.1 million which is classified as short-term and is included in Prepaid expenses and other current assets on the Consolidated Balance Sheet as of October 31, 2005 and July 31, 2005, which primarily represents cash collateral requirements for standby letters of credit associated with several of the Company s facility and equipment leases.

(d) 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.

(e) 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 identifiable 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. If these assumptions differ materially from future results, the Company may record impairment charges in the future.

(f) Financial Instruments and Concentration of Credit Risk

Our financial instruments include cash, accounts receivable, obligations under capital leases, software agreements, notes payable, accounts payable, and accrued expenses. As of October 31, 2005, 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 10% and 8% of our total revenue for the three months ended October 31, 2005 and 2004, respectively. Accounts receivable included approximately $1.7 million due from this third-party customer at October 31, 2005.

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NAVISITE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

(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 adjustment, on the Condensed Consolidated Balance Sheet.

(h) 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.

(i) Stock Based Compensation

In December 2004, FASB issued a Statement, Share-Based Payment, an amendment of FASB Statements Nos. 123 and 95 (SFAS 123R), that addresses the accounting for share-based payment transactions in which a company receives employee services in exchange for either equity instruments of the company or liabilities that are based on the fair value of the company s equity instruments or that may be settled by the issuance of such equity instruments. The statement eliminates the ability to account for share-based compensation transactions using the intrinsic value method and generally requires that such transactions be accounted for using a fair value based method and recognized as expense in the Consolidated Statement of Operations. In March 2005, the SEC issued Staff Accounting Bulletin (SAB) No. 107 regarding the Staff s interpretation of SFAS 123R. This interpretation provides the Staff s views regarding interpretations between SFAS 123R and certain SEC rules and regulations and provides interpretations of the valuation of share-based payments for public companies. The interpretive guidance is intended to assist companies in applying the provisions of SFAS 123R and investors and users of financial statements in analyzing the information provided.

Following the guidance prescribed in SAB 107, on August 1, 2005, NaviSite adopted SFAS 123R using the modified prospective method, and accordingly, we have not restated the consolidated results of income from prior interim periods and fiscal years. Under SFAS 123R, we are required to measure compensation cost for all stock based awards at fair value on date of grant and recognize compensation expense over the service period that the awards are expected to vest. The Company generally grants options under its equity plan that vest as to 25% of the original number of shares on the six month anniversary of the option holder and thereafter in equal monthly amounts over the three year period commencing on the six month anniversary of the option holder.

Prior to the adoption of SFAS 123R, we recognized compensation cost for stock options issued with exercise prices set below market prices on the date of grant. During the quarter ended October 31, 2004, we recognized compensation expense of approximately $184,000 for stock options in our Consolidated Statement of Operations. 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 SFAS 123 to stock based compensation.

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NAVISITE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

	Three Months Ended October 31, 2004 (in thousands, except per share data)
Net loss, as reported	$ (6,576)
Add: Stock based employee compensation expense from the Amended and Restated 2003 Stock Incentive Plan included in reported net loss	184
Deduct: Total stock based employee compensation expense determined under fair value based method for all awards	(1,236)
Net loss, as adjusted	$ (7,628)
Net loss per common share:	
Basic and diluted as reported	$ (0.24)
Basic and diluted as adjusted	$ (0.27)

Upon adoption of SFAS 123R, we recognized the compensation expense associated with awards granted after August 1, 2005 and the unvested portion of previously granted awards that remain outstanding as of August 1, 2005, in our Consolidated Statement of Operations for the first quarter of fiscal year 2006. During the quarter ended, October 31, 2005, we recognized $250,000 in cost of sales compensation expense, $79,000 in sales and marketing compensation expense and $758,000 in general and administrative compensation expense for stock options. Our deferred stock based compensation balance of $633,000 on July 31, 2005, which was accounted for under APB 25, was reclassified into additional paid in capital.

The total remaining unrecognized compensation cost related to nonvested awards is $6.0 million. The weighted average period over which the cost is expected to be recognized is 2.00 years.

Consistent with our valuation method for the disclosure-only provisions of SFAS 123, we are using the Black-Scholes option pricing model to value the compensation expense associated with our stock-based awards under SFAS 123R. In addition, we estimate forfeitures when recognizing compensation expense, and we will adjust our estimate of forfeitures when they are expected to differ. For the quarter ended October 31, 2005, we estimated that 15% of options granted will be forfeited before the first vesting tranche.

The fair value of each stock option grant was estimated on the date of grant using the Black-Scholes option pricing model, assuming no expected dividends and the following weighted average assumptions. The expected volatility is based upon the historical volatility of the Company s stock price.

	Three Months Ended October 31,	
	2005	2004
Risk-free interest rate	4.17%	2.56%
Expected volatility	108.60%	125.48%

Expected life (years)	2.18	2.09
Weighted average fair value of options granted	$ 0.88	$ 1.69

The following table reflects stock option activity under the Company s equity plans for the quarter ending October 31, 2005.

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (years)	Aggregate Intrinsic Value
Options outstanding, beginning of quarter	6,086,655	$3.26		
Granted	648,000	$1.47		
Exercised				
Forfeited or Expired	(474,765)	$3.78		
Options Outstanding, end of quarter	6,259,890	$3.04	8.74	$5,230
Options Exercisable, end of quarter	2,698,341	$3.86	8.18	$ 56

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NAVISITE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

(j) Net Loss Per Share

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

For the three months ended October 31, 2005 and 2004, 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. For the three months ended October 31, 2005, there were 6,250 of dilutive shares related to warrants and employee stock options that were excluded as they have an anti-dilutive effect due to the net loss during this period. There were no dilutive shares excluded for the three months ended October 31, 2004.

(k) Segment Reporting

We currently operate in one segment, managed IT 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.

(l) 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).

(m) Reclassifications

Certain fiscal quarter 2005 balances have been reclassified to conform to the fiscal quarter 2006 financial statement presentation.

(n) Recent Accounting Pronouncements

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections: A Replacement of APB Opinion No. 20 and SFAS No. 3. This statement changes the requirements for the accounting for and reporting of a voluntary change in accounting principle, and also applies to instances when an accounting pronouncement does not include specific transition provisions. The statement replaces the previous requirement that voluntary changes be recognized by including the cumulative effect of the change in net income of the period of the change. The statement requires retrospective application of a new accounting principle to prior periods financial statements, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. The statement is effective for changes and corrections made in fiscal years beginning after December 15, 2005. The Company does not expect the adoption of the statement to have a material effect on its financial condition, results of operations or cash flows.

In March 2005, the FASB issued Interpretation (FIN) No. 47, Accounting for Conditional Asset Retirement Obligations an Interpretation of FASB Statement No. 143. This Interpretation clarifies the timing of liability recognition for legal obligations associated with an asset retirement when the timing and (or) method of settling the obligation are conditional on a future event that may or may not be within the control of the entity. FIN No. 47 is effective no later than the end of fiscal years ending after December 15, 2005. We do not believe the adoption of FIN No. 47 will have a material impact on our consolidated financial statements or results of operations.

NAVISITE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

(3) Liquidity

As of October 31, 2005, 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 $79.4 million, including cash and cash equivalents of $1.8 million at October 31, 2005, as compared to a working capital deficit of $77.6 million, including cash and cash equivalents of $6.8 million, at July 31, 2005.

The total net change in cash and cash equivalents for the three months ended October 31, 2005 was a decrease of $5.0 million. The primary uses of cash during the three months ended October 31, 2005 included $2.5 million of cash used for operating activities, $1.2 million for purchases of property and equipment and approximately $1.6 million in repayments on notes payable and capital lease obligations. Our primary sources of cash during the three months ended October 31, 2005 were $0.3 million in proceeds from a note payable. Net cash used for operating activities of $2.5 million during the three months ended October 31, 2005, resulted primarily from funding our $3.5 million net loss and $3.8 million of net changes in operating assets and liabilities, which was partially offset by non- cash charges of approximately $4.8 million. At October 31, 2005, we had an accumulated deficit of $459.4 million, and have reported losses from operations since incorporation. At July 31, 2005, we had an accumulated deficit of $455.9 million.

Our accounts receivable financing line with Silicon Valley Bank (SVB) allows for maximum borrowing of $20.4 million and expires on April 29, 2006. On October 31, 2005, we had an outstanding balance under the amended agreement of $20.4 million. 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%. The financing agreement also contains certain affirmative and negative covenants and is secured by substantially all of our assets, tangible and intangible. Following the completion of certain equity or debt financings, and provided we continue to meet certain ratios, 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 October 31, 2005 and July 31, 2005 is reported net of the remaining value ascribed to the related warrants of $27,000 and $53,000, respectively.

At October 31, 2005, the Company had $1.2 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 of which $1.1 million is classified as non-current on our balance sheet at October 31, 2005 and July 31, 2005.

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, including closing and integrating strategic acquisitions, making changes to our senior management and bringing costs more in line with projected revenue. We will need to find sources of additional financing, or refinance or restructure our existing indebtedness, in order to remain a going concern. In September 2005, we engaged financial advisors to assist us in refinancing our debt and, while there can be no assurances that we will be successful in our refinancing efforts, we believe we will conclude this process within 90 days from the filing of our first fiscal quarter 10-Q. We are obligated to use a significant portion of any proceeds raised in an equity or debt financing or by sales of assets to make payments on the notes payable to Waythere, Inc. (formerly known as Surebridge, Inc.), depending on the total net proceeds received by us in the financing (see Note 10(e)).

Our operating forecast incorporates growth projections from industry analysts for the markets in which we participate. 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 SVB among other

assumptions, including the improvement in the overall macroeconomic environment. However, there can be no

NAVISITE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

assurance that we will be able to meet such assumptions. Our operating forecast does not depend upon our ability to make additional acquisitions which could be impacted by our current stock price. 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/or 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 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.

(4) Impairment of Long-Lived Assets

The Company recorded no impairment charges during the three months ended October 31, 2005, for property and equipment. For the three months ended October 31, 2004, the Company recorded a $0.3 million impairment charge for property and equipment, consisting primarily of unamortized leasehold improvements related to our 10 Maguire Road facility in Lexington, MA, which we abandoned during the three months ended October 31, 2004. The impairment charge is included in Impairment, restructuring and other in the accompanying Condensed Consolidated Statements of Operations.

(5) Property and Equipment

Property and equipment at October 31, 2005 and July 31, 2005 are summarized as follows:

	October 31, 2005	July 31, 2005
	(In thousands)	
Office furniture and equipment	$ 3,257	$ 3,159
Computer equipment	40,658	38,690
Software licenses	10,759	10,658
Leasehold improvements	9,477	9,369
	64,151	61,876
Less: Accumulated depreciation and amortization	(48,527)	(46,677)
Property and equipment, net	$ 15,624	$ 15,199

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, life of the lease.

Equipment valued at approximately $1.1 million was purchased under capital leases during the three months ended October 31, 2005.

(6) Intangible Assets

The gross carrying amount and accumulated amortization as of October 31, 2005 and July 31, 2005 for customer lists related to prior acquisitions are as follows:

	October 31, 2005	July 31, 2005

	(In thousands)	
Gross carrying amount	$ 29,791	$ 29,791
Less: Accumulated amortization	(14,465)	(13,228)
Customer lists, net	$ 15,326	$ 16,563

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NAVISITE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
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Intangible asset amortization expense for the three months ended October 31, 2005 and 2004 aggregated $1.2 million and $1.4 million, respectively. Customer lists are being amortized over estimated useful lives ranging from five to eight years. The amount reflected in the table below for fiscal year 2006 includes year to date amortization. Amortization expense related to intangible assets for the next five years is as follows: