



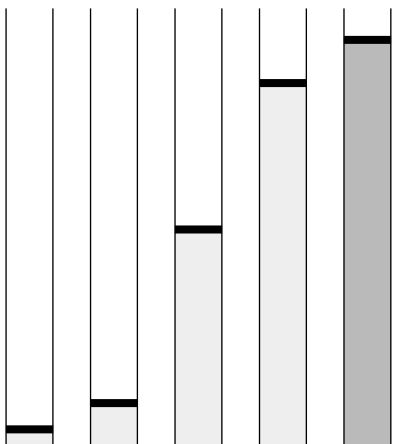
THE INTERNET PERFORMANCE COMPANY

**BUSINESS DESCRIPTION**

Internap delivers mission-critical, Internet-based solutions to business customers throughout the U.S., Europe and Japan. The Company's network-of-network's architecture, patented and patent-pending route management technology, industry-leading Service Level Agreement, and world-class customer service provide our customers with confidence to migrate revenue generating applications to the Internet.

**REVENUE INCREASE 13%**

\$1.957 \$12.520 \$69.613 \$117.404 \$132.487

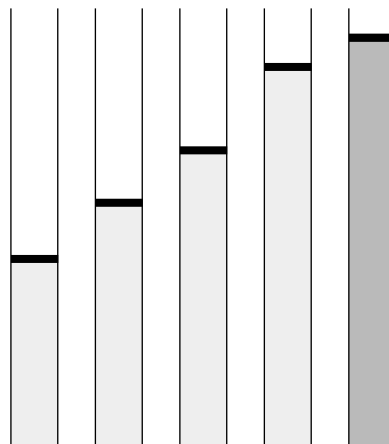


'98 '99 '00 '01 '02

Figures In \$ millions

**DIRECT MARGIN UP 120%**

20% 26% 32% 41% 44%

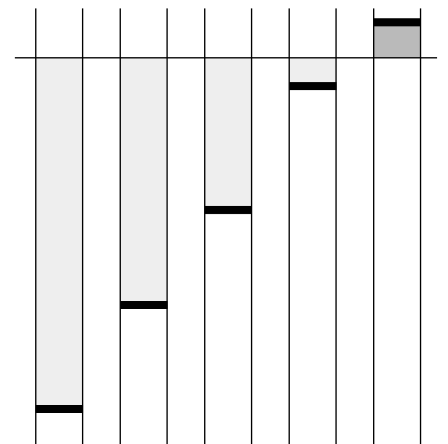


Q401 Q1 Q2 Q3 Q402

Expressed as a percentage

**EBITDA POSITIVE**

\$(13.9) \$(9.8) \$(6.1) \$(1.2) \$1.5



Q401 Q1 Q2 Q3 Q402

EBITDA is defined as earnings before interest, taxes, depreciation and amortization.

Internap guarantees the highest quality of service levels in the industry – enabling the growth of mission-critical, Internet-based applications. Private networks, dedicated facilities, and large operations organizations are rapidly being replaced with cost-efficient Internet Protocol solutions. Internap leads this evolution with carrier-class, Internet-based service for the Financial Services; Entertainment/Media; Travel; Internet Commerce; Government, Education, Healthcare; Legal; and Technology verticals. These industries trust the performance of their applications to Internap.

Selected Internap customers include:

Financial Services	Entertainment/Media	Airlines	Retailers	Technology
Charles Schwab	Fox	United	JCPenney.com	Microsoft
Ameritrade	The New York Times	American	CompUSA	Gateway
Morgan Stanley	The Walt Disney Co.	Delta	Walmart.com	Sun Microsystems
Equifax	Ticketmaster		Recreational Equipment Inc. (REI)	Apple
Union Bank of California				

Internap provides industry leading quality-of-service to these customers and many more. In addition to IP Connectivity, Internap offers a portfolio of performance-based products – Colocation, Managed Security and Storage, VPNs, and Content Distribution Networks. Internap’s unique business model is built on:

- ≡ Multiple Internet pathways providing customers with redundant IP connectivity that assures customers their Internet service will always be available.
- ≡ Proprietary, intelligent, performance-based routing that provides superior performance by getting data to its destination in the fastest, safest, most efficient way.
- ≡ A 100 percent, proactive, Internet-wide Service Level Agreement.
- ≡ Dedicated customer service and support 24 hours a day, 7 days a week, 365 days a year.

**WITH INTERNAP, YOU GET PERFORMANCE. GUARANTEED.**

## WHEN YOU SELL MORE THAN 38 MILLION TICKETS A YEAR ONLINE LIKE TICKETMASTER, YOU MAKE SURE THE LINE MOVES QUICKLY.

The world's largest ticket retailer, Ticketmaster, knows how to keep its online consumers happy. So ticketmaster.com relies on Internap's highly robust, reliable and scalable Internet connectivity. Because when the curtain goes up, nothing's more important to Ticketmaster than making sure its customers get a great seat to see their favorite band, sporting event or theatrical performance.



### BEHIND THE PERFORMANCE

Eric Suddith  
*Director, Service Delivery*

Jackie Barnette  
*Corporate Counsel*

## WITH ITS 'BANK@HOME' ONLINE BANKING SERVICE, UNION BANK OF CALIFORNIA MAKES A LOT OF CENTS.

With 265 branches in California, Washington and Oregon, Union Bank of California knows all about how to manage its money wisely. So when it came to picking an Internet Service Provider for its online banking services, the state's third largest commercial bank wasn't about to take any chances. For UBOC, the choice of Internap for redundant, robust and scalable Internet connectivity was like money in the bank.



### BEHIND THE PERFORMANCE

In Ho Lee  
*Regional Technical Manager*



## REI HAS ALWAYS BEEN AT HOME IN THE GREAT OUTDOORS, BUT THEY WANT CONNECTIVITY THAT NEVER GOES OUT.

Recreational Equipment Inc. (REI) members know they'll find the highest quality gear and clothing for their outdoor adventures at REI.com and REI-OUTLET.com. And when it comes to tracking down the most robust and reliable Internet connectivity, REI isn't about to be lost in the woods – so they use Internap. No one else takes the “adventure” out of networking like Internap.



### BEHIND THE PERFORMANCE

*(starting at top right)*

Amy Cielinski  
*Sales Program Manager*

Mike Orell  
*Product Marketing Manager*

Lucien Ntab  
*Sales Analyst*

## GATEWAY.COM LETS THOUSANDS OF PEOPLE BUILD THEIR OWN COMPUTERS ONLINE, SO EVERYTHING HAS TO CLICK RIGHT ALONG.

Selling \$4 billion a year in custom-built desktop PCs, laptops and network servers is no small task. But thanks to a commitment to quality, performance and innovation, Gateway keeps its assembly lines "moooving." And the company found that same dedication to superior quality when it asked Internap to provide IP services for the company and its Gateway.com website.



### BEHIND THE PERFORMANCE

(left to right)

Tyler West

*Product Marketing Manager*

Smitha Perumal

*HQ Operations Support*

Lucy Seastres

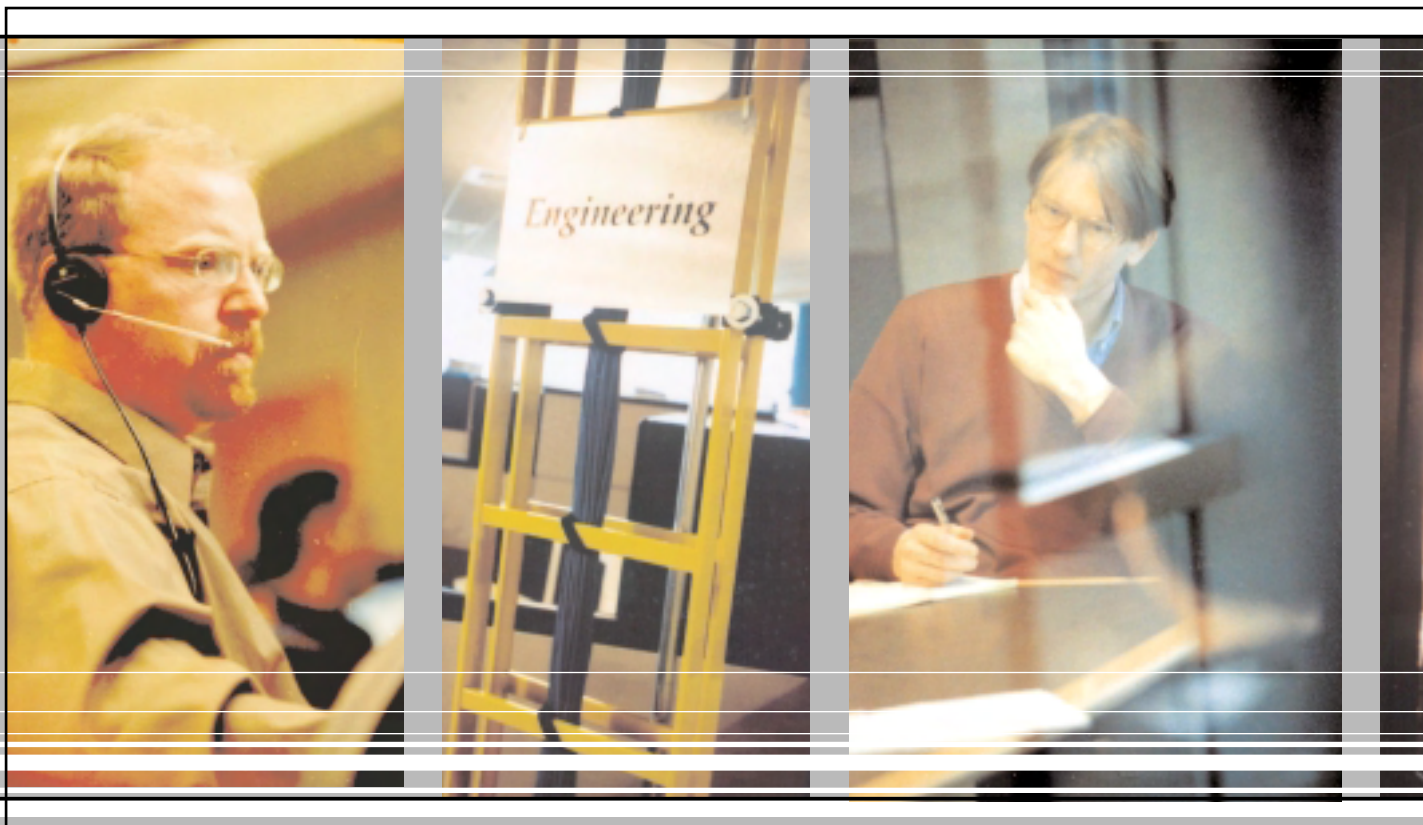
*Network Capacity Planner*



THE INTERNET PERFORMANCE COMPANY

## **OFFERS** MULTIPLE PATHWAYS INSTEAD OF ONE.

The foundation of Internap's IP service model is our network architecture. Internap's Private Network Access Points (PNAPs) are interconnected with the diverse network paths of the major Network Service Providers (NSPs). Since each Service Point is independent, Internap is able to leverage the local and national strengths of all its providers and partners.



THE INTERNET PERFORMANCE COMPANY

## **DELIVERS** INTELLIGENT PERFORMANCE-BASED ROUTING.

Internap's technology leverages a robust and redundant network architecture to introduce a higher level of certainty and reliability into the Internet Protocol services platform. BGP, the protocol traditional Network Service Providers (NSPs) employ to direct routing decisions, does not enable NSPs to deliver the network quality customer applications demand.



The architecture of each PNAP is fully redundant, giving our customers the confidence that there is no single point of failure in our network. Our PNAPs are located in facilities providing redundant power, environmental systems, security, and carrier presence required to support mission-critical applications.

Internap's highly redundant and resilient network architecture, managed through an intelligent routing technology platform, allows Internap to uniquely route manage Internet-based traffic and deliver a truly carrier-class service.



Internap's ASsimilator technology identifies and leverages the unique strengths of each Network Service Provider and avoids performance affecting weaknesses. The result is carrier-class Internet service to support mission-critical needs. ASsimilator constantly monitors network performance (e.g., latency and packet loss) across all major Internet pathways. This performance data, evaluated in conjunction with network costs, available bandwidth, and global BGP routing tables, enables ASsimilator to select the highest performing Internet segments.

NSPs relying on BGP and traditional peering alone are only able to deliver sub-optimal guarantees across their own network. Internap's ASsimilator platform ensures an enterprise receives carrier-class performance across the entire Internet to support its business-critical needs.

THE INTERNET PERFORMANCE COMPANY

**PROVIDES** A 100% GUARANTEE –  
ALL THE INTERNET, ALL THE TIME.

Internap's unique network architecture, intelligent routing technology, and world-class customer service enable Internap to deliver an industry-leading Service Level Agreement (SLA) to our customers.

Internap's SLA guarantees a broad range of service quality commitments and metrics including network availability, packet loss, latency and Domain Name Service (DNS), colocation environmental conditions, and



THE INTERNET PERFORMANCE COMPANY

**PROTECTS** YOUR BUSINESS  
WITH 24-SEVEN-365 CUSTOMER SERVICE.

Internap's business model allows our customers to outsource the challenges of managing the Internet to our team. Internap's expansive geographic footprint, the multiple and diverse network backbone architecture, and advanced route management technology are the platform. The next layer is Internap's Network Operations Centers (NOCs).

data center security. Internap's SLA leads the industry with guarantees of 100 percent network availability; packet loss of less than 0.3 percent; and latency of less than 45 milliseconds. Traditional NSPs' guarantees apply only to traffic that stays on their network. Once traffic exits the NSPs' network, their SLA no longer applies. Internap's SLA not only delivers stronger guarantees on the NSPs' network than they themselves deliver, Internap's SLA covers 100 percent of our customers' traffic across the entire Internet.

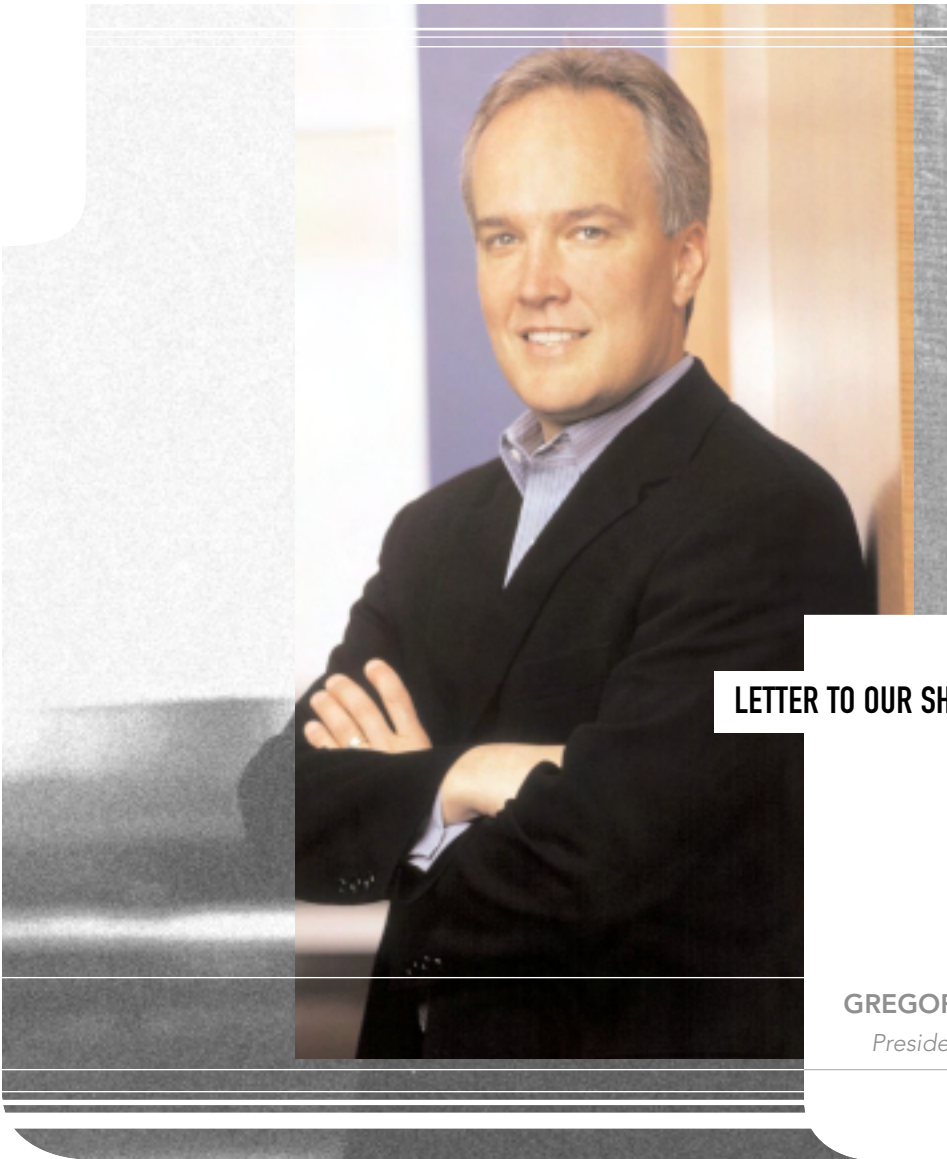
Distinguishing our commitment to quality and customer service even further, Internap's SLA is proactive. This dictates that we constantly monitor ourselves. If Internap fails to meet one of its service commitments, the customer will see credits applied automatically during the next billing cycle.

Internap's SLA defines our commitment to service quality and ensures an enterprise has the certainty they demand in Internap's carrier-class service to place mission-critical applications on the Internet.



Internap's parallel NOCs, located in Atlanta and Seattle, monitor performance of all Internet routes, oversee and route hundreds of millions of transactions per day, and provide world-class customer service for our customers. These advanced facilities are staffed with certified network engineers who proactively resolve quality assurance issues associated with the Internet and the customers' local access. Internap's 1-Tier approach ensures that customers have direct interaction with our engineers to resolve their issues. Our engineers pride themselves on being proactive and notifying clients of critical information, such as upstream provider maintenance windows and network troubles... in real time.

Internap NOC personnel are empowered to diagnose, troubleshoot and remedy any problems – and they are ready to help customers 24 hours a day, seven days a week, 365 days a year.



## LETTER TO OUR SHAREHOLDERS

**GREGORY A. PETERS**

*President & Chief Executive Officer*

Dear Internap Shareholder:

Despite a challenging economic environment worldwide, Internap today is poised for growth with a strong business model precisely positioned at the center of Internet commerce. As I write this letter to you, the Company's restructuring is nearly complete, a new management team is in place, Internap customers are growing, our financial strength is improved, and our long-term prospects are strong.

During 2002, Internap improved on all major financial metrics, while many competitors struggled with declining revenues, shrinking margins and even bankruptcies. Internap achieved these milestones without compromising customer growth, service or technology advancements. This remarkable accomplishment is a credit to the dedication of the Internap team.

Our team embraced many challenges during the year. Operationally, our consolidation included closing a development location in Utah, transferring Amsterdam operations to London, eliminating P-NAP redundancy in many U.S. cities, reducing headcount by over 50 percent, and transitioning headquarters operations from Seattle to Atlanta. These initiatives were implemented during one of the most difficult management periods our industry has ever faced. Our team accepted these challenges and surpassed expectations while growing revenues and increasing profitability.

Revenues for 2002 grew by 13 percent to a record \$132.5 million. The Company reduced its EBITDA loss by a substantial 84 percent to \$15.6 million, compared to an EBITDA loss of \$97.9 million in 2001. The year's net loss, computed in accordance with generally accepted accounting principles, also decreased by 84 percent to \$75.4 million.

What is most important to note is that in the third quarter of 2002, Internap reported that it had turned EBITDA positive ahead of schedule. Moreover, in the fourth quarter, the Company posted a positive EBITDA of \$1.5 million – compared to an EBITDA loss of \$13.9 million in the same quarter of the previous year.

In 2002, Internap raised its total customer base to 1,273, a 31 percent growth year over year. In the fourth quarter alone, Internap installed 118 new customers, including: Con Edison; Screen Actors Guild; government of Orange County, California; Penn State Hershey Medical Center; Toyota Motor Sales, USA; Amgen; and Nextel Communications. Additional customers added during the year include: American Airlines; Compaq; McKinsey & Company; Morningstar, Inc.; Charles Schwab; DHL; Southwest Airlines; Callaway Golf; Sharp Electronics; Ameritrade; eBay; The Franklin Mint; and Continental Airlines.

Our sales and marketing efforts are focused on key vertical markets where mission-critical applications are Internet based. These verticals include: travel, financial services, Internet commerce, media and entertainment, manufacturing, legal, and government and education. We have captured many top accounts in each segment, for example, Internap currently serves five of the nation's eight largest airlines.

Advancements in technology remain a priority at Internap. During 2002, the Company continued to enhance network performance and announced a Service Level Agreement (SLA) that surpasses all in our industry. Internap is the only service provider that guarantees its services Internet-wide, and at service levels that introduce "carrier-class" performance across the Internet. These service level guarantees are the reason that traditional brick-and-mortar companies have confidence to run revenue-producing applications over the Internet. Internap is leading the industry, and the Internet, in this key measurement of service performance.

In recognition of strong performance in 2002, Cisco Capital and Silicon Valley Bank modified existing financial facilities to a structure that enables our strategic growth initiatives; and action was taken by the Board to protect our NASDAQ listing. We appreciate this ongoing support from our strategic partners.

INTERNAP'S <b>KEY PERFORMANCE METRICS</b>		12-MONTH PERIOD ENDED		
		DECEMBER 31,		
FINANCIAL DATA: (In thousands)		2001	2002	% CHANGE
Revenues		\$117,404	\$132,487	<b>13%</b>
Direct Cost of Network		98,915	83,207	<b>(16%)</b>
EBITDA <sup>(1)</sup>		(97,866)	(15,669)	<b>84%</b>
SUPPLEMENTAL FINANCIAL DATA:				
Direct Margin <sup>(2)</sup>		20%	44%	<b>120%</b>
Total Customers		974	1,273	<b>31%</b>
Day Sales Outstanding		45	38	<b>16%</b>
Operating Cash Flow Positive Metro Markets		4	12	<b>200%</b>

(1) EBITDA is defined as net loss before interest, investment income (loss), lease termination expenses, loss on sales and retirement of property and equipment, income taxes, depreciation, amortization, amortization of deferred stock compensation, and restructuring costs and credits. Excludes a one-time benefit of \$2.1 million recorded during 2002.

(2) Direct margin is defined as revenues less direct cost of network divided by revenue.

Highlights of the Company's financial and operational performance in 2002 include:

## **FINANCIAL**

- Achieved 26th sequential quarter of customer growth, increasing customer base 31 percent to 1,273
- Reduced cost of network by 22 percent
- Reduced cash use by 78 percent
- Restructured key lease and credit facilities, eliminating over \$100 million in excess real estate obligations
- Achieved 120 percent improvement in Direct Margin to a record 44 percent, and became operating cash flow positive in 12 metro markets

## **OPERATIONAL**

- Launched 15 new product/service offerings
- Expanded service reach to 15 additional domestic markets and 14 additional countries
- Relocated corporate headquarters from Seattle to Atlanta
- Established parallel Network Operations Centers in Seattle and Atlanta
- Created the industry's first 100 percent Internet-wide network availability Service Level Agreement

These achievements were accomplished during one of the most difficult economic periods we have faced in many years – and now place Internap in an excellent position to once again grow market share and revenues at a time when many competitors in the industry are faltering.

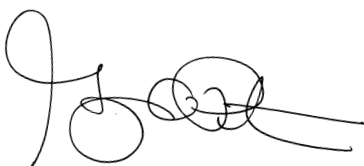
Internap's turnaround is a result of significant work behind the scenes. I'd like to thank our employees, management team and, especially, our customers, who have continued to recognize the inherent value of Internap, and have remained loyal and committed even during an especially trying time. As we move the Company forward, it is important that we pay tribute to each of these key constituencies for their unique contribution.

In particular, I'd like to express my gratitude to the Board of Directors, former Chief Financial Officer John Scanlon, and my predecessor, Chairman Eugene Eidenberg, who guided the Company as CEO from August 2001 until April 2002. I would also like to thank the many former employees who were unable to make the transition to our new corporate headquarters. Your contributions have given Internap the ability to reach its milestones and grow as a profitable business.

2003 will be a year in which we will continue to take market share from competitors; continue to expand our operational footprint, our service offerings and customer base; and participate in the strategic growth of the Internet, as a leader in the Internet services industry. We look forward to expanding our operational margins, improving our ability to lead our customers' transition to Internet-based services, and growing the value of our Company.

To all our shareholders, customers, employees and business partners, thank you for your investment in Internap, your trust and your continued support.

Sincerely,

A handwritten signature in black ink, appearing to read 'Gregory A. Peters', with a stylized, cursive script.

Gregory A. Peters  
President and Chief Executive Officer



## FROM THE CHAIRMAN

Dear Fellow Shareholders:

In 2002, Internap turned the corner in its two-year effort to reduce its cost structure without compromising revenue and market share growth. The program that began in 2001 culminated in the decision this year to relocate the Company's headquarters from Seattle to Atlanta while building the outstanding management team that now leads Internap. This successful transition was nothing less than a re-start of your company.

All this was accomplished during a period of unprecedented challenge for American corporate governance in general and the telecommunications industry in particular. Revelations of shocking irregularities in accounting with resulting declarations of bankruptcy, as well as the continuing weakness of global equity markets, cost shareholders billions of dollars and cast a cloud on the integrity of the leadership of American business.

While Internap has been a public company for less than four years, the Company's governance practices and its system of internal financial controls are fully compliant with the recently adopted Sarbanes-Oxley legislation. I want you to know that your board and management will continually seek to achieve the highest standards of conduct in every aspect of Internap's business.

One unfortunate result of the excesses and malfeasance of several large companies has been criticism of the use of equity as an important element in compensation programs to motivate and reward employees. During this period, which saw Internap's equity value drop significantly, your board has relied on stock options as an important element in the compensation program that helped us retain and recruit the world-class team that leads the Company. Indeed, we are recommending a significant increase in the Company's option pool in order to enable us to continue to retain and attract the talent necessary to achieve the fair return on investment that our shareholders deserve.

With quality leadership, companies can plan and operate for long-term growth while also rewarding good results with equity value for both employees and shareholders. In sum, your board believes that broad employee stock ownership of young and emerging companies is a good thing.

Internap's value proposition and business model have emerged stronger than ever from the prolonged tumult of our industry. Now, as a more focused and efficient business, your company stands on the threshold of significant new opportunities. On behalf of the entire board, I thank you for your continued support of the Company.

Eugene Eidenberg  
Chairman

## INTERNAP 2002 FINANCIAL REVIEW

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## INTERNAP 2002 SELECTED FINANCIAL DATA

The following selected financial data are qualified by reference to, and should be read in conjunction with, our financial statements and the notes thereto and "Management's Discussion and Analysis of Financial Condition and Results of Operations" appearing elsewhere in this annual report. The statement of operations data presented below for the years ended December 31, 2000, 2001 and 2002, and the selected balance sheet data as of December 31, 2001 and 2002 are derived from our audited financial statements included elsewhere in this annual report. The statement of operations data presented below for the years ended December 31, 1998 and 1999, and the selected balance sheet data as of December 31, 1998, 1999 and 2000 are derived from our audited financial statements that are not included in this annual report.

Year Ended December 31,	1998	1999	2000	2001	2002
(in thousands, except per share data)					
Revenues	\$ 1,957	\$ 12,520	\$ 69,613	\$ 117,404	\$132,487
Costs and expenses:					
Direct cost of network	1,990	17,848	62,465	98,915	83,207
Customer support	666	5,796	20,320	21,480	12,913
Product development	754	3,876	11,924	12,233	7,447
Sales and marketing	2,822	17,519	35,390	38,151	21,641
General and administrative	1,734	7,335	32,962	44,491	20,848
Depreciation and amortization	736	4,808	20,522	48,550	49,600
Amortization of goodwill and other intangible assets	-	-	54,334	38,116	5,626
Amortization of deferred stock compensation	205	7,569	10,651	4,217	260
Lease termination expense	-	-	-	-	804
Restructuring cost (benefit)	-	-	-	64,096	(3,781)
Impairment of goodwill and other intangible assets	-	-	-	195,986	-
In-process research and development	-	-	18,000	-	-
Loss on sales and retirements of property and equipment	-	-	-	2,714	2,829
Total operating costs and expenses	8,907	64,751	266,568	568,949	201,394
Loss from operations	(6,950)	(52,231)	(196,955)	(451,545)	(68,907)
Other income (expense):					
Interest income (expense), net	(23)	2,314	11,498	(1,272)	(2,194)
Loss on investments	-	-	-	(26,345)	(1,244)
Total other income (expense)	(23)	2,314	11,498	(27,617)	(3,438)
Net loss	\$(6,973)	\$(49,917)	\$(185,457)	\$(479,162)	\$(72,345)
Basic and diluted net loss per share	\$ (1.04)	\$ (1.31)	\$ (1.30)	\$ (3.19)	\$ (0.47)
Weighted average shares used in computing basic and diluted net loss per share <sup>(1)</sup>	6,673	37,994	142,451	150,328	155,545

As of December 31,	1998	1999	2000	2001	2002
(in thousands)					

### Balance Sheet Data:

Cash, cash equivalents and short-term investments	\$ 275	\$205,352	\$ 153,965	\$ 82,306	\$ 25,219
Total assets	7,487	245,546	650,110	284,977	172,969
Notes payable and capital lease obligations, less current portion	2,342	14,378	27,646	16,448	27,913
Series A convertible preferred stock	-	-	-	86,314	79,790
Total stockholders' equity (deficit)	(436)	210,500	531,953	66,169	1,835

(1) See Note 2 of notes to financial statements for a description of the computation of basic and diluted net loss per share and the number of shares used to compute basic and diluted net loss per share.



### **Overview**

Internap is a leading provider of IP-based connectivity solutions to businesses seeking to maximize the performance of mission-critical Internet-based applications. Customers connected to one of our 34 service points have their data intelligently routed to and from destinations on the Internet using our overlay network, which analyzes the traffic situation on the many networks that comprise the Internet and delivers mission-critical information and communications faster and more reliably. Use of our overlay network results in lower instances of data loss and greater quality of service than services offered by conventional Internet connectivity providers. Our customers are primarily businesses that desire high-performance Internet connectivity services in order to run mission-critical Internet-based applications. Due to our high quality of service, we generally price our services at a premium to providers of conventional Internet connectivity services. We expect to remain a premium provider of high-quality Internet connectivity services and anticipate continuing our pricing policy in the future. We believe customers will continue to demand the highest quality of service, as their Internet connectivity needs grow and become even more complex and, as such, will continue to pay a premium for high-quality service.

The following discussion should be read in conjunction with the consolidated financial statements provided under Part II, Item 8 of this Annual Report on Form 10-K. Certain statements contained herein may constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements involve a number of risks, uncertainties and other factors that could cause actual results to differ materially, as discussed more fully herein.

The forward-looking information set forth in this Annual Report on Form 10-K is as of January 31, 2003, and Internap undertakes no duty to update this information. Should events occur subsequent to January 31, 2003, that make it necessary to update the forward-looking information contained in this Form 10-K, the updated forward-looking information will be filed with the SEC in a Quarterly Report on Form 10-Q or as a press release included as an exhibit to a Form 8-K, each of which will be available via the SEC's Edgar database, available at [www.sec.gov](http://www.sec.gov). More information about potential factors that could affect our business and financial results is included in the section entitled "Risk Factors" in our Form 10-K.

### **Critical Accounting Policies and Estimates**

Our discussion and analysis of the Company's financial condition and results of operations are based upon the consolidated financial statements of Internap Network Services Corporation, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an ongoing basis, we evaluate our estimates, including those related to revenue recognition, doubtful accounts, investments, intangible assets, long-lived assets, income taxes, restructuring costs, long-term service contracts, contingencies and litigation. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ materially from these estimates under different assumptions or conditions.

Management believes the following critical accounting policies affect the judgments and estimates used in the preparation of Internap's consolidated financial statements.

**Customer credit risk.** We review the creditworthiness of our customers routinely. If we determine that collection of service revenues is uncertain, we do not recognize revenue until cash has been collected. Additionally, we maintain allowances for doubtful accounts resulting from the inability of our customers to make required payments on accounts receivable. If the financial condition of our customers were to deteriorate, additional allowances may be required.

Internap has a substantial number of its service points located in facilities of third parties. In many of those arrangements, we do not have property rights similar to those customarily possessed by a lessee or sublessee, but instead have lesser rights of occupancy. In certain situations, the financial condition of those parties providing occupancy to us could have an adverse impact on the continued occupancy arrangement or the level of service delivered to us under such arrangement.

### **Restructuring and Impairment Costs**

**2001 RESTRUCTURING CHARGE.** During fiscal year 2001, due to the decline and uncertainty of the telecommunications market, we announced two separate restructurings of our business. Under the restructuring programs, management decided to exit certain non-strategic real estate lease and license arrangements, consolidate and exit redundant network connections and streamline the operating cost structure. As part of the 2001 restructuring activity, 313 employees were involuntarily terminated. Employee separations occurred in all departments. The majority of the costs related to the termination of employees in 2001 were paid during 2001. The total charges include restructuring costs of \$71.6 million. During fiscal year 2001, we incurred cash restructuring expenditures totaling \$19.9 million and non-cash restructuring expenditures of \$4.7 million. We reduced the original 2001 restructuring charge cost estimate by \$7.7 million primarily as a result of favorable lease obligation settlements, leaving a balance of \$39.3 million as of December 31, 2001. During the first and third quarters of 2002, we further reduced our 2001 restructuring charge liability by \$5.0 million and \$7.2 million, respectively. The first reduction was primarily due to settlements to terminate and restructure certain collocation lease obligations on terms more favorable than our original restructuring estimates. The second reduction was primarily due to the decision to relocate our corporate headquarters to the previously restructured Atlanta, Georgia, facility. Pursuant to the original restructuring plans, we did not anticipate using the Atlanta facility in the future. However, due to changes in management, corporate direction, and other factors, which could not be foreseen at the time of the original restructuring plans, the Atlanta facility was selected as the location for the new corporate headquarters.

**2002 RESTRUCTURING AND ASSET IMPAIRMENT CHARGE.** With the continuing decline and uncertainty of the telecommunications market during 2002, we took additional restructuring actions to align our business with market opportunities. As a result, we recorded a business restructuring charge and asset impairments of \$7.6 million in the three months ended September 30, 2002. The charges were primarily comprised of real estate obligations related to a decision to relocate the corporate headquarters from Seattle, Washington, to an existing leased facility in Atlanta, Georgia, net asset write-downs related to the departure from the Seattle office and costs associated with further personnel reductions. The restructuring and asset impairment charge of \$7.6 million during 2002 was offset by a \$7.2 million adjustment, described above, resulting from the decision to utilize the Atlanta facility as our corporate headquarters. The previously unused space in the Atlanta location had been accrued as part of the restructuring liability established during fiscal year 2001.

Included in the \$7.6 million 2002 restructuring charge are \$1.1 million of personnel costs related to a reduction in force of approximately 145 employees. This represents employee severance payments made during 2002. We expect that there will be additional restructuring costs in the future as additional payments are made to employees who are subject to deferred compensation arrangements payable at the completion of interim employment agreements. We expect these costs to total less than \$1.0 million. Additionally, we continue to evaluate the restructuring reserve as plans are being executed, which could result in additional charges or adjustments.

**Real estate obligations.** Both the 2001 and 2002 restructuring plans require us to abandon certain leased properties not currently in use or that will not be utilized by us in the future. Also included in real estate obligations is the abandonment of certain collocation license obligations. Accordingly, we recorded real estate related restructuring costs of \$40.8 million, net of non-cash plan adjustments, which are estimates of losses in excess of estimated sublease revenues or termination fees to be incurred on these real estate obligations over the remaining lease terms expiring through 2015. These costs were determined based upon our estimate of anticipated sublease rates and time to sublease the facilities. If rental rates decrease in these markets or if it takes longer than expected to sublease these properties, the actual loss could exceed this estimate.

**Network infrastructure obligations.** The changes to our network infrastructure require that we decommission certain network ports we do not currently use and will not use in the future pursuant to the restructuring plan. These costs have been accrued as components of the restructuring charge because they represent amounts to be incurred under contractual obligations in existence at the time the restructuring plan was initiated. These contractual obligations will continue in the future with no economic benefit, or they contain penalties that will be incurred if the obligations are cancelled.

**Asset impairments.** On June 20, 2000, we completed the acquisition of CO Space, which was accounted for under the purchase method of accounting. The purchase price was allocated to net tangible assets and identifiable intangible assets and goodwill.

On February 28, 2001, management and the Board of Directors approved a restructuring plan that included ceasing development of the executed but undeveloped leases and the termination of core collocation development personnel. Consequently, financial projections for the business were lowered and, pursuant to the guidance provided by Financial Accounting Standards Board No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of" ("SFAS 121"), management completed a cash flow analysis of the collocation assets, including the assets acquired from CO Space. The cash flow analysis showed that the estimated cash flows were less than the carrying value of the collocation assets. Accordingly, pursuant to SFAS 121, management estimated the fair value of the collocation assets to be \$79.5 million based upon a discounted future cash flow analysis. As estimated fair value of the collocation assets was less than their recorded amounts, we recorded an impairment charge of approximately \$196.0 million.

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The following table displays the activity and balances for restructuring and asset impairment activity for 2001 (in millions):

	Charge	Cash Reductions	Non-Cash Write-downs	Non-cash Plan Adjustments	December 31, 2001 Reserve
<b>Restructuring costs</b>					
Real estate obligations	\$ 60.0 <sup>(a)</sup>	\$(14.7) <sup>(a)</sup>	\$ (3.7)	\$(7.0)	\$34.6
Employee separations	3.3	(3.2)	–	–	0.1
Network infrastructure obligations	6.3	(1.9)	(1.0)	(0.7)	2.7
Other	2.0	(0.1)	–	–	1.9
Total restructuring costs	71.6	(19.9)	(4.7)	(7.7)	39.3
<b>Asset impairments</b>					
Goodwill	176.1	–	(176.1)	–	–
Assembled workforce	1.5	–	(1.5)	–	–
Trade name and trademarks	2.2	–	(2.2)	–	–
Completed real estate leases	14.8	–	(14.8)	–	–
Customer relationships	1.4	–	(1.4)	–	–
Total asset impairments	196.0	–	(196.0)	–	–
Total	\$267.6	\$(19.9)	\$(200.7)	\$(7.7)	\$39.3

(a)Includes the use of \$6.0 million in restricted cash related to payment of a lease deposit on our corporate office space.

Of the \$71.6 million recorded during 2001 as restructuring reserves, approximately \$50.7 million related to the direct cost of network, \$1.1 million related to customer support, \$0.3 million related to product development, \$1.5 million related to sales and marketing and \$18.0 million related to general and administrative costs.

The following table displays the activity and balances for restructuring and asset impairment activity for 2002 (in millions):

	December 31, 2001 Restructuring Liability	Restructuring and Impairment Charge	Cash Reductions	Non-cash and Write- downs	Non-Cash Plan Adjustments	December 31, 2002 Restructuring Liability
<b>Restructuring costs activity for 2001</b>						
restructuring charge –	\$34.6	\$ –	\$(11.2)	\$(1.6)	\$(12.2)	\$ 9.6
Network infrastructure obligations	2.7	–	(1.4)	–	–	1.3
Other	2.0	–	(0.9)	–	–	1.1
<b>Restructuring costs activity for 2002 restructuring charge –</b>						
Real estate obligations	–	2.2	(0.4)	–	–	1.8
Personnel	–	1.1	(1.1)	–	–	–
Other	–	0.2	(0.1)	–	–	0.1
Total restructuring cost	39.3	3.5	(15.1)	(1.6)	(12.2)	13.9
<b>Net asset write-downs for 2002</b>						
restructuring charge	–	4.1	–	(4.3)	–	(0.2)
Total	\$39.3	\$7.6	\$(15.1)	\$(5.9)	\$(12.2)	\$13.7

Of the \$3.5 million recorded during 2002 as restructuring reserves, approximately \$212,000 related to the direct cost of network and \$3.3 million related to general and administrative costs.

We expect to complete the majority of the restructuring activities related to the 2001 and 2002 restructuring charges during 2003, although certain remaining restructured real estate and network obligations represent long-term contractual obligations that extend beyond 2003.

### **Business Combinations**

On July 31, 2000, we completed our acquisition of VPNX.com. The acquisition was recorded using the purchase method of accounting under APB Opinion No. 16. The aggregate purchase price of the acquired company, plus related charges, was approximately \$87.4 million and was comprised of issuance of our common stock, cash, acquisition costs and assumed options to purchase common stock. We issued approximately 2.0 million shares of common stock and assumed options to purchase VPNX common stock that were subsequently converted into options to purchase approximately 268,000 shares of our common stock to effect the transaction. Results of operations of VPNX have been included in our financial results from the closing date of the acquisition forward.

As a result of the VPNX acquisition, we recorded a total of \$67.9 million of goodwill and other intangible assets. Through December 31, 2001, the goodwill and other intangible assets were amortized to expense over their useful lives, which are estimated to be three years, resulting in an expense of \$9.4 million and \$22.7 million for the years ended December 31, 2000 and 2001 respectively. Internap has a substantial number of its service points in facilities of third parties. In many of those arrangements, we do not have property rights similar to those customarily possessed by a lessee or sublessee, but instead have lesser rights of occupancy. In certain situations, the financial condition of those parties providing occupancy to us could have an adverse impact on the continued occupancy arrangement or the level of service delivered to us under such arrangement. We also recorded an expense of \$18.0 million related to acquired in-process research and development costs for the year ended December 31, 2000. The amount allocated to acquired in-process research and development is related to technology acquired from VPNX that was expensed immediately subsequent to the closing of the acquisition since the technology had not completed the preliminary stages of development, had not commenced application development and did not have alternative future uses. Furthermore the technologies associated with the acquired in-process research and development did not have a proven market and are sufficiently complex so that the probability of completion of a marketable service or product could not be determined. The fair value of the acquired in-process research and development was determined using the income approach, which estimates the expected cash flows from projects once commercially viable and discounts expected future cash flows to present value. The percentage of completion for each project was determined based upon time and costs incurred on the project in addition to the relative complexity. The percentages of completion varied by individual project and ranged from 25% to 70%. The discount rate of 35% used in the present value calculation was derived from an analysis of weighted average costs of capital, weighted average returns on assets and venture capital rates of returns adjusted for the specific risks associated with the in-process research and development expense. The development of the acquired technologies remains a significant risk as the nature of the efforts to develop the acquired technologies into commercially viable services consists primarily of planning, designing and testing activities necessary to determine that the products can meet customer expectations.

### **Results of Operations**

Our revenues are generated primarily from the sale of Internet connectivity services at fixed rates or usage-based pricing to our customers that desire a DS-3 or faster connection and other ancillary services, such as collocation, content distribution, server management and installation services, virtual private networking services, managed security services, data backup, remote storage and restoration services and video conferencing services. We also offer T-1 and fractional DS-3 connections at fixed rates. We recognize revenues when persuasive evidence of an arrangement exists, the service has been provided, the fees for the service rendered are fixed or determinable and collectibility is probable. Customers are billed on the first day of each month either on a usage or a flat-rate basis. The usage based billing relates to the month prior to the month in which the billing occurs, whereas certain flat rate billings relate to the month in which the billing occurs. Deferred revenues consist of revenues for services to be delivered in the future and consist primarily of advance billings, which are amortized over the respective service period and billings for initial installation of customer network equipment, which are amortized over the estimated life of the customer relationship.

Direct cost of network is comprised primarily of the costs for connecting to and accessing Internet backbone providers and competitive local exchange providers, costs related to operating and maintaining service points and data centers and costs incurred for providing additional third-party services to our customers. To the extent a service point is located a distance from the respective Internet backbone providers, we may incur additional local loop charges on a recurring basis.

Customer support costs consist primarily of employee compensation costs for employees engaged in connecting customers to our network, installing customer equipment into service point facilities, and servicing customers through our network operation centers. In addition, facilities costs associated with the network operations center are included in customer support costs.

Product development costs consist principally of compensation and other personnel costs, consultant fees and prototype costs related to the design, development and testing of our proprietary technology, enhancement of our network management software and development of internal systems. Costs associated with internal use software are capitalized when the software enters the application development stage until implementation of the software has been completed. All other product development costs are expensed as incurred.

Sales and marketing costs consist of compensation, commissions and other costs for personnel engaged in marketing, sales and field service support functions, as well as advertising, tradeshow, direct response programs, new service point launch events, management of our web site and other promotional costs.

General and administrative costs consist primarily of compensation and other expenses for executive, finance, human resources and administrative personnel, professional fees and other general corporate costs.

Since inception, in connection with the grant of certain stock options to employees, we recorded deferred stock compensation totaling \$25.0 million, representing the difference between the fair value of our common stock on the date options were granted and the exercise price. In connection with our acquisition of VPNX, we recorded deferred stock compensation totaling \$5.1 million related to unvested options we assumed. These amounts are included as a component of stockholders' equity and are being amortized over the vesting period of the individual grants, generally four years, using an accelerated method as described in Financial Accounting Standards Board Interpretations No. 28. We recorded amortization of deferred stock compensation in the amount of \$10.7 million and \$4.2 million and \$0.2 million for the years ended December 31, 2000, 2001 and 2002, respectively. At December 31, 2002, we had a total of \$396,000 remaining to be amortized over the corresponding vesting periods of the stock options.

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The revenue and income potential of our business and market is unproven, and our limited operating history makes it difficult to evaluate its prospects. We have only been in existence since 1996, and our services are only offered in limited regions. We have incurred net losses in each quarterly and annual period since our inception, and as of December 31, 2002, our accumulated deficit was \$796.4 million.

The following table sets forth, as a percentage of total revenues, selected statement of operations data for the periods indicated:

Year Ended December 31,	2000	2001	2002
Revenues	100%	100%	100%
Costs and expenses:			
Direct cost of network	90%	84%	63%
Customer support	29%	18%	10%
Product development	17%	10%	6%
Sales and marketing	51%	32%	16%
General and administrative	47%	38%	16%
Depreciation and amortization	30%	41%	37%
Amortization of goodwill and other intangible assets	78%	33%	4%
Amortization of deferred stock compensation	15%	4%	–
Lease termination expense	–	–	1%
Restructuring costs	–	55%	(3)%
Impairment of goodwill and other intangible assets	–	167%	–
In-process research and development	26%	–	–
Loss on sales and retirements of property and equipment	–	2%	2%
Total operating costs and expenses	383%	484%	152%
Loss from operations	(283)%	(384)%	(52)%
Other income (expense):			
Interest income (expense), net	17%	(1)%	(2)%
Loss on Investment	–	(23)%	(1)%
Total other income (expense)	17%	(24)%	(3)%
Net loss	(266)%	(408)%	(55)%

**Years Ended December 31, 2002 and 2001**

**Revenues.** Revenues for the year ended December 31, 2002, increased by 13% to \$132.5 million, up from \$117.4 million for the year ended December 31, 2001. The increase during 2002 was primarily driven by increased connectivity service revenues, accounting for 75% of the increase, which reflects a full year of operations at the 6 service points that were opened during 2001, and an increase in our overall customer base from 974 to 1,273 customers, across our metropolitan market service points. Also included is contract termination revenues of \$1.3 million collected from customers that discontinued service during the year. Of the remaining increase, 23% can be attributed primarily to content delivery network services and the remaining 2% can be attributed to collocation data center services, including facilities charges. We expect that revenues will continue to increase for the 2003 fiscal year as compared to the 2002 fiscal year and connectivity revenues will remain our primary revenue source. We expect the composition of future revenue increases will include an increasing percentage of revenue from non-connectivity products and services than in the past.

**Direct Cost of Network.** Direct cost of network for the year ended December 31, 2002, decreased 16% to \$83.2 million from \$98.9 million for the year ended December 31, 2001. The decrease of \$15.7 million in 2002 reflects reduced network cost and local access expenses (representing 107% of the decrease), resolution of disputes with network vendors (representing 9% of the decrease) and lower third-party collocation and service point facility costs (representing an additional 8% of the decrease). These decreases were offset by a 10% increase in customer local access costs, a 6% increase in collocation costs in our facilities and a 14% increase in costs associated with content delivery network services. Connectivity costs vary dependent on customer demands and pricing variables and are expected to decrease during 2003, even with modest revenue growth, due to the full year impact of pricing improvements negotiated during 2002. Collocation and other service point facility costs are generally fixed in nature, and we expect these costs to remain stable during 2003. Content delivery network and other costs associated with reseller arrangements are generally variable in nature and are expected to increase, although to a lesser extent as revenue increases.

**Customer Support.** Customer support costs for the year ended December 31, 2002, decreased 40% to \$12.9 million from \$21.5 million for the year ended December 31, 2001. The decrease of \$8.6 million was primarily driven by decreases in compensation (representing 65% of the decrease), facilities (representing 20% of the decrease), and decreases in communications, general office, travel and entertainment and other costs (representing 15% of the decrease). Customer support costs are primarily related to employee costs. We expect customer support costs to decrease during 2003 due to the full year effect of employee terminations completed during 2002.

**Product Development.** Product development costs for the year ended December 31, 2002, decreased 39% to \$7.4 million from \$12.2 million for the year ended December 31, 2001. The decrease of \$4.8 million reflects reduced compensation expense (representing 51% of the decrease), facilities (representing 16% of the decrease), outside professional services (representing 25% of the decrease) and communications and other costs (representing 8% of the decrease). Product development costs are primarily related to employee and professional service costs. We anticipate product development costs in 2003 to decrease due to the full year effect of employee terminations completed during 2002.

**Sales and Marketing.** Sales and marketing costs for the year ended December 31, 2002, decreased 44% to \$21.6 million from \$38.1 million for the year ended December 31, 2001. Approximately 35% of the \$16.5 million decrease can be attributed to a marketing and advertising campaign in 2001. Additionally, 34% of the decrease relates to compensation costs as a result of employee terminations completed during 2002. Sales and marketing expenses in 2003 should remain consistent with 2002 expenses as a result of more focused and efficient marketing and advertising efforts than those in prior periods.

**General and Administrative.** General and administrative costs for the year ended December 31, 2002, decreased 54% to \$20.8 million from \$44.5 million for the year ended December 31, 2001. The decrease of \$23.7 million reflects lower facility costs (representing 28% of the decrease), lower compensation costs (representing 25% of the decrease), decreases in taxes and bad debt expense (each representing 12% of the decrease), reduced professional services (representing 8% of the decrease) lower training, communications, travel and entertainment and other office costs (representing 15% of the decrease). We anticipate general and administrative costs will be lower in 2003 as compared to 2002 as a result of employee terminations and other cost savings measures taken during 2002.



**Depreciation and Amortization.** Depreciation and amortization expense for the year ended December 31, 2002 increased 2% to \$49.6 million as compared to \$48.6 million for the year ended December 31, 2001. The increase is attributable to a 6% increase in depreciation and amortization expense relating to network and service point assets, including the deployment of six additional service points during 2001. We expect network depreciation and amortization to decrease in 2003 as compared to 2002 as assets reach the end of their depreciable lives. The increase in depreciation and amortization related to network assets was partially offset by a 5% decrease in depreciation and amortization related to non-network assets. This decrease was primarily due to retirements and write-downs of assets during 2001 and 2002. We expect depreciation related to these assets to decrease in 2003 as compared to 2002. Overall depreciation and amortization is expected to be generally consistent with 2002 levels as network assets that become technologically obsolete or reach the end of their estimated useful lives will be replaced with newer assets. Our current plans do not require the deployment of significant additional capital assets during 2003.

**Other Income (Expense).** Other income (expense) consists of interest income, interest and financing expense, investment losses and other non-operating expenses. Other income (expense) for the year ended December 31, 2002, increased to \$3.4 million from other expense of \$27.6 million for the year ended December 31, 2001. This increase was primarily due to losses incurred during 2001 on our investments in 360 Networks and Aventail of \$14.5 million and \$4.8 million, respectively, and the \$6.0 million provision we recorded on a note receivable. During 2002, our other expense items consisted of \$1.3 million in losses related to our equity-method investment and \$2.2 million of interest income (expense), which decreased due to lower cash balances and higher levels of debt during 2002 as compared to 2001. We expect other expenses in 2003 to be generally consistent with 2002 levels.

**Years Ended December 31, 2001 and 2000**

**Revenues.** Revenues for the year ended December 31, 2001, increased by 69% to \$117.4 million, up from \$69.6 million for the year ended December 31, 2000. The increase during 2001 was primarily driven by increased connectivity service revenues (accounting for 70% of the increase), for a full year of operations at the 17 service points that were opened during 2000, 6 additional service points deployed during 2001 and an increase in our overall customer base across all markets. Of the remaining 30% of the increase, 10% can be attributable to collocation services and the remaining 20% of the revenue increase stems from revenues generated from our other products and services, including facilities charges, content delivery network services, and collocation services, as well as contract termination revenues collected from customers that discontinued service during the year.

**Direct Cost of Network.** Direct cost of network for the year ended December 31, 2001, increased 58% to \$98.9 million from \$62.5 million for the year ended December 31, 2000. The increase of \$36.4 million in 2001 reflects higher costs relating to our service point facility costs for providing collocation services to our customers (representing 49% of the increase) and connections to Internet backbone providers (representing 43% of the increase). Both collocation facility costs and connectivity costs vary depending on customer demands and pricing variables and are expected to increase during 2003 due to additions of new customers.

**Customer Support.** Customer support costs for the year ended December 31, 2001, increased 6% to \$21.5 million from \$20.3 million for the year ended December 31, 2000. The increase of \$1.2 million was primarily driven by higher compensation and facility costs which increased costs 14% and 6% during the current year, respectively, offset by consultant, travel and entertainment and other costs which decreased current year costs 8%, 5%, and 1%, respectively.

**Product Development.** Product development costs increased 3% to \$12.2 million from \$11.9 million during the years ended December 31, 2001 and 2000, respectively. The increase of \$0.3 million reflects increases in facilities and compensation costs which increased costs by 9% and 1%, respectively, offset by decreases in consultant and other costs which reduced costs by 5% and 2%, respectively.

**Sales and Marketing.** Sales and marketing costs for the year ended December 31, 2001, increased 8% to \$38.2 million from \$35.4 million for the year ended December 31, 2000. The increase was primarily attributed to a marketing and advertising campaign launched during 2001.

**General and Administrative.** General and administrative costs for the year ended December 31, 2001, increased 35% to \$44.5 million from \$33.0 million for the year ended December 31, 2000. The increase of \$11.5 million was primarily driven by increased taxes, facilities costs and bad debt expenses, which increased costs by 12%, 11% and 10%, respectively. Other costs, net of certain cost reductions, increased current period costs by 2%.

**Depreciation and Amortization.** Depreciation and amortization for the year ended December 31, 2001, increased 137% to \$48.6 million from \$20.5 million for the year ended December 31, 2000. The increase was primarily attributable to increased depreciation and amortization expense relating to network and service point assets, representing 78% of the increase, including the deployment of 17 service points during 2000, resulting in a full year of depreciation during 2001.

**Other Income (Expense).** Other income (expense) consists of interest income, interest and financing expense, investment losses and other non-operating expenses. Other income (expense), net, decreased to \$27.6 million for the year ended December 31, 2001 from other income of \$11.5 million for the year ended December 31, 2000. This decrease was primarily due to losses incurred on our investments in 360networks and Aventail of \$14.5 million and \$4.8 million, respectively, and the provision we recorded on a note receivable of \$6.0 million.

### **Provision for Income Taxes**

We have incurred operating losses from inception through December 31, 2002. We have recorded a valuation allowance for the full amount of our net deferred tax assets due to the uncertainty of our ability to realize those assets in future periods.

As of December 31, 2002, we had net operating loss carryforwards of approximately \$435.0 million, capital loss carryforwards of approximately \$14.0 million and tax credit carryforwards of approximately \$2.0 million. Due to limitations imposed by provisions of the Internal Revenue Code of 1986, as amended, upon certain substantial changes in our ownership, approximately \$169.0 million of the aggregate net operating loss and capital loss carryforwards, and \$1.0 million of the tax credit carryforwards will not be utilized. Loss carryforwards of approximately \$280.0 million are available to reduce future taxable income and expire at various dates beginning in 2006, and the amount that could be utilized annually in the future to offset taxable income will be limited.

### **Liquidity and Capital Resources**

#### ***Cash Flow for the Years Ended December 31, 2002, 2001, and 2000***

***Net Cash Used in Operating Activities.*** Net cash used in operating activities was \$40.3 million for the year ended December 31, 2002, and was primarily due to the loss from continuing operations of \$72.3 million, adjusted for non-cash items of \$58.0 million, an increase in accounts receivable of \$2.4 million, a decrease in accounts payable of \$802,000, a decrease in deferred revenue of \$4.3 million, a decrease in accrued restructuring costs of \$15.3 million and a decrease in accrued liabilities of \$3.9 million. These uses of cash were offset by a \$712,000 decrease in prepaid and other assets. The increase in receivables was related to higher overall revenue offset by a seven-day improvement in day's sales outstanding compared to the prior year. The decrease in payables is primarily related to a lower overall level of operating expenses in 2002 compared to 2001.

Net cash used in operating activities was \$123.0 million for the year ended December 31, 2001 and was primarily due to the loss from continuing operations (adjusted for non-cash items) of \$153.5 million, a decrease in accounts payable of \$8.5 million, a decrease in deferred revenue of \$2.2 million and a decrease in accrued liabilities of \$3.1 million. These uses of cash were partially offset by decreases in receivables of \$0.7 million and an increase in accrued restructuring costs of \$39.3 million. The decreases in accounts payable and accrued liabilities are a result of our efforts to streamline operations during 2001, resulting in lower monthly operating costs in the final quarter of 2001. The accounts receivable decrease is largely a result of improved collections during 2001. Day's sales outstanding were 62 days at December 31, 2000, and reached 65 days during the first half of 2001, ending 2001 at 45 days. The decrease in prepaid expenses is due to our focus on cash flow during 2001 and a related reduction in prepayment activities.

Net cash used in operating activities was \$95.1 million for the year ended December 31, 2000, and was primarily due to the loss from continuing operations (adjusted for non-cash items) of \$80.0 million, an increase in accounts receivable of \$17.3 million, an increase in prepaid expenses and other assets of \$7.4 million and a decrease in accounts payable of \$5.3 million. These uses of cash were partially offset by a \$4.0 million increase in deferred revenue and a \$10.9 million increase in accrued liabilities. The increase in accounts receivable was primarily related to the overall growth in the business during 2000 as total revenue for the year increased by \$57.1 million compared to 1999, an increase of 456%. The increase in accounts payable, prepaid expense and accrued liabilities was a result of significant growth in operating expenses as we deployed more service points and expanded into new geographical markets.

***Net Cash Provided by (Used In) Investing Activities.*** Net cash provided by investing activities was \$9.6 million for the year ended December 31, 2002, and was primarily from proceeds of \$18.7 million received on the redemption or maturity of investments. Cash received was partially offset by \$8.6 million used for purchases of property and equipment and \$1.3 million contributed to our joint venture investment, Internap Japan. Of the \$8.6 million used for purchases of property and equipment, \$5.8 million related to the purchase of assets from our primary provider of leased networking equipment as part of terms of an amendment to our master lease arrangement with the lessor.

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Net cash provided by investing activities was \$12.3 million for the year ended December 31, 2001, and was primarily from proceeds of \$62.0 million received on the redemption or maturity of investments and \$6.1 million received from restricted cash related to a real estate settlement of a corporate office facility. As part of the settlement, the lessor was paid from a restricted cash deposit. Cash provided from investing activities was offset by \$32.1 million used for purchases of property and equipment and \$22.7 million used to purchase investments. The purchases of property and equipment primarily represent leasehold improvements and infrastructure purchases for our collocation facilities that were not financed through lease facilities. The majority of the cash paid for purchases of property and equipment occurred during the first two quarters of 2001 to complete certain collocation facilities under construction during 2000. In connection with the restructuring plan adopted by management during February 2001, capital spending for new collocation facilities was significantly reduced.

On April 10, 2001, we announced the formation of a joint venture with NTT-ME Corporation of Japan. The formation of the joint venture involved our cash investment of \$2.8 million to acquire 51% of the common stock of the newly formed entity, Internap Japan. The investment in the joint venture is being accounted for as an equity-method investment under Accounting Principles Board Opinion No. 18 "The Equity Method of Accounting for Investments in Common Stock." Subsequent to December 31, 2001, the joint venture authorized a second capital call, and we invested an additional \$1.3 million into the partnership in proportion to our ownership interest.

Net cash used in investing activities was \$106.2 million for the year ended December 31, 2000, and was primarily related to \$161.1 million used to purchase investments, \$57.7 million used to purchase property and equipment, \$12.2 million used in the purchase of CO Space, Inc. and VPNX.com during 2000 (net of cash acquired) and \$8.5 million used to support restricted cash balances required in certain real estate transactions. The use of cash was partially offset by \$132.8 million redemption of investments. Note that the purchase of property and equipment represents leasehold improvements and infrastructure purchases for our collocation facilities that were not financed through lease facilities.

During 2000, pursuant to an investment agreement among Internap, Ledcor Limited Partnership, Worldwide Fiber Holdings Ltd. and 360networks, Inc., we purchased 374,182 shares of 360networks Class A Non-Voting Stock at \$5.00 per share and 1,122,545 shares of 360networks Class A Subordinate Voting Stock at \$13.23 per share. The total cash investment was \$16.7 million. During 2001 we liquidated our entire investment in 360networks for cash proceeds of \$2.2 million and recognized a loss on investment totaling \$14.5 million.

Also during 2000, pursuant to an investment agreement, we purchased 588,236 shares of Aventail Corporation Series D preferred stock at \$10.20 per share for a total cash investment of \$6.0 million. Because Aventail is a privately held enterprise for which no active market for its securities exists, the investment is recorded as a cost basis investment. During the second quarter of 2001, we concluded based on available information, specifically Aventail's most recent round of financing, that our investment in Aventail had experienced a decline in value that was other than temporary. As a result during June 2001, we recognized a \$4.8 million loss on investment when we reduced its recorded basis to \$1.2 million, which remains its estimated value as of December 31, 2002.

Additionally, we entered into a joint marketing agreement with Aventail which, among other things, granted us limited exclusive rights to sell Aventail's managed extranet service and granted Aventail specified rights to sell our services. In return, we committed to either sell Aventail services or pay Aventail, or a combination of both, which would result in Aventail's receipt of \$3.0 million over a two-year period. The joint marketing agreement expired during 2002 and we accrued a liability for the \$1.8 million shortfall as a component of accrued expenses. During the second quarter of 2002 we entered into a note payable to Aventail in lieu of immediate payment of the shortfall amount and reclassified the \$1.8 million accrued expense to notes payable. The note matures October 5, 2003, is payable in quarterly principal and interest payments, bears interest of 6.0% and is collateralized by certain network equipment. Outstanding borrowings under this note were \$900,000 as of December 31, 2002.

**Net Cash Provided by (Used In) Financing Activities.** Since our inception, we have financed our operations primarily through the issuance of our equity securities, capital leases and bank loans. As of December 31, 2002, we have raised an aggregate of approximately \$499.6 million, net of offering expenses, through the sale of our equity securities.

Net cash used in financing activities for the year ended December 31, 2002 was \$7.7 million. Cash used included \$10.3 million related to payments on capital lease obligations and \$3.4 million for payments of notes payable. These uses were offset by proceeds of \$0.4 million related to exercises of stock options and warrants and \$0.7 million related to the sale of common stock, including stock issued to employees pursuant to the Amended and Restated 1999 Employee Stock Purchase Plan. During 2002 we amended the terms of our master lease agreement with our primary supplier of networking equipment. The amended terms of the master lease included a retroactive effective date to March 1, 2002, and extended the payment terms and provided for a deferral of lease payments of the underlying lease schedules for a period of 24 months in exchange for a buy-out payment of \$12.1 million in satisfaction of the outstanding lease obligation on 14 schedules totaling \$6.3 million and for the purchase of the equipment leased under the same schedules totaling \$5.8 million.

We paid \$10.3 million under capital lease agreements for the year ended December 31, 2002. Capital equipment leases have been used since inception to finance the majority of our networking equipment located in our service points other than leasehold improvements related to our collocation facilities. Approximately \$61.7 million of networking equipment has been purchased under capital leases from inception through December 31, 2002.

Net cash provided by financing activities for the year ended December 31, 2001, was \$72.1 million, primarily related to a \$95.6 million issuance of Series A convertible preferred stock (net of \$5.4 million in issuance costs) and \$2.2 million proceeds from the issuance of common stock and the exercise of stock options. Net cash provided by financing activities was offset by \$23.4 million in payments on capital leases and \$2.3 million paid on a note payable. Net proceeds from financing activities were primarily used to fund operating losses during 2001 and, to a lesser extent, for purchases of property and equipment.

On September 14, 2001, we completed a \$101.5 million private placement of units at a per unit price of \$1.60 per unit and issued an aggregate of 63,429,976 units, with each unit consisting of 1/20 of a share of Series A convertible preferred stock and a warrant to purchase 1/4 of a share of common stock, resulting in the issuance of 3,171,499 shares of Series A convertible preferred stock and 17,113,606 warrants to purchase equivalent shares of common stock at an exercise price of \$1.48256 per share, which are exercisable for a period of five years. The aggregate amount of common stock issuable upon conversion of the Series A convertible preferred stock and the exercise of the warrants is 85,568,119 shares at September 30, 2001.

Holders of Series A convertible preferred stock shall be entitled to the number of votes equal to the number of shares of common stock into which the shares of Series A convertible preferred stock could be converted. Each share of Series A convertible preferred stock is initially convertible into 21.58428 shares of common stock subject to adjustments for certain dilutive events. Each share of Series A convertible preferred stock may be converted at any time at the option of the holder. Subject to satisfaction of certain conditions, including the listing of the Company's common stock on the NASDAQ National Market System, shares of Series A convertible preferred stock automatically convert to common stock on the earlier of September 14, 2004, a date more than six months after issuance on which the common stock has traded in excess of \$8.00 for a period of 45 consecutive trading days or upon the affirmative vote of 60% of the outstanding shares of Series A convertible preferred stock.

Upon the liquidation, dissolution, merger or other event in which existing stockholders own less than 50% of the post-event voting power, holders of Series A convertible preferred stock are entitled to be paid out of existing assets an amount equal to \$32.00 of preferred per share prior to distributions to holders of common stock. Upon completion of distribution to holders of Series A convertible preferred stock, remaining assets will be distributed ratably between holders of Series A convertible preferred stock and holders of common stock until holders of Series A convertible preferred stock have received an amount equal to three times the original issue price.

We received net proceeds of \$95.6 million from the issuance of the Series A convertible preferred stock and allocated \$86.3 million to the Series A convertible preferred stock and \$9,321,000 to the warrants to purchase shares of common stock based upon their relative fair values on the date of issuance (September 14, 2001) pursuant to Accounting Principles Board Opinion No. 14 "Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants." The fair value used to allocate proceeds to the Series A convertible preferred stock was based upon a valuation that among other considerations was based upon the closing price of the common stock on the date of closing, on an as converted basis, and liquidation preferences. The fair value used to allocate proceeds to the warrants to purchase common stock was based on a valuation using the Black Scholes model and the following assumptions: exercise price \$1.48256; no dividends; term of 5 years; risk free rate of 3.92%; and volatility of 80%.

Net cash provided from financing activities for the year ended December 31, 2000, was \$148.3 million, primarily from the issuance of \$145.2 million of common stock, \$8.5 million drawn under a revolving line of credit and \$6.3 million in proceeds from the exercise of common stock options and warrants partially offset by \$12.4 million in payments on capital lease and note payable obligations.

On April 6, 2000, 8,625,000 shares of our common stock were sold in a public offering at a price of \$43.50 per share. Of these shares, we sold 3,450,000 and 5,175,000 shares were sold by selling stockholders. We did not receive any of the proceeds from the sale of shares of common stock by the selling stockholders. Our proceeds from the offering were \$142.9 million, net of underwriting discounts and commissions of \$7.1 million.

### ***Liquidity***

We have experienced significant net operating losses since inception. During fiscal 2002, we incurred net losses of \$72.3 million and used \$40.3 million of cash in our operating activities. Management expects operating losses will continue through December 31, 2003, and negative cash flows to continue for several more quarters. We have decreased the size of our workforce by 216 employees, or 40% as compared to the number of employees at December 31, 2001, and terminated certain real estate leases and commitments in order to control costs. Our plans indicate our existing cash and investments are adequate to fund our operations in 2003. However, our capital requirements depend on several factors, including the rate of market acceptance of our services, the ability to expand and retain our customer base and other factors. If we fail to realize our planned revenues or costs, management believes it has the ability to curtail capital spending and reduce expenses to ensure cash and investments will be sufficient to meet our cash requirements in 2003. If, however, our cash requirements vary materially from those currently planned, or if we fail to generate sufficient cash flow from the sales of our services, we may require additional financing sooner than anticipated. We cannot assure you such financing will be available on acceptable terms, if at all.

Our cash requirements through the end of 2003 are primarily to fund operations, restructuring outlays, payments to service capital leases, payments on notes payable and capital expenses.

With a slowdown in the macroeconomic environment during 2001 and continuing into 2002, we have been focused on significantly reducing the cost structure of the business while maintaining a continued focus on growing revenue. During fiscal year 2001 we announced two separate restructurings of our business. Under the 2001 restructuring programs, management made decisions to exit certain non-strategic real estate lease and license arrangements, consolidate and exit redundant network connections and to streamline the operating cost structure. The total charges include restructuring costs of \$71.6 million and a charge for asset impairment of \$196.0 million. We completed the majority of our restructuring activities related to the 2001 plan during 2002, although certain remaining restructured real estate and network obligations represent long-term contractual obligations that extend through 2015.

With the continuing decline and uncertainty in the telecommunications market, we committed to additional restructuring actions during 2002 to align our business with market opportunities. As a result, we recorded a business restructuring charge and asset impairments of \$7.6 million. The charges were primarily comprised of real estate obligations related to a decision to relocate our corporate headquarters from Seattle, Washington, to an existing leased facility in Atlanta, Georgia, net asset write-downs related to the departure from the Seattle office and costs associated with further personnel reductions. We expect to complete the restructuring activities related to the 2002 plan during 2003.

INTERNAP 2002 **MANAGEMENT'S DISCUSSION AND ANALYSIS**  
**OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

Based on savings from our 2001 and 2002 restructuring programs and other forecasted cash savings, we believe our cash should be sufficient to meet our cash requirements in 2003. If we fail to realize our planned revenues or costs, management believes it has the ability to curtail capital spending and reduce expenses to ensure cash and investments will be sufficient to meet our cash requirements in 2003.

However, the cash impact of continuing uncertain market demand and the timing of cost reduction is difficult to project. Our cost reduction initiatives may have unanticipated adverse effects on our business. A portion of our planned operating cash improvement is expected to come from an increase in revenues and cash collections from customers.

**Commitments and Other Obligations.** We have commitments and other obligations that are contractual in nature and will represent a use of cash in the future unless there are modifications to the terms of those agreements. The amounts in the table below captioned "Network commitments" primarily represent purchase commitments made to our largest bandwidth vendors and, to a lesser extent, contractual payments to license collocation space used for resale to customers. Our ability to improve cash used in operations in the future would be negatively impacted if we did not grow our business at a rate that would allow us to offset the service commitments with corresponding revenue growth.

The following table summarizes our credit obligations and future contractual commitments (in thousands) as of December 31, 2002:

	Payment due by period				
	Total	Less than 1 year	1 to 3 years	4 to 5 years	After 5 years
Line of credit	\$ 10,000	\$10,000	\$ -	\$ -	\$ -
Notes Payable	9,710	4,514	5,196	-	-
Capital Lease Obligations	38,975	1,784	24,356	3,474	9,181
Operating leases commitments	139,801	16,652	25,083	18,439	79,629
Network commitments	85,032	36,264	28,424	19,778	566
Total	\$283,388	\$69,214	\$83,059	\$41,691	\$89,374

One of our network commitment contracts with an Internet backbone service provider, representing \$20 million of scheduled minimum payments in 2003 and \$11.7 million in 2004, includes a provision allowing us to defer portions of our minimum commitments into future periods in the event we do not meet annual contract minimums.

**Credit Facilities.** At December 31, 2001, we had a revolving line of credit of \$10.0 million and had drawn all available amounts under the facility. In October 2002, the line was renewed and amended, allowing us to borrow an additional \$5.0 million, up to \$15.0 million in aggregate. The renewed facility originally was due to expire on December 31, 2002. Our ability to maintain the drawn amount under the line of credit and have access to the additional \$5.0 million depended on a number of factors including the level of eligible receivable balances and liquidity. The facility allowed advances equal to 80% of eligible accounts receivable or 25% of cash and short-term investments, whichever is greater. The facility also contained financial covenants that required us to grow revenues, limit the cash losses, and require minimum levels of liquidity and tangible net worth as defined in the agreement.



In October 2002, we entered into a revised loan and security agreement, refinancing the line of credit facility and other equipment notes with the same lender. Under the terms of the new loan and security agreement, the \$15 million outstanding under the previous facility was refinanced into a \$15 million revolving line of credit and a \$5 million equipment note. Availability under the revolver is based on 80% of eligible accounts receivable plus 25% of unrestricted cash and investments. Availability is further restricted by the \$5 million outstanding under the term loan until the Company achieves a specified minimum debt coverage service level for six consecutive months as defined in the agreement. The amount available under the revolver at the time of the refinancing and at December 31, 2002, was \$10 million and \$10 million was drawn under the line at December 31, 2002. On March 28, 2003 we entered into an amended loan and security agreement.

The revolving line of credit facility is a 24-month facility expiring during October 2004 and bears interest at a rate ranging from prime plus 1% to prime plus 2% per year (6.25% at December 31, 2002), depending on a certain balance sheet ratio as defined in the agreement. Monthly payments are interest only over the term of the facility. Both the revolving facility and the equipment notes are governed by a common security agreement and are collateralized by substantially all the assets of the Company. The agreement allows the lender to require us to maintain cash and investment accounts with them and allows the lender greater control over our customer deposits, as defined in the agreement. Both the revolving credit facility and the term loan also contain financial covenants that require us to maintain a minimum tangible net worth as defined in the agreement. Further, the lender has the ability to demand repayment in the event, in its view, there has been a material adverse change in our business. At December 31, 2002, we were in compliance with the financial covenants.

**Preferred Stock.** As discussed under the description of financing activities, we received net proceeds of \$95.6 million during 2001 from the sale of preferred stock. Among other things, the preferred stock purchase agreement establishes restrictions on the amount of new debt that we can incur without specific preferred stockholder approval. If we should, in the future, decide to obtain additional debt to improve our liquidity, there can be no assurance that preferred stockholder approval could be obtained.

**Lease Facilities.** Since our inception, we have financed the purchase of network routing equipment using capital leases. The present value of these the capital lease payments are \$25.5 million at December 31, 2002, with \$631,000 to be paid during 2003. We have fully utilized available funds under our lease facilities.

In June 2002, we amended the terms of our master lease agreement with our primary supplier of networking equipment. The amended terms of the master lease included a retroactive effective date to March 1, 2002, and extended the payment terms and provided for a deferral of lease payments of the underlying lease schedules for a period of 24 months in exchange for a buy-out payment of \$12.1 million in satisfaction of the outstanding lease obligation on 14 schedules totaling \$6.3 million and for the purchase of the equipment leased under the same schedules totaling \$5.8 million. The terms of our master lease agreement, as amended, include financial covenants that require us to maintain minimum liquidity balances, periodic revenues, EBITDA levels and other customary covenants. Should we breach the covenants, experience a change-of-control represented by a change in 35% of the aggregate ordinary voting power, or the lessor believes we have experienced a material adverse change in our business, the lessor has the ability to demand payment of all amounts due. As of December 31, 2002, we were in compliance with all financial covenants and have obtained a waiver for a non-financial covenant for which we were not in compliance.

### **Recent Accounting Pronouncements**

In June 2001, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 143, "Accounting for Asset Retirement Obligations," which is effective January 1, 2003. This standard addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated retirement costs. The Company is currently assessing the application of SFAS No. 143.

In July 2002, the FASB issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities." This standard requires costs associated with exit or disposal activities to be recognized when they are incurred. The requirements of SFAS No. 146 apply prospectively to activities that are initiated after December 31, 2002, and as such, the Company cannot reasonably estimate the impact of adopting these new rules until and unless it undertakes relevant activities in future periods.

In November 2002, the FASB issued Interpretation No. 45 ("FIN 45"), "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of the Indebtedness of Others," which clarifies the requirements of SFAS No. 5, "Accounting for Contingencies," relating to a guarantor's accounting for and disclosures of certain guarantees issued. FIN 45 requires enhanced disclosures for certain guarantees. It also will require certain guarantees that are issued or modified after December 31, 2002, including certain third-party guarantees, to be initially recorded on the balance sheet at fair value. The Company has determined that the implementation of this standard will not have a material effect on its previously issued financial statements. Disclosures required under FIN 45 for 2002 are included in the notes to the financial statements. The Company cannot reasonably estimate the impact of adopting FIN 45 until guarantees are issued or modified in future periods, at which time their results will be initially reported in the financial statements.

In January 2003, the FASB issued Interpretation No. 46 ("FIN 46"), "Consolidation of Variable Interest Entities," which clarifies the application of Accounting Research Bulletin No. 51, "Consolidated Financial Statements," relating to consolidation of certain entities. First, FIN 46 will require identification of the Company's participation in variable interests entities ("VIE"), which are defined as entities with a level of invested equity that is not sufficient to fund future activities to permit them to operate on a standalone basis, or whose equity holders lack certain characteristics of a controlling financial interest. Then, for entities identified as VIE, FIN 46 sets forth a model to evaluate potential consolidation based on an assessment of which party to the VIE, if any, bears a majority of the exposure to its expected losses, or stands to gain from a majority of its expected returns. FIN 46 also sets forth certain disclosures regarding interests in VIE that are deemed significant, even if consolidation is not required. The Company is currently assessing the application of FIN 46 as it relates to its variable interests.

## INTERNAP 2002 CONSOLIDATED BALANCE SHEETS

December 31,	2001	2002
(In thousands)		
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 63,551	\$ 25,219
Short-term investments	18,755	-
Accounts receivable, net of allowance of \$1,183 and \$1,595, respectively	14,749	15,232
Prepaid expenses and other assets	2,981	5,632
Total current assets	100,036	46,083
Property and equipment, net	139,589	88,394
Restricted cash	2,432	2,053
Investments	2,794	3,047
Other intangible assets, net of accumulated amortization of \$7,939 and \$13,578, respectively	9,196	3,557
Goodwill, net of accumulated amortization of \$27,177	27,022	27,022
Deposits and other assets, net	3,908	2,813
Total assets	\$284,977	\$172,969
<b>LIABILITIES, CONVERTIBLE PREFERRED STOCK AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 13,058	\$ 13,247
Accrued liabilities	16,727	11,020
Deferred revenue	2,747	6,850
Notes payable, current portion	2,038	4,514
Line of credit	10,000	10,000
Capital lease obligations, current portion	22,450	631
Restructuring liability, current portion	16,498	6,574
Total current liabilities	83,518	42,836
Deferred revenue	9,755	1,317
Notes payable, less current portion	954	5,196
Capital lease obligations, less current portion	15,494	24,917
Restructuring liability, less current portion	22,773	7,078
Total liabilities	132,494	91,344
Commitments and contingencies (Note 14)		
Series A convertible preferred stock, \$0.001 par value, 3,500 shares designated; 3,171 and 2,931 shares issued and outstanding, respectively with a liquidation preference of \$101,487 and \$93,792 respectively	86,314	79,790
Stockholders' equity:		
Common stock, \$0.001 par value, 600,000 shares authorized, 151,294 and 160,094 shares issued and outstanding, respectively	151	160
Additional paid in capital	794,459	798,344
Deferred stock compensation	(4,371)	(396)
Accumulated deficit	(724,077)	(796,422)
Accumulated other comprehensive income	7	149
Total stockholders' equity	66,169	1,835
Total liabilities and stockholders' equity	\$284,977	\$172,969

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

## INTERNAP 2002 CONSOLIDATED STATEMENTS OF OPERATIONS

Year Ended December 31,	2000	2001	2002
(In thousands, except per share amounts)			
Revenues	\$ 69,613	\$ 117,404	<b>\$132,487</b>
Costs and expenses:			
Direct cost of network	62,465	98,915	<b>83,207</b>
Customer support	20,320	21,480	<b>12,913</b>
Product development	11,924	12,233	<b>7,447</b>
Sales and marketing	35,390	38,151	<b>21,641</b>
General and administrative	32,962	44,491	<b>20,848</b>
Depreciation and amortization	20,522	48,550	<b>49,600</b>
Amortization of goodwill and other intangible assets	54,334	38,116	<b>5,626</b>
Amortization of deferred stock compensation	10,651	4,217	<b>260</b>
Lease termination expense	-	-	<b>804</b>
Restructuring costs	-	64,096	<b>(3,781)</b>
Impairment of goodwill and other intangible assets	-	195,986	<b>-</b>
Loss on sales and retirements of property and equipment	-	2,714	<b>2,829</b>
In-process research and development	18,000	-	<b>-</b>
Total operating costs and expenses	266,568	568,949	<b>201,394</b>
Loss from operations	(196,955)	(451,545)	<b>(68,907)</b>
Other income (expense):			
Interest income (expense), net	11,498	(1,272)	<b>(2,194)</b>
Loss on investments	-	(26,345)	<b>(1,244)</b>
Total other income (expense)	11,498	(27,617)	<b>(3,438)</b>
Net loss	<b>\$(185,457)</b>	<b>\$(479,162)</b>	<b>\$ (72,345)</b>
Basic and diluted net loss per share	<b>\$ (1.30)</b>	<b>\$ (3.19)</b>	<b>\$ (.47)</b>
Weighted average shares used in computing basic and diluted net loss per share	142,451	150,328	<b>155,545</b>

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

INTERNAP 2002 **CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY  
AND COMPREHENSIVE LOSS**

(In thousands)	Shares	Par Value	Additional Paid-In Capital	No Par Value Common Stock	Deferred Stock Compensation	Accumulated Deficit	Accumulated Items of Comprehensive Income (Loss)	Total Stockholders' Equity	Comprehensive Loss
Balance, January 1, 2000	132,089	\$ -	\$ -	\$287,186	\$ (17,228)	\$ (59,458)	\$ -	\$210,500	\$ -
Issuance of common stock, net of costs of proceeds	3,450	-	-	141,953	-	-	-	141,953	-
Amortization of deferred stock compensation	-	-	-	-	10,651	-	-	10,651	-
Exercise of employee stock options	3,686	-	-	5,895	-	-	-	5,895	-
Issuance of Employee Stock Purchase Plan shares	350	-	-	3,237	-	-	-	3,237	-
Exercise of warrants to purchase common stock	296	-	-	443	-	-	-	443	-
Purchase of CO Space	6,881	-	-	254,951	-	-	-	254,951	-
Purchase of VPNX.com	2,027	-	-	92,232	(5,138)	-	-	87,094	-
Issuance of warrants to purchase common stock	-	-	-	286	-	-	-	286	-
Comprehensive loss:									
Net loss	-	-	-	-	-	(185,457)	-	(185,457)	(185,457)
Unrealized gain on investments	-	-	-	-	-	-	2,400	2,400	2,400
Comprehensive loss, December 31, 2000	-	-	-	-	-	-	-	-	(183,057)
Balance, December 31, 2000	148,779	-	-	786,183	(11,715)	(244,915)	2,400	531,953	-
Amortization of deferred stock compensation	-	-	-	(1,893)	6,110	-	-	4,217	-
Reversal of deferred stock compensation for terminated employees	-	-	-	(1,234)	1,234	-	-	-	-
Sale of stock through the Employee Stock Purchase Plan	1,292	-	-	1,745	-	-	-	1,745	-
Exercise of employee stock options	1,223	-	-	440	-	-	-	440	-
Issuance of Common Stock warrants in conjunction with Series A financing	-	-	-	9,321	-	-	-	9,321	-
Issuance of a warrants to purchase shares of common stock to non-employees	-	-	-	48	-	-	-	48	-
Establishment of par value of common stock	-	151	794,459	(794,610)	-	-	-	-	-
Comprehensive loss:									
Net loss	-	-	-	-	-	(479,162)	-	(479,162)	(479,162)
Unrealized loss on investments	-	-	-	-	-	-	(16,883)	(16,883)	(16,883)
Realized loss on investments	-	-	-	-	-	-	14,490	14,490	14,490
Comprehensive loss, December 31, 2001	-	-	-	-	-	-	-	-	(481,555)
Balance, December 31, 2001	151,294	151	794,459	-	(4,371)	(724,077)	7	66,169	-
Amortization of deferred stock compensation	-	-	(2,668)	-	2,928	-	-	260	-
Reversal of deferred stock compensation for terminated employees	-	-	(1,047)	-	1,047	-	-	-	-
Sale of stock through the Employee Stock Purchase Plan	1,599	2	696	-	-	-	-	698	-
Exercise of options and warrants to purchase common stock	1,915	2	275	-	-	-	-	277	-
Conversion of Series A preferred stock to common stock	5,174	5	6,518	-	-	-	-	6,523	-
Issuance and exercise of warrants to purchase common stock to non-employees	112	-	111	-	-	-	-	111	-
Comprehensive loss:									
Net loss	-	-	-	-	-	(72,345)	-	(72,345)	(72,345)
Realized loss on investments	-	-	-	-	-	-	(7)	(7)	(7)
Unrealized gain on investments	-	-	-	-	-	-	149	149	149
Comprehensive loss, December 31, 2002	-	-	-	-	-	-	-	-	-
<b>Balance, December 31, 2002</b>	<b>160,094</b>	<b>\$160</b>	<b>\$798,344</b>	<b>\$ -</b>	<b>\$ (396)</b>	<b>\$(796,422)</b>	<b>\$ 149</b>	<b>\$ 1,835</b>	<b>\$(72,203)</b>

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

# INTERNAP 2002 CONSOLIDATED STATEMENTS OF CASH FLOWS

Year Ended December 31,	2000	2001	2002
(In thousands)			
<b>Cash flows from operating activities:</b>			
Net loss	\$(185,457)	\$(479,162)	\$(72,345)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation and amortization	74,856	86,666	55,239
Impairment of goodwill and other intangible assets	-	195,986	-
Loss on disposal of assets	-	2,714	2,829
Non-cash restructuring costs/(adjustments)	-	4,714	(4,602)
Non-cash interest expense on capital lease obligations	-	-	702
Provision for doubtful accounts	1,643	4,798	1,902
Provision notes receivable	-	6,000	-
Loss on write-down of deposits related to a lease termination	-	-	474
Loss on write-down of investment	-	4,824	-
Loss on sale of investment security	-	14,490	-
Loss on equity-method investment	-	1,216	1,244
Non-cash expense related to warrants issued	286	48	-
Non-cash compensation expense	10,651	4,217	260
Acquired in-process research and development	18,000	-	-
Changes in operating assets and liabilities, net of acquisitions:			
Accounts receivable	(17,294)	744	(2,385)
Prepaid expenses and other assets	(7,380)	4,248	712
Accounts payable	(5,293)	(8,477)	(802)
Deferred revenue	3,963	(2,228)	(4,335)
Accrued restructuring	-	39,271	(15,284)
Accrued liabilities	10,921	(3,117)	(3,870)
Net cash used in operating activities	(95,104)	(123,048)	(40,261)
<b>Cash flows from investing activities:</b>			
Purchases of property and equipment	(57,698)	(32,094)	(8,632)
Sales of property and equipment	-	1,880	434
Acquisitions, net of cash acquired	(12,173)	-	-
Collection of full recourse notes assumed for outstanding common stock	642	-	-
Purchase of investments	(161,080)	(22,729)	-
Investment in equity-method investee	-	(2,833)	(1,347)
Redemption of investments	132,838	61,985	18,747
Restriction of cash related to obtaining lease lines and letters of credit	(8,515)	6,083	379
Payments for patents and trademarks	(207)	-	-
Net cash (used in) provided by investing activities	(106,193)	12,292	9,581
<b>Cash flows from financing activities:</b>			
Proceeds from the issuance of Series A convertible preferred stock, net of issuance costs	-	95,635	-
Principal payments on equipment financing notes payable	(1,442)	(2,317)	(3,420)
Proceeds from line of credit	8,475	-	5,000
Principal payments on capital lease obligations	(11,005)	(23,356)	(10,318)
Proceeds from equipment leaseback financing	717	-	-
Proceeds from exercise of warrants	443	-	111
Proceeds from exercise of stock options	5,895	440	277
Proceeds from issuance of common stock, net of issuance costs	145,190	1,745	698
Net cash provided by (used in) financing activities	148,273	72,147	(7,652)
Net decrease in cash and cash equivalents	(53,024)	(38,609)	(38,332)
Cash and cash equivalents at beginning of period	155,184	102,160	63,551
<b>Cash and cash equivalents at end of period</b>	<b>\$ 102,160</b>	<b>\$ 63,551</b>	<b>\$ 25,219</b>
<b>Supplemental disclosure of cash flow information:</b>			
Cash paid for interest, net of amounts capitalized	\$ 2,851	\$ 5,235	\$ 3,264
Non-cash adjustment to fixed assets and capital leases due to restructuring of capital lease obligation	\$ -	\$ -	\$ 3,710
Impairment of fixed assets due to restructuring	\$ -	\$ -	\$ 5,175
Equipment note transferred from line of credit	\$ -	\$ -	\$ 5,000
Prepayment of future lease obligation via note payable	\$ -	\$ -	\$ 3,300
Accrued expenses transferred to a note payable	\$ -	\$ -	\$ 1,838
Purchase of property and equipment financed with capital leases	\$ 35,054	\$ 18,511	\$ 930
Forfeiture of deposits to restructuring	\$ -	\$ -	\$ 558
Change in accounts payable attributable to purchases of property and equipment	\$ 13,556	\$ (5,311)	\$ (991)
Non-cash cost of issuing Series A convertible preferred stock	\$ -	\$ 500	\$ -
Conversion of preferred stock to common stock	\$ -	\$ -	\$ 6,524
Items of other comprehensive income	\$ -	\$ -	\$ 142

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

## Note 1

### DESCRIPTION OF THE COMPANY

Internap Network Services Corporation ("Internap," "we," "us," "our" or the "Company") is a leading provider of Internet Protocol (IP)-based connectivity solutions to businesses that need assured network availability for mission-critical applications. Customers connected to the Internet through one of our service points have their data intelligently routed to and from destinations on the Internet using our overlay network, which analyzes the traffic situation on the major networks that comprise the Internet and delivers mission-critical information and communications fast and reliably. Use of our overlay network usually results in lower instances of data loss and greater quality of service than services offered by conventional Internet connectivity providers. In addition to IP connectivity, we offer colocation services and virtual private networking ("VPN") services. We also complement our service offerings as resellers of VPN, content delivery network ("CDN"), managed security and managed storage services. The majority of our revenue is derived from high-performance Internet connectivity and related colocation services. As of December 31, 2002, we provided our services to 1,273 customers located throughout the United States and globally.

Our high-performance Internet connectivity services are available at speeds ranging from fractional T-1 (256 kbps), T-1 (1.544 mbps) to OC-12 (622 mbps), and Ethernet Connectivity from 10 mbps to 1,000 mbps (Gigabit Ethernet) from Internap's 34 service points to customers. We provide our connectivity services through the deployment of service points, which are redundant network infrastructure facilities coupled with our proprietary routing technology. Service points maintain high-speed, dedicated connections to major global Internet networks, commonly referred to as backbones. As of December 31, 2002, we operated 34 service points in 17 major metropolitan market areas.

On September 17, 2001, Internap changed the state of its incorporation from Washington to Delaware with the approval of its stockholders. We accomplished the reincorporation by merging Internap Network Services Corporation with and into our newly formed, wholly owned Delaware subsidiary, Internap Delaware, Inc. Upon consummation of the merger, stockholders of Internap Network Services Corporation became stockholders of Internap Delaware, Inc. and Internap Delaware's name was changed to Internap Network Services Corporation. As a result of the reincorporation, the amount of authorized common and preferred stock changed to 600,000,000 and 200,000,000, respectively, and par value of \$0.001 was established.

During December 1999, we formed a wholly owned subsidiary in the United Kingdom, Internap Network Services U.K. Limited, and during June 2000, we formed a wholly owned subsidiary in the Netherlands, Internap Network Services B.V. During 2002, we discontinued our operations in Amsterdam and are providing service to our Amsterdam customers from our London service point. The consolidated financial statements of the Internap Network Services Corporation include all activity of these subsidiaries since their dates of incorporation forward. Foreign exchange gains and losses have not been material to date.

We have a limited operating history and our operations are subject to certain risks and uncertainties frequently encountered by rapidly evolving markets. These risks include the failure to develop or supply technology or services, the ability to obtain adequate financing, competition within the industry and technology trends.

We have experienced significant net operating losses since inception. During fiscal 2002, we incurred net losses of \$72.3 million and used \$40.3 million of cash in our operating activities. Management expects operating losses will continue through December 31, 2003, and negative cash flows to continue until October 2003. During 2002, we have decreased the size of our workforce by 216 employees, or 40% as compared to the number of employees at December 31, 2001, and terminated certain real estate leases and commitments in order to control costs. Our plans indicate our existing cash and investments are adequate to fund our operations through December 31, 2003. However, our capital requirements depend on several factors, including the rate of market acceptance of our services, the ability to expand and retain our customer base and other factors. If we fail to realize our planned revenues or costs, management

believes it has the ability to curtail capital spending and reduce expenses to ensure cash and investments will be sufficient to meet our cash requirements through December 31, 2003. If, however, our cash requirements vary materially from those currently planned, or if we fail to generate sufficient cash flow from the sales of our services, we may require additional financing sooner than anticipated. We cannot assure such financing will be available on acceptable terms, if at all.

## Note 2

### SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND BASIS OF PRESENTATION

#### **Accounting principles**

The consolidated financial statements and accompanying notes are prepared in accordance with accounting principles generally accepted in the United States of America. The consolidated financial statements include the accounts of Internap Network Services Corporation and all majority owned subsidiaries. Significant inter-company transactions have been eliminated in consolidation.

#### **Estimates and assumptions**

The consolidated financial statements of Internap Network Services Corporation have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an ongoing basis, we evaluate our estimates, including those related to revenue recognition, doubtful accounts, investments, intangible assets, income taxes, restructuring costs, long-term service contracts, contingencies and litigation. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ materially from these estimates under different assumptions or conditions.

#### **Cash and cash equivalents**

We consider all highly liquid investments purchased with an original or remaining maturity of three months or less at the date of purchase and money market mutual funds to be cash equivalents. We invest our cash and cash equivalents with major financial institutions and may, at times, exceed federally insured limits. We believe that the risk of loss is minimal. To date, we have not experienced any losses related to cash and cash equivalents.

At December 31, 2002 and 2001 we had placed approximately \$2.1 and \$2.4 million respectively, in restricted cash accounts to collateralize letters of credit with financial institutions. These amounts are reported separately as restricted cash and are classified as non-current assets.

#### **Investments**

Our investments are comprised of U.S. Treasury, Government Agency, and corporate debt and equity securities.

We classify our marketable securities for which there is a determinable fair value as available-for-sale in accordance with the provisions of Statement of Financial Standards ("SFAS") No. 115, "Accounting for Certain Investments in Debt and Equity Securities." Available-for-sale securities are reported at fair value with the related unrealized gains and losses included in other comprehensive income. The fair values of investments are determined based on quoted market prices for those securities. The cost of securities sold is based on the specific identification method. Realized gains and losses and declines in value of securities judged to be other than temporary are recorded as a component of losses on investments.



We account for investments without readily determinable fair values at historical cost, as determined by our initial investment. The recorded value of cost basis investments is periodically reviewed to determine the propriety of the recorded basis. When a decline in the value that is judged to be other than temporary has occurred based on available data, the cost basis is reduced and an investment loss is recorded.

We account for investments that provide us with the ability to exercise significant influence, but not control, over an investee using the equity method of accounting. Significant influence, but not control, is generally deemed to exist if Internap has an ownership interest in the voting stock of the investee of between 20% and 50%, although other factors, such as minority interest protections, are considered in determining whether the equity method of accounting is appropriate. As of December 31, 2001 and 2002, we have a single investment that qualifies for equity method accounting, our joint venture with NTT-ME Corporation of Japan. We record our proportional share of the losses of our investee one month in arrears. We record our investment in our equity-method investee on the consolidated balance sheets as a component of non-current investments and our share of the investee's losses as loss on investment on the consolidated statements of operations.

#### **Accounts receivable and concentration of credit risk**

We extend trade credit terms to our customers based upon credit analysis performed by management. Further credit reviews are performed on a periodic basis as deemed necessary. Generally, collateral is not required on accounts receivable, however, advance deposits are collected for accounts considered credit risks. An allowance is made for customer accounts for which collection has become doubtful. The allowance is maintained until such time as collection becomes probable.

#### **Fair value of financial instruments**

Our short-term financial instruments, including cash and cash equivalents, accounts receivable, accounts payable, notes payable, capital lease obligations, and the line of credit are carried at cost. The cost of our short-term financial instruments approximate fair value due to their relatively short maturities. The carrying value of our long-term financial instruments, including notes payable and capital lease obligations, approximate fair value as the interest rates approximate current market rates of similar debt obligations.

#### **Property and equipment**

Property and equipment are carried at original acquisition cost less accumulated depreciation and amortization. Depreciation and amortization are calculated on a straight-line basis over the lesser of the estimated useful lives of the assets or the duration of the underlying lease obligation or commitment. Estimated useful lives used for network equipment are three years; furniture, equipment and software are three to seven years; and leasehold improvements are the shorter of seven years or the duration of the lease. Lease obligations and commitment durations range from 24 months for certain networking equipment to 180 months for certain leasehold improvements. Additions and improvements that increase the value or extend the life of an asset are capitalized. Maintenance and repairs are expensed as incurred. Gains or losses from asset disposals are charged to operations.

#### **Costs of computer software developed or obtained for internal use**

In accordance with Statement of Position ("SOP") 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use," we capitalize certain direct costs incurred developing internal use software. During the year ended December 31, 2000, 2001 and 2002, we capitalized approximately \$1.3 million, \$3.0 million and \$820,000, respectively, of internal software development costs.

#### **Goodwill and other intangible assets**

Goodwill and other intangible assets consist of goodwill, covenants not to compete and developed technology recorded as a result of our acquisition of VPNX.com, Inc. We adopted SFAS No. 142, "Goodwill and Other Intangible Assets" during 2002. Accordingly, effective January 1, 2002, goodwill is not being amortized and is being reviewed for impairment on an annual basis, or more frequently if indications of

impairment arise. We have determined that the remainder of our intangible assets have finite lives and we have recorded these assets at cost less accumulated amortization. Intangibles, other than goodwill, are being amortized on a straight-line basis over the economic useful life of the assets, estimated to be three years, except approximately \$435,000 of capitalized patent costs, which are being amortized over 15 years.

**Valuation of long-lived assets**

Management periodically evaluates the carrying value of its long-lived assets, including, but not limited to, property and equipment pursuant to the guidance provided by SFAS No. 144, "Accounting for the Impairment and Disposal of Long-Lived Assets." The carrying value of a long-lived asset is considered impaired when the undiscounted cash flow from such asset is separately identifiable and is estimated to be less than its carrying value. In that event, a loss is recognized based on the amount by which the carrying value exceeds the fair value of the long-lived asset. Fair value is determined primarily using the anticipated cash flows discounted at a rate commensurate with the risk involved. Losses on long-lived assets to be disposed of would be determined in a similar manner, except that fair values would be reduced by the cost of disposal. Losses due to impairment of long-lived assets are recorded during the period in which the impairment is identified.

**Income taxes**

We account for income taxes under the liability method. Deferred tax assets and liabilities are determined based on differences between financial reporting and tax bases of assets and liabilities, and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. We provide a valuation allowance to reduce our deferred tax assets to their estimated realizable value.

**Stock-based compensation**

On December 31, 2002, we had eight stock-based employee compensation plans, which are described more fully in Note 16. The company accounts for those plans under the recognition and measurement principles of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations.

The following table illustrates the effect on net income and earnings per share if the company had applied the fair value recognition provisions of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, to stock-based employee compensation.

Year Ended December 31	2000	2001	2002
Net loss, as reported	\$(185,457)	\$(479,162)	<b>\$(72,345)</b>
Add: stock-based employee compensation expense included in reported net loss	10,651	4,217	<b>260</b>
Deduct: total stock-based employee compensation expense determined under fair-value based method for all awards	(142,794)	32,844	<b>(37,577)</b>
Pro Forma net loss	\$(317,600)	\$(442,101)	<b>\$(34,508)</b>
Loss per share:			
Basic and diluted – as reported	\$ (1.30)	\$ (3.19)	<b>\$ (.47)</b>
Basic and diluted – pro forma	\$ (2.23)	\$ (2.94)	<b>\$ (.22)</b>

The \$37.6 million pro forma reduction of employee compensation expense is due to a \$115.1 million reduction related to options cancelled as a result of employee terminations offset by amortization of compensation determined under the fair-value based method.

### Revenue recognition

We recognize revenues when persuasive evidence of an arrangement exists, the service has been provided, the fees for the service rendered are fixed or determinable and collectibility is probable. We review the creditworthiness of our customers routinely. If we determine that collection of service revenues is uncertain, we do not recognize revenue until cash has been collected. Customers are billed for services as of the first day of each month either on a usage or a flat-rate basis. The usage based billing relates to the month prior to the month in which the billing occurs, whereas certain flat rate billings relate to the month in which the billing occurs.

Revenues associated with billings for installation of customer network equipment are deferred and amortized over the estimated life of the customer relationship in accordance with the Securities and Exchange Commission Staff Accounting Bulletin No. 101 as the installation service is integral to our primary service offering. Deferred revenues consist of revenues for services to be delivered in the future, which are amortized over the respective service period, and billings for initial installation of customer network equipment.

### Product development costs

Product development costs are primarily related to network engineering costs associated with changes to the functionality of the Internap's proprietary services and network architecture. Such costs that do not qualify for capitalization are expensed as incurred. Research and development costs, which are included in product development cost, primarily consist of compensation cost related to our service development network architecture and are expensed as incurred. Research and development costs were approximately, \$7.7 million, \$6.3 million, and \$4.1 million for the years ended December 31, 2000, 2001 and 2002, respectively.

### Advertising costs

We expense all advertising costs as they are incurred. Advertising costs for 2000, 2001 and 2002 were, \$2.9 million, \$4.5 million and \$575,000, respectively.

### Net loss per share

Basic and diluted net loss per share has been computed using the weighted average number of shares of common stock outstanding during the period, less the weighted average number of unvested shares of common stock issued that are subject to repurchase. The Company has excluded all outstanding convertible preferred stock, warrants to purchase convertible preferred stock, outstanding options to purchase common stock and shares subject to repurchase from the calculation of diluted net loss per share, as such securities are antidilutive for all periods presented.

The following table presents the calculation of basic and diluted net loss per share (in thousands, except per share data):

Year Ended December 31,	2000	2001	2002
Net loss	\$(185,457)	\$(479,162)	<b>\$ (72,345)</b>
Basic and diluted:			
Weighted average shares of common stock outstanding used in computing basic and diluted net loss per share	142,451	150,328	<b>155,545</b>
Basic and diluted net loss per share	\$ (1.30)	\$ (3.19)	<b>\$ (0.47)</b>
Antidilutive securities not included in diluted net loss per share calculation:			
Convertible preferred stock – equivalent common shares	–	68,455	<b>63,281</b>
Options to purchase common stock	24,159	25,732	<b>23,321</b>
Warrants to purchase common and Series B convertible preferred stock	1,646	18,259	<b>17,327</b>
Unvested shares of common stock subject to repurchase	100	–	–
	25,905	112,446	<b>103,929</b>

### Segment information

The Company uses the management approach for determining which, if any, of its products, locations, customers or management structures constitute a reportable business segment. The management approach designates the internal organization that is used by management for making operating decisions and assessing performance as the source of the Company's reportable segments. Management uses one measurement of profitability and does not disaggregate its business for internal reporting and therefore operates in a single business segment. Through December 31, 2002, long-lived assets and revenues located outside the United States are not significant.

### Recent accounting pronouncements

In June 2001, the Financial Accounting Standards Board ("FASB") issued SFAS No. 143, "Accounting for Asset Retirement Obligations," which is effective January 1, 2003. This standard addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated retirement costs. The Company is currently assessing the application of SFAS No. 143.

In August 2001, the FASB issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." This supersedes FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, and the accounting and reporting provisions of APB Opinion No. 30, *Reporting the Results of Operations – Reporting the Effects of Disposal of a Segment of a Business*, and *Extraordinary, Unusual and Infrequently Occurring Events and Transactions*, for the disposal of a segment of a business. This Statement also amends ARB No. 51, *Consolidated Financial Statements*, to eliminate the exception to consolidation for a subsidiary for which control is likely to be temporary. This standard is effective for fiscal years beginning after December 15, 2001 and, therefore, was adopted by the Company during 2002.

In July 2002, the FASB issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities." This standard requires costs associated with exit or disposal activities to be recognized when they are incurred. The requirements of SFAS No. 146 apply prospectively to activities that are initiated after December 31, 2002, and as such, the Company cannot reasonably estimate the impact of adopting these new rules until and unless it undertakes relevant activities in future periods.

In December 2002, the FASB issued SFAS No. 148, "Accounting for Stock-Based Compensation – Transition and Disclosure." This standard amends FASB Statement No. 123, *Accounting for Stock-Based Compensation*, to provide alternative methods of transition for a voluntary change to the fair-value based method of accounting for stock-based employee compensation. In addition, this Statement amends the disclosure requirements of Statement 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. The Company adopted the disclosure provisions of this standard during 2002.

In February 2003, the EITF issued an abstract, Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables." This Issue addresses certain aspects of the accounting by a vendor for arrangements under which it will perform multiple revenue-generating activities. Specifically, this Issue addresses how to determine whether an arrangement involving multiple deliverables contains more than one unit of accounting. The Company is currently assessing the impact of EITF No. 00-21 as it relates to revenue arrangements with multiple deliverables.

In December 2002, the FASB issued SFAS No. 148, "Accounting for Stock-Based Compensation – Transition and Disclosure." This standard amends FASB Statement No. 123, *Accounting for Stock-Based Compensation*, to provide alternative methods of transition for a voluntary change to the fair-value based method of accounting for stock-based employee compensation. In addition, this Statement amends the disclosure requirements of Statement 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. The Company adopted the disclosure provisions of this standard during 2002.

In November 2002, the FASB issued Interpretation No. 45 ("FIN 45"), "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of the Indebtedness of Others," which clarifies the requirements of SFAS No. 5, "Accounting for Contingencies," relating to a guarantor's accounting for and disclosures of certain guarantees issued. FIN 45 requires enhanced disclosures for certain guarantees. It also will require certain guarantees that are issued or modified after December 31, 2002, including certain third-party guarantees, to be initially recorded on the balance sheet at fair value. The Company has determined that the implementation of this standard will not have a material effect on its previously issued financial statements. The Company cannot reasonably estimate the impact of adopting FIN 45 until guarantees are issued or modified in future periods, at which time their results will be initially reported in the financial statements.

In January 2003, the FASB issued Interpretation No. 46 ("FIN 46"), "Consolidation of Variable Interest Entities," which clarifies the application of Accounting Research Bulletin No. 51, "Consolidated Financial Statements," relating to consolidation of certain entities. First, FIN 46 will require identification of the Company's participation in variable interests entities ("VIE"), which are defined as entities with a level of invested equity that is not sufficient to fund future activities to permit them to operate on a standalone basis, or whose equity holders lack certain characteristics of a controlling financial interest. Then, for entities identified as VIE, FIN 46 sets forth a model to evaluate potential consolidation based on an assessment of which party to the VIE, if any, bears a majority of the exposure to its expected losses, or stands to gain from a majority of its expected returns. FIN 46 also sets forth certain disclosures regarding interests in VIE that are deemed significant, even if consolidation is not required. The Company is currently assessing the application of FIN 46 as it relates to its variable interests.

### Reclassifications

Certain reclassifications have been made to prior year balances to conform to the current year presentation. These reclassifications had no impact on previously reported net loss, stockholders' equity or cash flows.

## Note 3

### IMPAIRMENT AND RESTRUCTURING COSTS

#### 2001 restructuring charge

During fiscal year 2001, due to the decline and uncertainty of the telecommunications market, we announced two separate restructurings of our business. Under the restructuring programs, management decided to exit certain non-strategic real estate lease and license arrangements, consolidate and exit redundant network connections and streamline the operating cost structure. As part of the 2001 restructuring activity, 313 employees were involuntarily terminated. Employee separations occurred in all Internap departments. The majority of the costs related to the termination of employees in 2001 were paid during 2001. The total charges include restructuring costs of \$71.6 million. During fiscal year 2001, we incurred cash restructuring expenditures totaling \$19.9 million and non-cash restructuring expenditures of \$4.7 million. We reduced the original 2001 restructuring charge cost estimate by \$7.7 million primarily as a result of favorable lease obligation settlements, leaving a balance of \$39.3 million as of December 31, 2001. During the first and third quarters of 2002, we further reduced our 2001 restructuring charge liability by \$5.0 million and \$7.2 million, respectively. The first reduction was primarily due to settlements to terminate and restructure certain collocation lease obligations on terms more favorable than our original restructuring estimates. The second reduction was primarily due to the decision to relocate our corporate headquarters to the previously restructured Atlanta, Georgia, facility. Pursuant to the original restructuring plans, we did not anticipate using the Atlanta facility in the future. However, due to changes in management, corporate direction, and other factors, which could not be foreseen at the time of the original restructuring plans, the Atlanta facility was selected as the location for the new corporate headquarters.

**2002 restructuring and asset impairment charge**

With the continuing decline and uncertainty in the telecommunications market during 2002, we implemented additional restructuring actions to align our business with market opportunities. As a result, we recorded a business restructuring charge and asset impairments of \$7.6 million in the three months ended September 30, 2002. The charges were primarily comprised of real estate obligations related to a decision to relocate the corporate headquarters from Seattle, Washington, to an existing leased facility in Atlanta, Georgia, net asset write-downs related to the departure from the Seattle office and costs associated with further personnel reductions. The restructuring and asset impairment charge of \$7.6 million during 2002 was offset by a \$7.2 million adjustment, described above, resulting from the decision to utilize the Atlanta facility as our corporate headquarters. The previously unused space in the Atlanta location had been accrued as part of the restructuring liability established during fiscal year 2001.

Included in the \$7.6 million 2002 restructuring charge are \$1.1 million of personnel costs related to a reduction in force of approximately 145 employees. This represents employee severance payments made during 2002. We expect that there will be additional restructuring costs in the future as additional payments are made to employees who are subject to deferred compensation arrangements payable at the completion of interim employment agreements. We expect these costs to total less than \$1.0 million. Additionally, we continue to evaluate the restructuring reserve as plans are being executed, which could result in additional charges or adjustments.

**Real estate obligations.** Both the 2001 and 2002 restructuring plans require us to abandon certain leased properties not currently in use or that will not be utilized by us in the future. Also included in real estate obligations is the abandonment of certain collocation license obligations. Accordingly, we recorded real estate related restructuring costs of \$40.8 million, net of non-cash plan adjustments, which are estimates of losses in excess of estimated sublease revenues or termination fees to be incurred on these real estate obligations over the remaining lease terms expiring through 2015. This cost was determined based upon our estimate of anticipated sublease rates and time to sublease the facility. If rental rates decrease in these markets or if it takes longer than expected to sublease these properties, the actual loss could exceed this estimate.

**Network infrastructure obligations.** The changes to our network infrastructure require that we decommission certain network ports we do not currently use and will not use in the future pursuant to the restructuring plan. These costs have been accrued as components of the restructuring charge because they represent amounts to be incurred under contractual obligations in existence at the time the restructuring plan was initiated. These contractual obligations will continue in the future with no economic benefit, or they contain penalties that will be incurred if the obligations are cancelled.

**Asset impairments.** On June 20, 2000, we completed the acquisition of CO Space, which was accounted for under the purchase method of accounting. The purchase price was allocated to net tangible assets and identifiable intangible assets and goodwill.

On February 28, 2001, management and the Board of Directors approved a restructuring plan that included ceasing development of the executed but undeveloped leases and the termination of core collocation development personnel. Consequently, financial projections for the business were lowered and, pursuant to the guidance provided by Financial Accounting Standards Board No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of" ("SFAS 121"), management completed a cash flow analysis of the collocation assets, including the assets acquired from CO Space. The cash flow analysis showed that the estimated cash flows were less than the carrying value of the collocation assets. Accordingly, pursuant to SFAS 121, management estimated the fair value of the collocation assets to be \$79.5 million based upon a discounted future cash flow analysis. As estimated fair value of the collocation assets was less than their recorded amounts, we recorded an impairment charge of approximately \$196.0 million.

## INTERNAP 2002 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following table displays the activity and balances for restructuring and asset impairment activity for 2001 (in millions):

	Charge	Cash Reductions	Non-cash Write-downs	Non-cash Plan Adjustments	December 31, 2001 Restructuring Liability
<b>Restructuring costs</b>					
Real estate obligations	\$ 60.0	\$(14.7)	\$ (3.7)	\$(7.0)	\$34.6
Employee separations	3.3	(3.2)	-	-	0.1
Network infrastructure obligations	6.3	(1.9)	(1.0)	(0.7)	2.7
Other	2.0	(0.1)	-	-	1.9
<b>Total</b>	<b>71.6</b>	<b>(19.9)</b>	<b>(4.7)</b>	<b>(7.7)</b>	<b>39.3</b>
<b>Asset impairments</b>					
Goodwill	176.1	-	(176.1)	-	-
Assembled workforce	1.5	-	(1.5)	-	-
Trade name and trademarks	2.2	-	(2.2)	-	-
Completed real estate leases	14.8	-	(14.8)	-	-
Customer relationships	1.4	-	(1.4)	-	-
<b>Total asset impairments</b>	<b>196.0</b>	<b>-</b>	<b>(196.0)</b>	<b>-</b>	<b>-</b>
<b>Total</b>	<b>\$267.6</b>	<b>\$(19.9)</b>	<b>\$(200.7)</b>	<b>\$(7.7)</b>	<b>\$39.3</b>

Of the \$71.6 million recorded during 2001 as restructuring reserves, approximately \$50.7 million related to the direct cost of network, \$1.1 million related to customer support, \$0.3 million related to product development, \$1.5 million related to sales and marketing and \$18.0 million related to general and administrative costs.

The following table displays the activity and balances for restructuring and asset impairment activity for 2002 (in millions):

	December 31, 2001 Restructuring Liability	Restructuring and Impairment Charge	Cash Reductions	Non-cash and Write- downs	Non-cash Plan Adjustments	December 31, 2002 Restructuring Liability
<b>Restructuring costs activity for 2001</b>						
restructuring charge -						
Real estate obligations	\$34.6	\$ -	\$(11.2)	\$(1.6)	\$(12.2)	\$ 9.6
Network infrastructure obligations	2.7	-	(1.4)	-	-	1.3
Other	2.0	-	(0.9)	-	-	1.1
<b>Restructuring costs activity for 2002</b>						
restructuring charge -						
Real estate obligations	-	2.2	(0.4)	-	-	1.8
Personnel	-	1.1	(1.1)	-	-	-
Other	-	0.2	(0.1)	-	-	0.1
<b>Total</b>	<b>39.3</b>	<b>3.5</b>	<b>(15.1)</b>	<b>(1.6)</b>	<b>(12.2)</b>	<b>13.9</b>
<b>Net asset write-downs for 2002</b>						
restructuring charge	-	4.1	-	(4.3)	-	(0.2)
<b>Total</b>	<b>\$39.3</b>	<b>\$7.6</b>	<b>\$(15.1)</b>	<b>\$(5.9)</b>	<b>\$(12.2)</b>	<b>\$13.7</b>

Of the \$3.5 million recorded during 2002 as restructuring reserves, approximately \$212,000 related to the direct cost of network and \$3.3 million related to general and administrative costs.

We expect to complete the majority of these restructuring activities related to the 2001 and 2002 restructuring charges during 2003, although certain remaining restructured real estate and network obligations represent long-term contractual obligations that extend beyond 2003.

## Note 4

### BUSINESS COMBINATIONS

On June 20, 2000, we completed our acquisition of CO Space, Inc. ("CO Space"). CO Space provides collocation, or data center, space to customers who wish to collocate certain computer server and telecommunications equipment with a third party provider. We have integrated the CO Space service into our primary service offerings. The acquisition was recorded using the purchase method of accounting under Accounting Principle Board Opinion No. 16 ("APB 16"). The aggregate purchase price of the acquired company, plus related charges, was approximately \$270.9 million and was comprised of our common stock, cash, acquisition costs and options to purchase common stock. The Company issued approximately 6,881,000 shares of common stock and assumed options to purchase CO Space common stock that were subsequently converted into options to purchase approximately 322,000 shares of our common stock to effect the transaction. Results of operations of CO Space have been included in our financial results since the closing date of the transaction.

Supplemental disclosure of cash flow information for CO Space is as follows (in thousands):

Cash acquired	\$ 3,488
Accounts receivable	546
Property and equipment, net	36,715
Full recourse notes receivable for outstanding common stock	642
Other tangible assets	1,887
<b>Tangible assets acquired</b>	<b>43,278</b>
Customer relationships	1,800
Completed real estate leases	19,300
Trade name and trademarks	2,800
Workforce in place	2,000
Goodwill	229,160
<b>Intangible assets acquired</b>	<b>255,060</b>
<b>Total assets acquired</b>	<b>\$298,338</b>
Cash paid	\$ 7,200
Acquisition expenses incurred	12,383
Liabilities assumed	23,804
Value of stock and options issued	254,951
<b>Total cash paid, liabilities assumed, common stock issued and options assumed</b>	<b>\$298,338</b>

On July 31, 2000, we completed our acquisition of VPNX.com, Inc., formerly Switchsoft Systems, Inc. ("VPNX"). The acquisition was recorded using the purchase method of accounting under APB 16. The aggregate purchase price of the acquired company, plus related charges, was approximately \$87.4 million and was comprised of our common stock, cash, acquisition costs and assumed options to purchase common stock. We issued approximately 2,027,000 shares of common stock and assumed options to purchase VPNX common stock that were subsequently converted into options to purchase approximately 268,000 shares of the our common stock to effect the transaction. Results of operations of VPNX have been included in our financial results since the closing date of the transaction.



Supplemental disclosure of cash flow information for VPNX is as follows (in thousands):

Cash acquired	\$ 3,070
Property and equipment	834
Other tangible assets	798
<b>Tangible assets acquired</b>	<b>4,702</b>
Developed technology	2,600
Acquired in-process research and development	18,000
Covenants not to compete	14,100
Workforce in place	1,000
Goodwill	50,199
<b>Intangible assets acquired</b>	<b>85,899</b>
<b>Total assets acquired</b>	<b>\$90,601</b>
Acquisition expenses incurred	\$ 329
Liabilities assumed	3,178
Value of stock and options issued	92,232
Deferred stock compensation	(5,138)
<b>Total liabilities assumed, common stock issued and options assumed</b>	<b>\$90,601</b>

In accordance with APB 16, all identifiable assets were assigned a portion of the purchase price of the acquired companies on the basis of their respective fair values. Identifiable intangible assets and goodwill are included in "Goodwill and other intangible assets, net" on the accompanying consolidated balance sheets, intangible assets are amortized over their average estimated useful lives of three years. Intangible assets were identified and valued by considering our intended use of acquired assets, and analysis of data concerning products, technologies, markets, historical financial performance and underlying assumptions of future performance. The economic and competitive environments in which the acquired companies and we operate were also considered in the valuation analysis. The amount allocated to acquired in-process research and development is related to technology acquired from VPNX that was expensed immediately subsequent to the closing of the acquisition since the technology had not completed the preliminary stages of development, had not commenced application development and did not have alternative future uses. Furthermore, the technologies associated with the acquired in-process research and development does not have a proven market and are sufficiently complex so that the probability of completion of a marketable service or product cannot be determined. The fair value of the acquired in-process research and development was determined using the income approach, which estimates the expected cash flows from projects once commercially viable, and discounts expected future cash flows to present value. The percentage of completion for each project was determined based upon time and costs incurred on the project in addition to the relative complexity. The percentage of completion varied by individual project and ranged from 25% to 70%. The discount rate of 35% was used in the present value calculation was derived from an analysis of weighted average costs of capital, weighted average returns on assets, and venture capital rates of returns adjusted for the specific risks associated with the in-process research and development acquired. This analysis resulted in an allocation of \$18.0 million to acquired in-process research and development expense. The development of the acquired technologies remains a significant risk as the nature of the efforts to develop the acquired technologies into commercially viable services consists primarily of planning, designing, and testing activities necessary to determine that the products can meet customer expectations.

The pro forma consolidated financial information for the year ended December 31, 2000, determined as if the acquisitions of CO Space and VPNX had occurred at the beginning of the year ended December 31, 2000, would have resulted in revenues of approximately \$72.0 million, net loss of approximately \$241.2 million and basic and diluted loss per share of approximately \$1.64. This unaudited pro forma information is presented for illustrative purposes only and is not necessarily indicative of the results of operations in future periods or results that would have been achieved had we, CO Space and VPNX been combined during the specified periods.

## Note 5

### INVESTMENTS

On April 10, 2001, we announced the formation of a joint venture with NTT-ME Corporation of Japan. The formation of the joint venture involved our cash investment of \$2.8 million to acquire 51% of the common stock of the newly formed entity, Internap Japan. We are unable to assert control over the joint venture's operational and financial policies and practices required to account for the joint venture as a subsidiary whose assets, liabilities, revenues and expenses would be consolidated (due to certain minority interest protections afforded to our joint venture partner, NTT-ME Corporation). We are, however, able to assert significant influence over the joint venture and, therefore, account for our joint venture investment using the equity-method of accounting pursuant to Accounting Principles Board Opinion No. 18 "The Equity Method of Accounting for Investments in Common Stock" and consistent with EITF 96-16 "Investor's accounting for an investee when the investor has a majority of the voting interest but the minority shareholder or shareholders have certain approval or veto rights." During the year ended December 31, 2001, we recognized our proportional share of Internap Japan's losses totaling \$1.2 million, resulting in a net investment balance of \$1.6 million. Our investment in Internap Japan is reflected as a component of long-term investments and losses are reflected as a component of loss on investments.

During the year ended December 31, 2002, the joint venture authorized a capital call in which we invested an additional \$1.3 million and maintained our 51% ownership interest. Additionally, we recognized our proportional share of Internap Japan's losses totaling \$1.2 million and recorded an unrealized translation gain of \$149,000, resulting in a net investment balance of \$1.9 million at December 31, 2002.

Summarized balance sheet and results of operations of our equity-method investee, shown one month in arrears, are as follows (in thousands):

As of December 31, 2002

Current assets	\$3,434
Total assets	4,373
Current liabilities	708
Total liabilities	708

For the Year Ended December 31, 2002

Revenues	\$1,833
Net loss from continuing operations	(2,183)
Net loss	(2,169)

## INTERNAP 2002 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Pursuant to an investment agreement among Internap, Ledcor Limited Partnership, Worldwide Fiber Holdings Ltd. and 360networks, Inc. ("360networks"), on April 17, 2000, we purchased 374,182 shares of 360networks Class A Non-Voting Stock at \$5.00 per share and, on April 26, 2000, we purchased 1,122,545 shares of 360networks Class A Subordinate Voting Stock at \$13.23 per share. The total cash investment was \$16.7 million. During 2001 we liquidated our entire investment in 360networks for cash proceeds of \$2.2 million and recognized a loss on investment totaling \$14.5 million.

We account for investments without readily determinable fair values at cost. Realized gains and losses and declines in value of securities judged to be other than temporary are included in other income (expense). On February 22, 2000, pursuant to an investment agreement, we purchased 588,236 shares of Aventail Corporation ("Aventail") Series D preferred stock at \$10.20 per share for a total cash investment of \$6.0 million. Because Aventail is a privately held enterprise for which no active market for its securities exists, the investment is recorded as a cost basis investment. During the second quarter of 2001, we concluded based on available information, specifically Aventail's most recent round of financing, that our investment in Aventail had experienced a decline in value that was other than temporary. As a result during June 2001, we recognized a \$4.8 million loss on investment when we reduced its recorded basis to \$1.2 million, which remains its estimated value as of December 31, 2002.

Investments consisted of the following (in thousands):

As of December 31, 2001	Cost Basis	Unrealized Gain	Recorded Value
U.S. Government and Government Agency Debt Securities	\$ 6,210	\$ 3	\$ 6,213
Corporate Debt Securities	12,538	4	12,542
Equity Securities	1,618	-	1,618
Cost Basis Investments	1,176	-	1,176
	<b>\$21,542</b>	<b>\$ 7</b>	<b>\$21,549</b>

As of December 31, 2002	Cost Basis	Unrealized Gain	Recorded Value
<b>Equity-method Investments</b>	<b>\$1,722</b>	<b>\$149</b>	<b>\$1,871</b>
<b>Cost Basis Investments</b>	<b>1,176</b>	<b>-</b>	<b>1,176</b>
	<b>\$2,898</b>	<b>\$149</b>	<b>\$3,047</b>

## Note 6

### PROPERTY AND EQUIPMENT

Property and equipment consists of the following (in thousands):

December 31,	2001	2002
Network equipment	\$ 39,187	\$ 56,663
Network equipment under capital lease	60,528	37,753
Furniture, equipment and software	34,921	26,024
Furniture, equipment and software under capital lease	3,609	4,378
Leasehold improvements	71,851	68,923
	210,096	193,741
Less: Accumulated depreciation and amortization (\$32,438 and \$28,735 related to capital leases at December 31, 2001 and 2002, respectively)	(70,507)	(105,347)
Property and equipment, net	\$139,589	\$ 88,394

Assets under capital leases are pledged as collateral for the underlying lease agreements. Assets not under lease are pledged as collateral under our line of credit facility or notes payable facilities.

During the year ended December 31, 2002, the Company amended the terms of the master lease agreement with our primary supplier of networking equipment (Note 11). As part of this amendment we purchased equipment for \$5.8 million; this purchase resulted in a \$23.7 million transfer from network equipment under capital lease to network equipment and a transfer of \$19.6 million of accumulated depreciation under capital lease to accumulated depreciation.

## Note 7

### GOODWILL AND INTANGIBLE ASSETS

Effective January 1, 2002, we adopted SFAS No. 142, "Goodwill and Other Intangible Assets," which establishes new accounting and reporting requirements for goodwill and other intangible assets. Under SFAS No. 142, all goodwill amortization ceased effective January 1, 2002 and recorded goodwill was tested for impairment by comparing the fair value of Internap Network Services Corporation as a single reporting unit, as determined by its implied market capitalization, to its consolidated carrying value including recorded goodwill. An impairment test is required to be performed at adoption of SFAS No. 142 and at least annually thereafter. Generally, any adjustments made as a result of the impairment testing are required to be recognized as operating expenses. We will perform our annual impairment testing during the third quarter of each year absent any impairment indicators that may cause more frequent analysis, as required by SFAS No. 142.

Based on our initial impairment test performed upon adoption of SFAS No. 142, we determined that none of the recorded goodwill was impaired as of January 1, 2002. During the period ended September 30, 2002, we performed our annual impairment testing. The Step 1 test, as defined by SFAS No. 142, was performed by comparing the adjusted book value of the consolidated company to its fair value. In determining Internap's fair value we considered both market-based and income-based approaches to estimate value.

Based on the results of the analysis performed we concluded that no goodwill impairment existed as of September 30, 2002. The assumptions, inputs and judgments used in performing the valuation analysis are inherently subjective and reflect estimates based on known facts and circumstances at the time the valuation was performed. The use of different assumptions, inputs and judgments, or changes in circumstances, could materially affect the results of the valuation. Adverse changes in the valuation would necessitate an impairment charge for the goodwill held by Internap. As of December 31, 2002, the recorded amount of goodwill totaled \$27.0 million.

In connection with adopting SFAS No. 142, we also reassessed the useful lives and the classification of our amortizing identifiable intangible assets and determined that they continue to be appropriate. The components of our amortized intangible assets are as follows (in thousands):

	December 31, 2001		December 31, 2002	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Contract based	\$14,535	\$(6,711)	<b>\$14,535</b>	<b>\$(11,484)</b>
Technology based	2,600	(1,228)	<b>2,600</b>	<b>(2,094)</b>
	\$17,135	\$(7,939)	<b>\$17,135</b>	<b>\$(13,578)</b>

Amortization expense for identifiable intangible assets during 2001 and 2002 was \$5.6 million. Estimated amortization expense for the next 5 years and thereafter is as follows (in thousands):

Years Ending December 31,	
2003	\$3,275
2004	28
2005	28
2006	28
2007	28
Thereafter	170

Actual and adjusted results of operations for the year ended December 31, 2000, 2001 and 2002, had we applied the non-amortization provisions of SFAS No. 142, is as follows (in thousands, except per share amounts):

Year Ended December 31,	2000	2001	2002
Reported net loss	\$(185,457)	\$(479,162)	<b>\$(72,345)</b>
Add amortization of goodwill	45,165	17,066	-
Adjusted net loss	\$(140,292)	\$(462,096)	<b>\$ 72,345</b>
Reported net loss per share	\$ (1.30)	\$ (3.19)	<b>\$ (0.47)</b>
Adjusted net loss per share	(0.98)	(3.07)	<b>(0.47)</b>

## Note 8

### NOTE RECEIVABLE

During August 2000, we loaned a private network company \$6.0 million in exchange for a convertible promissory note bearing interest at the prime rate plus 3% and initially maturing during May 2001. In two separate amendments executed during December 2000 and February 2001, we agreed to modify the note to eliminate the conversion feature and to extend the note's maturity through the earlier of May 2004 or upon the completion of a transaction in which there is a change in control of borrower or in which the borrower sells substantially all its assets.

Subsequent to the February 2001 amendment, we performed an updated analysis of the collection risk associated with this note receivable. The results of our analysis indicated that there was substantial doubt that the borrower would be able to repay the \$6.0 million obligation to us at the time of maturity. Therefore, we have recorded a provision of \$6.0 million as an allowance against our note receivable. The impact of the provision is reflected as a component of loss on investments. As of December 31, 2001, the \$6.0 million loan was outstanding and recorded at the outstanding balance as a note receivable offset in full by a \$6.0 million allowance for doubtful collection.

During 2002, we entered into negotiations with the borrower to settle the amounts due to us in advance of the stated May 2004 maturity. As a result of the negotiations, we agreed to release the borrower of its liability to us under the note in exchange for a cash payment for outstanding accounts receivable and the note receivable and equity in the company, for which the estimated fair value is zero. During January of 2002 we have recognized an investment gain of \$0.4 million with respect to the settlement of the note receivable.

## Note 9

### ACCRUED LIABILITIES

Accrued liabilities consist of the following (in thousands):

December 31,	2001	2002
Network commitments	\$ 6,609	\$ 3,455
Compensation payable	2,722	1,478
Property and equipment purchases	2,227	2,228
Taxes	2,120	2,370
Other	2,004	574
Insurance payable	747	915
Acquisition costs	298	-
	<b>\$16,727</b>	<b>\$11,020</b>

## Note 10

### LINE OF CREDIT AND NOTES PAYABLE

Line of credit and notes payable consist of the following (in thousands):

December 31,	2001	2002
Line of credit	\$10,000	\$10,000
Notes payable to financial institutions	2,992	6,094
Notes payable to vendors	-	3,616
	<b>\$12,992</b>	<b>\$19,710</b>

During June 1999, we entered into a line of credit agreement (the "Line") with a financial institution allowing aggregate borrowings of up to \$3.0 million for the purchase of equipment and working capital. This Line was amended during December 2000 to extend the maturity of the Line to June 30, 2001 and increased the allowable aggregate borrowings to \$10.0 million as limited by certain borrowing base requirements which include maintaining certain levels of revenues, customer turnover ratios and tangible net worth. During 2001, the Line was amended to extend the maturity of the line to December 31, 2001. The Line required monthly interest only payments at prime plus 1.0% (4.75% at December 31, 2001). Events of default for the Line, as amended, included failure to maintain certain financial covenants or a material adverse change in our financial position. A material adverse change was defined as a material impairment in the perfection or priority of the bank's collateral or a material impairment of the prospect of repayment of the Line. As of December 31, 2001, we had drawn all amounts available under the facility.

During February 2002, the Line was renewed and allowed us to borrow an additional \$5.0 million, up to \$15.0 million in aggregate. The renewed facility was originally scheduled to expire on December 31, 2002. Our ability to maintain the drawn amount under the line of credit and have access to the additional \$5.0 million depended on a number of factors including the level of eligible receivable balances and liquidity. The facility allowed advances equal to the greater of 80% of eligible accounts receivable or 25% of cash and short-term investments, whichever was greater. The facility contained financial covenants that

required us to grow revenues, limit the cash losses, and required minimum levels of liquidity and tangible net worth as defined in the agreement. The lender also had the ability to demand repayment in the event, in their view, there has been a material adverse change in our business. At December 31, 2001, we were in compliance with the financial covenants. Payments under the line were interest only with the full principal due at maturity or renewal.

As part of our acquisition of CO Space on June 20, 2000, we assumed an equipment financing agreement (the "Equipment Note") with a financial institution, which provided up to \$2.0 million through the commitment termination date of June 30, 2000 for the purchase of equipment. The Equipment Note was signed on July 29, 1999, has a 42-month term, and bears interest at 3.25% over the yield of a 42-month U.S. Treasury Note on the day of funding. There are two loan schedules under the Equipment Financing Agreement with interest rates of 8.99% and 9.12%. The financing agreement calls for equal monthly principal and interest payments over the term of the Equipment Financing Agreement with a final payment of 8.5% of the original loan amount. As of December 31, 2001 and 2002, we had outstanding borrowings of approximately \$0.9 million and \$.3 million respectively under this Equipment Note.

During October 2002, we entered into a revised loan and security agreement, refinancing the Line and the Equipment Note. Under the terms of the new loan and security agreement the \$15 million outstanding under the previous facility was refinanced into a \$15 million revolving line of credit and a \$5 million term loan. Availability under the revolver is based on 80% of eligible accounts receivable plus 25% of unrestricted cash and investments. Availability is further restricted by the \$5 million outstanding under the term loan until the Company achieves a specified minimum debt coverage service level for six consecutive months as defined in the agreement. The amount available under the revolver at the time of the refinancing and at December 31, 2002 was \$10 million.

The revolving line of credit facility is a 24-month facility expiring during October 2004 and bears interest at a rate ranging from prime plus 1% to prime plus 2% per year (6.25% at December 31, 2002), depending on a certain balance sheet ratio as defined in the agreement. Monthly payments are interest only over the term of the facility. The term loan is a 36-month amortizing facility and bears interest at a fixed rate of 8% per year. Equal monthly payments of principal and interest are due over the term of the facility. The balance outstanding under the term loan was \$5.0 million at December 31, 2002. Both the revolving facility and the term loan are governed by a common security agreement and are collateralized by substantially all the assets of the Company. The agreement allows the lender to require us to maintain cash and investment accounts with them and allows the lender greater control over our customer deposits, as defined in the agreement. Both the revolving credit facility and the term loan also contain financial covenants that require us to maintain a minimum tangible net worth as defined in the agreement. Further, the lender has the ability to demand repayment in the event, in its view, there has been a material adverse change in our business.

During August 1999, we entered into an equipment financing arrangement with a finance company, which allows borrowings of up to \$5.0 million for the purchase of property and equipment. The equipment financing arrangement includes sublimits of \$3.5 million for equipment costs and \$1.5 million for the acquisition of software and other service point and facility costs. Loans under the \$3.5 million sublimit require monthly principal and interest payments over a term of 48 months. This facility bears interest at 7.5% plus an index rate based on the yield of 4-year U.S. Treasury Notes. Loans under the \$1.5 million sublimit require monthly principal and interest payments over a term of 36 months. This facility bears interest at 7.9% plus an index rate based on the yield of 3-year U.S. Treasury Notes. Borrowings under each sublimit were completed prior to May 1, 2000 in accordance with the facility terms and the aggregate balance outstanding under this facility totaled \$2.0 million and \$781,000 as of December 31, 2001 and 2002 respectively. The weighted average interest rate for all borrowings under this facility was approximately 13% as of December 31, 2002.

On July 31, 2000, we assumed a senior loan and security agreement in connection with the acquisition of VPNX. The agreement provided up to \$2.0 through the commitment termination date of August 31, 2000 for the purchase of equipment and requires 36 equal monthly payments of principal and interest. The interest rates on the existing notes range from 6.59% to 8.03%, and each note has a final payment of 15% of the original balance. Outstanding borrowings at December 31, 2001 and 2002 were, \$0.1 million and \$0, respectively.

During 2002, we completed negotiations with a collocation space provider that resulted in a reduction of the periodic rents paid to the provider for 36 months in exchange for a \$2.7 million note payable to be paid in quarterly installments over 36 months. The note bears interest at a rate of 5.5% and is secured by leaseholds, equipment, and customer revenues at one of our service points. The note payable was recorded with an equal prepaid asset that is being amortized to direct cost of network over 36 months. Outstanding borrowings under this note were \$2.1 million at December 31, 2002.

During 2002, we completed negotiations with a second collocation space provider that resulted in a reduction of the periodic rent payments made to the provider in exchange for a \$604,000 unsecured note payable to be paid in monthly installments of principal and interest beginning in April 2003 and continuing for 28 months. The note bears interest at 12% per annum.

During 2000, we entered into an integrated sales agreement to act as an exclusive reseller for a service provider. The agreement included a revenue commitment to be fulfilled over a two-year period that ended during March 2002. We had fully accrued our liability for the \$1.8 million shortfall as of the expiration date of the agreement as a component of accrued expenses. During the second quarter of 2002 we entered into a note payable to the service provider in lieu of immediate payment of the shortfall amount and reclassified the \$1.8 million accrued expense to notes payable. The note matures October 5, 2003, is payable in quarterly principal and interest payments, bears interest of 6.0% and is collateralized by certain network equipment. Outstanding borrowings under this note were \$900,000 as of December 31, 2002.

Maturities of notes payable at December 31, 2002 are as follows:

Years Ending December 31,	
2003	\$4,514
2004	2,931
2005	2,265
2006 and beyond	-
Total maturities and principal payments	9,710
Less: current portion	(4,514)
Notes payable, less current portion	\$5,196

The carrying value of our notes payable as of December 31, 2002, approximate fair value as the interest rates approximate current market rates of similar debt obligations.

## Note 11

### CAPITAL LEASES

Internap leases a significant portion of its property and equipment that are classified as capital leases. Interest on equipment and furniture leases range from 2.3% to 21.5%, expire through 2015 and generally include an option allowing us to purchase the leased equipment or furniture at the end of the lease term for fair market value.



During January 1998, we entered into a Master Agreement to Lease Equipment with one of our equipment vendors. Individual leases under the Master Agreement to Lease Equipment terms ranging from 24 to 39 months. Since inception we have leased approximately \$60.9 million of equipment under the agreement.

During 2002, we amended the terms of our master lease agreement with our primary supplier of net-working equipment. The amended terms of the master lease included a retroactive effective date to March 1, 2002 and extended the payment terms and provided for a deferral of lease payments of the underlying lease schedules for a period of 24 months in exchange for a buy-out payment of \$12.1 million in satisfaction of the outstanding lease obligation on 14 schedules totaling \$6.3 million and for the purchase of the equipment leased under the same schedules totaling \$5.8 million. The terms of our master lease agreement, as amended, include financial covenants that require us to maintain minimum liquidity balances, periodic revenues, EBITDA levels and other customary covenants. Should we breach the covenants, experience a change-of-control represented by a change in 35% of the aggregate ordinary voting power, or the lessor believes we have experienced a material adverse change in our business, the lessor has the ability to demand payment of all amounts due. As of December 31, 2002, we were in compliance with all financial covenants.

Capital lease obligations and the leased property and equipment are recorded at acquisition at the present value of future lease payments based upon the terms of the lease agreement. The extension of payment terms under the amended master lease agreement reduced the present value of our future lease payments and, therefore, we reduced our capital lease obligation and the cost basis of our related leased property and equipment by \$2.6 million. At December 31, 2002, the capital lease obligation and leased property accounts were reduced by \$2.0 million representing the remaining discount. Interest will continue to accrue on a periodic basis and add to the capital lease obligation through March 2004, the remaining deferral period.

Future minimum capital lease payments together with the present value of the minimum lease payments are as follows (in thousands):

Years Ending December 31,	
2003	\$ 3,984
2004	10,733
2005	11,423
2006	2,228
2007	1,246
Beyond 2007	9,181
Total minimum lease payments	38,795
Less: amount representing interest	(11,288)
Less: amount representing discount	(1,959)
Present value of minimum lease payments	25,548
Less: current portion	(631)
Capital lease obligations, less current portion	\$24,917

## Note 12

### INCOME TAXES

We account for income taxes under the liability method. Deferred tax assets and liabilities are determined based on differences between financial reporting and tax bases of assets and liabilities, and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. We provide a valuation allowance to reduce our deferred tax assets to their estimated realizable value.

## INTERNAP 2002 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

A reconciliation of the provision (benefit) for income taxes from continuing operations for the amount complied by applying the statutory federal income tax rate to loss before income taxes is as follows:

Year Ended December 31,	2000	2001	2002
Federal income tax benefit at statutory rates	(34)%	(34)%	<b>(34)%</b>
State income tax benefit at statutory rates	(4)%	(4)%	<b>(4)%</b>
Foreign operating losses at statutory rates	-	1%	-
Amortization and write-down of goodwill	10%	16%	-
In-process research and development expense	4%	-	-
Stock compensation expense	2%	-	-
Future utilization of losses precluded by Section 382	-	11%	-
Other	(3)%	(1)%	-
Change in valuation allowance	25%	11%	<b>38%</b>
Effective tax rate	-%	-%	<b>-%</b>

Temporary differences between the financial statements carrying amounts and tax basis of assets and liabilities that give rise to significant portions of deferred taxes relate to the following (in thousands):

	2001	2002
Deferred income tax assets:		
Net operating loss carryforwards	\$ 75,253	<b>\$106,391</b>
Capital loss carryforwards	5,510	<b>5,446</b>
Investments	1,824	<b>1,824</b>
Restructuring costs	15,305	<b>5,425</b>
Allowance for doubtful accounts	393	<b>564</b>
Deferred revenue	5,294	<b>3,538</b>
Accrued compensation	149	<b>113</b>
Property and equipment	6,990	<b>13,993</b>
Other	261	<b>361</b>
	110,979	<b>137,655</b>
Deferred income tax liabilities:		
Amortization of discounts on investments	(44)	<b>(23)</b>
Purchased intangibles	(3,710)	<b>(1,584)</b>
	(3,754)	<b>(1,607)</b>
	107,225	<b>136,048</b>
Valuation allowance	(107,225)	<b>(136,048)</b>
Net deferred tax assets	\$ -	<b>\$ -</b>

As of December 31, 2002, we have net operating loss carryforwards, capital loss carryforwards and tax credit carryforwards of approximately \$435.0 million, \$14.0 million and \$2.0 million, respectively. The net operating loss and tax credit carryforwards expire during 2012 through 2022. The capital loss carryforwards expire in 2006. Utilization of net operating losses, capital losses and tax credits are subject to the limitations imposed by Section 382 of the Internal Revenue Code. Due to substantial changes in ownership, we will be precluded from utilizing approximately \$169.0 million of our net operating and capital losses, and \$1.0 million of our tax credit carryforwards. We have placed a valuation allowance against our deferred tax assets in excess of deferred tax liabilities due to the uncertainty surrounding the realization of such excess tax assets. Management periodically evaluates the recoverability of the deferred tax asset and the level of the valuation allowance. At such time as it is determined that it is more likely than not that the deferred tax assets are realizable, the valuation allowance will be reduced.

## Note 13

### EMPLOYEE RETIREMENT PLAN

Internap sponsors a defined contribution retirement savings plan that qualifies under Section 401(k) of the Internal Revenue Code. The 401(k) plan covers all employees who have attained 21 years of age. Plan participants may elect to have up to 15% of their pre-tax compensation contributed to the plan, subject to certain guidelines issued by the Internal Revenue Service. Beginning January 1, 2000, Internap matches the employees' contributions into the plan, up to 3% of the employees' annual compensation. During 2000 and 2001, the Internap contributed \$0.7 million and \$1.0 million of participant matching to the plan, respectively. No contributions were made during 2002.

## Note 14

### COMMITMENTS, CONTINGENCIES, CONCENTRATIONS OF RISK AND LITIGATION

#### Operating leases

Internap as lessee, has entered into leasing arrangements relating to office and service point rental space that are classified as operating. Future minimum lease payments on non-cancellable operating leases are as follows at December 31, 2002 (in thousands):

Years Ending December 31,	
2003	\$ 16,652
2004	13,823
2005	11,260
2006	9,194
2007	9,245
Thereafter	79,627
	\$139,801

Rent expense was approximately \$16.1 million, \$14.3 million and \$14.8 million for the years ended December 31, 2000, 2001 and 2002, respectively. Sub-lease income, recorded as a reduction of rent expense, was approximately \$406,000 during the year ended December 31, 2002.

#### Service commitments

We have entered into service commitment contracts with Internet backbone service providers to provide interconnection services and collocation providers to provide space for customers. Minimum payments under these service commitments are as follows at December 31, 2002 (in thousands):

Years Ending December 31,	
2003	\$36,264
2004	21,701
2005	6,723
2006	5,108
2007	14,670
Beyond 2007	566
	\$86,032

One of our service commitment contracts with an Internet backbone service provider, representing \$20 million of scheduled minimum payments in 2003 and \$11.7 million in 2004, includes a provision allowing us to defer portions of our minimum commitments into future periods in the event we do not meet annual contract minimums.

**Concentrations of risk**

We participate in a highly volatile industry that is characterized by strong competition for market share. Internap and others in the industry encounter aggressive pricing practices, evolving customer demands and continual technological developments. Our operating results could be negatively affected should we not be able to adequately address pricing strategies, customers' demands, and technological advancements.

We are dependent on other companies to supply various key components of our network infrastructure including the local loops between our service points and our Internet backbone providers and between our service points and our customers' networks. In addition, the routers and switches used in our network infrastructure are currently supplied by a limited number of vendors. For some components, we may only use a single supplier. Additional sources of these services and products may not be available in the future on satisfactory terms, if at all. Furthermore, we purchase these services and products pursuant to purchase orders placed from time to time. We do not carry significant inventories of the products we purchase, and we have no guaranteed supply arrangements with our vendors. We have in the past experienced delays in installation of services and receiving shipments of equipment purchased. To date, these delays have neither been material nor have adversely affected our operating results. If our limited source of suppliers fails to provide products or services that comply with evolving Internet and telecommunications standards or that interoperate with other products or services we use in our network infrastructure, we may be unable to meet our customer service commitments. Any failure to obtain required products or services from third party suppliers on a timely basis and at an acceptable cost could adversely impact our operating results.

**Litigation**

We may be subject to legal proceedings, claims and litigation arising in the ordinary course of business. Although the outcome of these matters is currently not determinable, we do not expect that the ultimate costs to resolve these matters will have a material adverse effect on its financial condition, results of operations or cash flows.

## Note 15

### CONVERTIBLE PREFERRED STOCK AND STOCKHOLDERS' EQUITY

During September 2001, Internap changed the state of its incorporation from Washington to Delaware with the approval of its stockholders. We accomplished the reincorporation by merging Internap Network Services Corporation with and into our newly formed, wholly owned Delaware subsidiary, Internap Delaware, Inc. Upon consummation of the merger, shareholders of Internap Network Services Corporation became stockholders of Internap Delaware, Inc. and Internap Delaware's name was changed to Internap Network Services Corporation.

As part of the reincorporation, we increased the number of authorized shares of our common stock from 500,000,000 shares to 600,000,000 shares and the number of our preferred stock from 10,000,000 shares to 200,000,000 shares. We designated 3,500,000 of the 200,000,000 authorized shares of preferred stock as "Series A Preferred Stock." We also changed the par values of our common stock and preferred stock from no par to \$0.001 per share.

Accordingly, the disclosures in the financial statements and related notes have been adjusted to reflect the September 2001 Certificate of Incorporation and the stock dividend for all periods presented.

**Convertible preferred stock**

On September 14, 2001, we completed a \$101.5 million private placement of units at a per unit price of \$1.60 per unit and issued an aggregate of 63,429,976 units, with each unit consisting of 1/20 of a share of Series A convertible preferred stock and a warrant to purchase 1/4 of a share of common stock, resulting in the issuance of 3,171,499 shares of Series A convertible preferred stock and 17,113,606 warrants to purchase equivalent shares of common stock at an exercise price of \$1.48256 per share, which are exercisable for a period of five years. The aggregate amount of common stock issuable upon conversion of the Series A convertible preferred stock and the exercise of the warrants is 80,395,000 shares at December 31, 2002.

Holders of Series A convertible preferred stock shall be entitled to the number of votes equal to the number of shares of common stock into which the shares of Series A convertible preferred stock could be converted. Each share of Series A convertible preferred stock is currently convertible into 21.58428 shares of common stock subject to adjustments for certain dilutive events. Each share of Series A convertible preferred stock may be converted at any time at the option of the holder. Shares of Series A convertible preferred stock automatically convert to common stock on the earlier of September 14, 2004, a date more than six months after issuance on which the common stock has traded in excess of \$8.00 for a period of 45 consecutive trading days or upon the affirmative vote of 60% of the outstanding shares of Series A convertible preferred stock.

Upon the liquidation, dissolution, merger or event in which existing stockholders own less than 50% of the post-event voting power, holders of Series A convertible preferred stock are entitled to be paid out of existing assets an amount equal to \$32.00 per share prior to distributions to holders of common stock. Upon completion of distribution to holders of Series A convertible preferred stock, remaining assets will be distributed ratably between holders of Series A convertible preferred stock and holders of common stock until holders of Series A convertible preferred stock have received an amount equal to three times the original issue price.

We received net proceeds of \$95.6 million from the issuance of the Series A convertible preferred stock and allocated \$86.3 million to the Series A convertible preferred stock and \$9.3 million to the warrants to purchase shares of common stock based upon their relative fair values on the date of issuance (September 14, 2001) pursuant to Accounting Principles Board Opinion No. 14 "Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants." The fair value used to allocate proceeds to the Series A convertible preferred stock was based upon a valuation that among other considerations was based upon the closing price of the common stock on the date of closing, on an as converted basis, and liquidation preferences. The fair value used to allocate proceeds to the warrants to purchase common stock was based on a valuation using the Black Scholes model and the following assumptions: exercise price \$1.48256; no dividends; term of 5 years; risk-free rate of 3.92%; and volatility of 80%.

During 2002, Series A convertible preferred stockholders converted 240,000 shares of convertible preferred stock at a recorded value of \$6.5 million into \$5.2 million shares of common stock.

**Common stock**

On April 6, 2000, 8,625,000 shares of our common stock were sold in a public offering at a price of \$43.50 per share. Of these shares, 3,450,000 were sold by Internap and 5,175,000 shares were sold by selling stockholders. We did not receive any of the proceeds from the sale of shares of common stock by the selling stockholders. The proceeds we received from the offering were \$142.9 million, net of underwriting discounts and commissions of \$7.1 million.

**Warrants to purchase Series B preferred stock and common stock**

During 1997 and 1998, we issued warrants to purchase up to 1,821,520 shares of our then Series B preferred stock at \$.30 per share in conjunction with its various financings during these periods. The warrants to purchase the Series B preferred stock converted to warrants to purchase common stock upon the closing of our initial public offering.

On August 2, 2000, we issued a warrant to purchase 20,000 shares of common stock at an exercise price of \$26.88 to an executive recruiting firm. The fair value of these warrants on the date of issuance was estimated to be approximately \$286,000 based upon the Black-Scholes option pricing model and was charged to expense.

On April 4, 2001, we issued a warrant to purchase 35,000 shares of common stock at an exercise price of \$1.156 to a consultant. The fair value of these warrants on the date of issuance was estimated to be approximately \$22,000 based upon the Black-Scholes option pricing model and was charged to expense.

On July 23, 2001, we issued a warrant to purchase 22,222 shares of common stock at an exercise price of \$2.16 to a consultant. The fair value of these warrants on the date of issuance was estimated to be approximately \$26,000 based upon the Black-Scholes option pricing model and was charged to expense.

On September 14, 2001, in conjunction with our Series A convertible preferred stock financing, we issued warrants to purchase up to 17,113,606 shares of common stock at \$1.48256 per share for a period of five years. The value allocated to these warrants was estimated to be approximately \$9.3 million based upon the Black-Scholes option-pricing model.

Outstanding warrants to purchase shares of common stock at December 31, 2002, are as follows (shares in thousands):

Year of Expiration	Weighted Average Exercise Price	Shares
2003	\$2.16	22
2004	8.38	191
2005	-	-
2006	1.48	17,114
		17,327

## Note 16

### STOCK-BASED COMPENSATION PLANS

During March 1998, our Board of Directors adopted the 1998 Stock Options/Stock Issuance Plan (the "1998 Plan"), which provides for the issuance of incentive stock options and non-qualified options to eligible individuals responsible for Internap's management, growth and financial success. Shares of common stock reserved for the 1998 Plan during March 1998 totaled 8,070,000 and were increased to 10,070,000 during January 1999. As of December 31, 2002 there were 3,174,000 options outstanding and 318,000 options available for grant pursuant to the 1998 Plan.

During June 1999, our Board of Directors adopted the 1999 Equity Incentive Plan (the "1999 Plan"), which provides for the issuance of incentive stock options and nonqualified stock options to eligible individuals responsible for Internap's management, growth and financial success. As of December 31, 1999, 13,000,000 shares of common stock were reserved for the 1999 Plan. Upon the first nine anniversaries of the adoption date of the 1999 Plan, the number of shares reserved for issuance under the 1999 Plan will automatically be increased by 3.5% of the total shares of common stock then outstanding or, if less, by 6,500,000 shares. Accordingly on June 19, 2000, and June 19, 2001, the number of shares reserved for the grant of stock options under the 1999 Plan was increased by 4,831,738 and 5,263,537 shares, respectively. The terms of the 1999 Plan are the same as the 1998 Plan with respect to incentive stock options treatment and vesting. As of December 31, 2002, there were 14,530,000 options outstanding and 7,454,000 options available for grant pursuant to the 1999 Plan.

During May 2000, we adopted the 2000 Non-Officer Equity Incentive Plan (the "2000 Plan"). The 2000 Plan initially authorized the issuance of 1,000,000 shares of Internap's common stock. On July 18, 2000, our Board of Directors increased the shares reserved under the 2000 Plan to 4,500,000. Under the 2000 Plan, we may grant stock options only to Internap employees who are not officers or directors. Options granted under the 2000 Plan are not intended to qualify as incentive stock options under the Internal Revenue Code. Otherwise, options granted under the 2000 Plan generally will be subject to the same terms and conditions as options granted under the 1999 Plan. As of December 31, 2002, there were 4,519,000 options outstanding and no options available for grant pursuant to the 2000 Plan.

During July 1999, we adopted the 1999 Non-Employee Directors' Stock Option Plan (the "Director Plan"). The Director Plan provides for the grant of non-qualified stock options to non-employee directors. A total of 1,000,000 shares of Internap's common stock have been reserved for issuance under the Director Plan. Under the terms of the Director Plan, 480,000 fully vested options were granted to existing directors on the effective date of our initial public offering with an exercise price of \$10.00 per share. Subsequent to our 1999 initial public offering, initial grants, which are fully vested as of the date of the grant, of 80,000 shares of Internap's common stock are to be made under the Director Plan to all non-employee directors on the date such person is first elected or appointed as a non-employee director. On the day after each of our annual stockholder meetings, starting with the annual meeting in 2000, each non-employee director will automatically be granted a fully vested and exercisable option for 20,000 shares, provided such person has been a non-employee director for at least the prior six months. The options are exercisable as long as the non-employee director continues to serve as a director, employee or consultant of Internap or any of its affiliates. As of December 31, 2002, there were 580,000 options outstanding and 260,000 options available for grant pursuant to the Director Plan.

In connection with the 2000 acquisition of CO Space, we assumed the CO Space, Inc. 1999 Stock Incentive Plan (the "CO Space Plan"). After applying the acquisition conversion ratio, the CO Space plan authorizes the issuance of up to 1,346,840 options to purchase shares of Internap's common stock. As of December 31, 2002 there were 506,000 options outstanding and 611,000 options available for grant pursuant to the CO Space Plan.

In connection with the 2000 acquisition of VPNX, we assumed the Switchsoft Systems, Inc. Founders 1996 Stock Option Plan and the Switchsoft Systems, Inc. 1997 Stock Option Plan (the "VPNX Plans"). After applying the acquisition conversion ratio, the VPNX Plans authorize the issuance of up to 307,417 options to purchase shares of Internap's common stock. As of December 31, 2001, there were 12,000 options outstanding and 211,000 options available for grant pursuant to the VPNX Plans.

On September 10, 2002, we adopted the Internap Network Services Corporation, 2002 stock compensation plan ("2002 Plan"). The 2002 Plan provides for the grant of non-qualified stock options to employees and non-employees. A total of 32,000,000 shares of Internap's common stock has been reserved for issuance under the 2002 Plan; however, this overall share reserve is reduced by any outstanding options issued under the VPNX Plans, the 1998 Plan, the 1999 Plan, the Directors Plan, the CO Space Plan, and the 2000 Plan, discussed above. The maximum number of shares granted to a single participant in any particular year is 10,000,000 shares. Also, subject to certain exclusions, the maximum number of awards issued to officers and directors is limited to 50% of the shares eligible for issuance at the time of the award or grant.

Incentive stock options may be issued only to Internap employees and have a maximum term of 10 years from the date of grant. The exercise price for incentive stock options may not be less than 100% of the estimated fair market value of the common stock at the time of the grant. In the case of options granted to holders of more than 10% of the voting power of Internap, the exercise price may not be less than 110% of the estimated fair market value of the common stock at the time of grant, and the term of the option may not exceed five years. Options become exercisable in whole or in part from time to time as determined by the Board of Directors at the date of grant, which will administer the Plan. Both incentive stock options and non-qualified options generally vest over four years.

We have elected to account for stock-based compensation using the intrinsic value method prescribed in APB 25. Accordingly, compensation cost for stock options is measured as the excess, if any, of the fair value of Internap's common stock at the date of grant over the exercise price to be paid to acquire the stock.

On May 4, 2001, we allowed employees to cancel certain outstanding stock option grants to purchase 8.9 million shares of common stock. On that date we agreed to grant to the same employees options to purchase 8.9 million shares of common stock to be granted six months plus one day after the cancellation, or November 5, 2001, provided, however, that (i) the exercise price of the future grant was the fair value of our common stock on the date of grant, the participating employees cancelled all options granted six months prior to the May 2001 offer exchange date, (ii) the participating employees did not receive any additional grants of options prior to the November 5, 2001 grant date, and (iii) the participating employees were common law employees of Internap on the date of grant. Since Internap accounts for stock-based compensation using the intrinsic value method prescribed by Accounting Principles Board Opinion No. 25, compensation cost for stock options is measured as the excess, if any, of the fair value of Internap's stock at the date of grant over the exercise price to be paid to acquire the stock. Therefore, we did not recognize compensation expense related to the grant of the new options.

Similarly, on January 6, 2003, under the terms of a related tender offer to allow domestic employees to cancel certain outstanding stock option grants, we accepted cancellation of 1.6 million options to purchase shares of common stock. On that date, we agreed to grant the same employees options to purchase 1.6 million shares of common stock to be granted six months and one day after the cancellation, or subsequent to June 7, 2003. The tender offer provides, however, that (i) the exercise price of the future grant must be the fair value of our common stock on the date of grant; the participating employees must also cancel all options granted six months prior to November 18, 2002, the offer to exchange date; (ii) the participating employees must not receive any additional grants of options prior to the future grant date; and (iii) the participating employees must be domestic common law employees of Internap on the date of



## INTERNAP 2002 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

grant. Since Internap accounts for stock-based compensation using the intrinsic value method prescribed by Accounting Principles Board Opinion No. 25, compensation cost for stock options is measured as the excess, if any, of the fair value of Internap's stock at the date of grant over the exercise price to be paid to acquire the stock. Therefore, we will not recognize compensation expense related to the grant of the new options.

Option activity for 2000, 2001 and 2002 under all of our stock option plans is as follows (shares in thousands):

	Shares	Weighted Average Exercise Price
Balance, December 31, 1999	15,481	\$ 4.10
Granted	12,894	39.44
Assumed from acquisitions	590	5.53
Exercised	(3,686)	1.60
Cancelled	(1,120)	36.88
Balance, December 31, 2000	24,159	21.71
Granted	16,729	1.40
Exercised	(1,223)	0.36
Cancelled	(13,933)	31.69
Balance, December 31, 2001	25,732	4.21
Granted	11,668	0.60
Exercised	(1,252)	0.25
Cancelled	(12,827)	4.49
<b>Balance, December 31, 2002</b>	<b>23,321</b>	<b>2.43</b>

The following table summarizes information about options outstanding at December 31, 2002 (shares in thousands):

Exercise Prices	Options Outstanding		(Options Exercisable Excluding Options Which Shares Would Be Subject to the Company's Right of Repurchase)	
	Number of Shares	Weighted Average Remaining Contractual Life (In years)	Number of Shares	Weighted Average Exercise Prices
\$0.03 - \$0.21	2,646	8.48	823	\$0.05
\$0.22 - \$0.43	2,029	8.83	531	0.35
\$0.48 - \$0.48	3,160	9.97	-	0.48
\$0.52 - \$0.54	546	9.83	80	0.54
\$0.59 - \$0.77	2,515	9.27	-	-
\$0.78 - \$0.96	5,520	8.84	3,646	0.96
\$0.98 - \$1.87	2,637	8.81	1,364	1.51
\$1.88 - \$4.00	2,611	7.04	2,062	2.64
\$4.12 - \$87.19	1,647	7.15	1,325	20.36
\$105.91	10	7.16	7	105.91
\$0.03- \$105.91	23,321	8.70	9,838	3.96

With the exception of options assumed in conjunction with the CO Space and VPNX acquisitions, the exercise price of options granted during 2000 equaled the fair value of the underlying shares at the date of grant. The weighted average grant date fair value of options granted during 2000, 2001 and 2002 was approximately \$363.9 million, \$16.8 million and \$7.0 million or \$28.22, \$1.00 and \$.60 per share, respectively.

During July 1999, we adopted the 1999 Employee Stock Purchase Plan (the "ESPP"). The ESPP provides a means by which employees may purchase Internap common stock through payroll deductions. The purchase plan is implemented by offering rights to eligible employees. Under the purchase plan, management may specify offerings with duration of not more than 27 months, and may specify shorter purchase periods within each offering. The first offering began on September 29, 1999 and terminated on September 30, 2002. Purchase dates occur each March 31 and September 30. Employees who participate in an offering under the purchase plan may have up to 15% of their earnings withheld. The amount withheld is then used to purchase shares of the common stock on specified dates determined by the Board of Directors. The price of common stock purchased under the purchase plan is equal to 85% of the lower of the fair market value of the common stock at the commencement date of each offering period or the relevant purchase date. Employees may end their participation in an offering at any time during the offering except during the 15-day period immediately prior to a purchase date. Employees' participation in all offerings ends automatically on termination of their employment with Internap or one of its subsidiaries. A total of 3,000,000 shares of common stock have been reserved for issuance pursuant to the ESPP. Upon the first nine anniversaries of the adoption date of the ESPP, the number of shares reserved for issuance under the ESPP will be increased by 2% of the total number of shares of common stock then outstanding or, if less, by 3,000,000 shares, subject to Series A shareholder approval. Accordingly, on July 24, 2000 and July 23, 2001, pursuant to the terms of the ESPP, the number of shares reserved for the grant of stock options under the ESPP was increased by 1,500,000 shares on each date. There was no increase to shares reserved during 2002. The purchase plan is intended to qualify as an employee stock purchase plan within the meaning of Section 423 of the Internal Revenue Code.

We have adopted the disclosure only provisions of Financial Accounting Standards No. 123 ("SFAS No. 123"), "Accounting for Stock-Based Compensation." Pro forma information regarding the net loss is required by SFAS No. 123, and has been determined as if we had accounted for its employee stock options (including ESPP participation) under the fair value method. The fair value of options granted in 2000, 2001 and 2002 (including ESPP participation) subsequent to Internap's initial public offering was estimated at the date of grant using the Black-Scholes option-pricing model assuming no expected dividends and the following weighted average assumptions:

Year Ended December 31,	2000	2001	2002
Risk free interest rate	6.00%	4.5%	<b>3.52%</b>
Volatility	100%	100%	<b>100%</b>
Expected life (excluding ESPP)	4 years	4 years	<b>4 years</b>
ESPP expected life	1 year	1 year	<b>1 year</b>

For purposes of the pro forma disclosures, the estimated fair value of options is amortized to expense over the options' vesting periods. If we had accounted for compensation expense related to stock options (including ESPP participation) under the fair value method prescribed by SFAS No. 123, the net loss and the basic and diluted net loss per share for the years ended December 31, 2000, 2001 and 2002 would have been approximately, \$317.6 million, \$442.1 million and \$34.5 million and \$2.23, 2.94, and \$0.22, respectively. The pro forma effect of applying SFAS No. 123 in future years will be significantly reduced since all deferred stock compensation will be fully amortized during 2003.

### Deferred stock compensation

Prior to 2000, we issued stock options to certain employees under the 1998 and 1999 Plans with exercise prices below the deemed fair value of Internap's common stock at the date of grant. In accordance with the requirements of APB 25, we recorded deferred stock compensation for the difference between the exercise price of the stock options and the deemed fair value of the common stock at the date of grant. Additionally, in connection with the acquisition of VPNX, we recorded deferred stock compensation related to the unvested options assumed, totaling \$5.1 million.

Deferred stock compensation is amortized to expense over the period during which the options or common stock subject to repurchase vest, generally four years, using an accelerated method as described in Financial Accounting Standards Board Interpretation No. 28.

During 2001 and 2002, primarily related to reductions in our workforce, we cancelled the options of individuals for whom we had recognized deferred stock compensation and had recognized related expense on unvested options using an accelerated amortization method. Accordingly, during the year ended December 31, 2001 and 2002, we reduced our deferred stock compensation, which would have been amortized to future expense, by \$1.2 million and \$1.0 million, and we reduced our amortization to expense of deferred stock compensation by \$1.9 million and \$2.7 million to record the benefit of previously recognized expense on unvested options.

As of December 31, 2002, we have recorded deferred stock compensation related to such options granted in the total amount of \$28.9 million, of which \$10.7 million, \$4.2 million and \$2.9 million has been amortized to expense during 2000, 2001 and 2002, respectively.

## Note 17

### RELATED PARTY TRANSACTIONS

On January 1, 2002, we entered into a consulting agreement with Lyford Cay Securities Corp., an affiliate of one of our stockholders, INT Investments, Inc., that beneficially owns more than 5% of our outstanding common stock. Under the terms of this consulting agreement, which was completed in 2002, we paid Lyford Cay Securities Corp. \$400,000 to provide us with financial advisory and strategic advice.

In 2002, we engaged Korn/Ferry International, a national executive recruiting firm, to assist in the identification and recruitment of senior executives. We also entered into agreement with other nationally known recruiting firms for additional senior executive searches. For the 2002 fiscal year, we paid Korn/Ferry \$262,096 in connection with executive placements. Gregory A. Peters, our President and Chief Executive Officer, is the son-in-law of a managing director of Korn/Ferry.

We have entered into indemnification agreements with our directors and executive officers for the indemnification of and advancement of expenses to such persons to the fullest extent permitted by law. We also intend to enter into these agreements with our future directors and executive officers. (THIS SECTION IS A PICKUP FROM 10-K. CLIENT PLEASE UPDATE.)

## Note 18

### SUBSEQUENT EVENTS

On March 25, 2003, we entered into an amendment to our existing loan and security agreement with Silicon Valley Bank ("SVB"). Pursuant to the loan amendment, the amount available under our credit facility with SVB will be increased by an additional \$5 million subject to certain conditions precedent. In addition, SVB will make available to us an additional \$5 million under a term loan if we meet certain debt coverage ratios.

On March 31, 2003, we entered into an agreement to amend out equipment lease obligations with Cisco Systems Capital Corporation. Specifically, this lease amendment provides for adjustments to our required minimum quarterly revenue levels and minimum quarterly EBITDA levels. In addition, the lease amendment provides for a revision to one non-financial covenant. The lease amendment also requires our payment on April 1, 2003 of a total of \$2.2 million to Cisco Systems Capital (representing advance payment of our lease payments due in March and April 2004). As a consequence of the advance payment, we will resume lease payments to Cisco Systems Capital commencing in May 2004 and ending February 2007. (THIS SECTION IS A PICKUP FROM 10-K. CLIENT PLEASE UPDATE.)

## Note 19

### UNAUDITED QUARTERLY RESULTS

The following table sets forth certain unaudited quarterly results of operations for the Company for the years ended December 31, 2001 and 2002. In the opinion of management, this information has been prepared on the same basis as the audited financial statements and all necessary adjustments, consisting of only normal recurring adjustments, have been included in the amounts stated below to present fairly, in all material respects, the quarterly information when read in conjunction with the audited financial statements and notes thereto included elsewhere in this annual report on Form 10-K. The quarterly operating results below are not necessarily indicative of those of future periods (in thousands).

	March 31, 2001	June 30, 2001	September 30, 2001	December 31, 2001	March 31, 2002	June 30, 2002	September 30, 2002	December 31, 2002
Revenues	\$ 28,440	\$ 29,285	\$ 29,163	\$ 30,516	\$ 32,614	\$ 33,030	\$ 32,711	\$ 34,132
Costs and expenses:								
Direct cost of network	23,208	26,594	24,637	24,476	24,105	22,627	17,302	19,173
Customer support	6,723	5,990	4,789	3,978	3,826	3,669	2,867	2,551
Product development	3,785	3,415	2,760	2,273	1,957	1,977	1,836	1,677
Sales and marketing	14,253	9,866	7,496	6,536	6,057	5,801	5,330	4,453
General and administrative	15,154	12,352	9,820	7,165	6,492	5,047	4,548	4,762
Depreciation and amortization	10,473	12,192	13,468	12,417	12,812	13,504	12,390	10,894
Amortization of goodwill and other intangible assets	19,828	6,972	5,658	5,658	1,427	1,606	1,165	1,428
Amortization of deferred stock compensation	2,209	109	814	1,085	352	(11)	(316)	235
Lease termination expense	-	-	-	-	-	-	-	804
Restructuring costs	4,342	-	67,211	(7,457)	(4,954)	-	352	821
Impairment of goodwill and other intangible assets	195,986	-	-	-	-	-	-	-
Loss on sale and retirements of property and equipment	-	-	-	2,714	298	841	1,510	180
Total operating costs and expenses	295,961	77,490	136,653	58,845	52,372	55,061	46,984	46,977
Loss from operations	(267,521)	(48,205)	(107,490)	(28,329)	(19,758)	(22,031)	(14,273)	(12,846)
Other income (expense):								
Interest income (expense), net	702	(750)	(861)	(363)	(231)	(464)	(629)	(870)
Loss on investments	-	(19,314)	(6,428)	(603)	(349)	(313)	(334)	(248)
Total other income	702	(20,064)	(7,289)	(966)	(580)	(777)	(963)	(1,118)
Net loss	\$(266,819)	\$(68,269)	\$(114,779)	\$(29,295)	\$(20,338)	\$(22,808)	\$(15,236)	\$(13,964)
Basic and diluted net loss per share	\$ (1.79)	\$ (0.45)	\$ (0.76)	\$ (0.19)	\$ (0.13)	\$ (0.15)	\$ (0.10)	\$ (0.09)
Weighted average shares used in computing basic and diluted net loss per share	149,115	150,251	150,541	151,221	152,002	153,537	157,177	159,433

To the Board of Directors and Stockholders  
of Internap Network Services Corporation

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations, of stockholders' equity and comprehensive loss and of cash flows present fairly, in all material respects, the financial position of Internap Network Services Corporation at December 31, 2002 and 2001, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2002 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 7, effective January 1, 2002, the Company adopted the provisions of Statement of Financial Accounting Standards ("SFAS") No. 142, "*Goodwill and Other Intangible Assets*," resulting in cessation of the amortization of goodwill in 2002.

PricewaterhouseCoopers LLP

Seattle, Washington  
March 31, 2003

**Corporate Headquarters**

Internap Network Services Corporation  
250 Williams Street, Suite E-100  
Atlanta, GA 30303  
404-302-9700

**Corporate Web Address**

[www.internap.com](http://www.internap.com)

**Stock Trading Information**

Internap's common stock trades on the NASDAQ.

**Ticker symbol (NASDAQ)**

INAP

**Independent Auditors**

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206-398-8000

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678-419-1000

**Transfer Agent**

American Stock Transfer & Trust Company  
59 Maiden Lane  
New York, NY 10038  
800-937-5449  
[info@amstock.com](mailto:info@amstock.com)

**Form 10-K**

A copy of Internap's Form 10-K filing with the Securities and Exchange Commission is posted to the investor relations section of our website, [www.internap.com](http://www.internap.com).

A printed copy is available without charge to shareholders upon written request to Investor Relations at the corporate addresses listed above.

**Product/Services Information**

To obtain information on Internap's products and services, contact:

David L. Abrahamson  
Chief Marketing Officer &  
Vice President, Sales  
404-302-9700

**Safe Harbor**

Forward-looking statements in this annual report are subject to change based on various important factors, including without limitation, competitive actions in the marketplace and adverse actions of governmental and other third-party payors. Further information on potential factors that could affect the Company's financial results is included in the Company's Form 10-K for the year ended December 31, 2002 and subsequent filings.

Inquiries regarding stock transfers, lost certificates or address changes should be directed to the transfer agent listed here.

## 2003 EXECUTIVE MANAGEMENT TEAM



**Allen Tohill**  
Vice President,  
Government Solutions

**Gregory A. Peters**  
President & Chief  
Executive Officer

**Marla Eichmann**  
Vice President,  
Operations

**Robert Jenks**  
Chief Financial  
Officer

**Ali Marashi**  
Chief Technical  
Officer &  
Vice President,  
Engineering

**Walter DeSocio**  
Vice President,  
Chief Administrative  
Officer &  
General Counsel

**David L. Abrahamson**  
Chief Marketing  
Officer &  
Vice President, Sales

## BOARD OF DIRECTORS

**Robert D. Shurtleff, Jr.**  
Director since January 1997.

**Gregory A. Peters**  
President and Chief Executive Officer  
since April 2002.

**Fredic W. Harman – need info**

**Kevin L. Ober**  
Director since October 1997.

**Eugene Eidenberg**  
Director and Chairman of the Board of  
Directors since November 1997.

**William J. Harding**  
Director since January 1999.

**Anthony C. Naughtin**  
Co-founded Internap and served as our  
Chief Executive Officer from May 1996  
until July 2001, and as our President  
from May 1996 until May 2001.



CORPORATE HEADQUARTERS  
250 WILLIAMS STREET  
SUITE E-100  
ATLANTA, GA 30303  
404-302-9700  
[www.internap.com](http://www.internap.com)