INTERNAP®

We can make this company

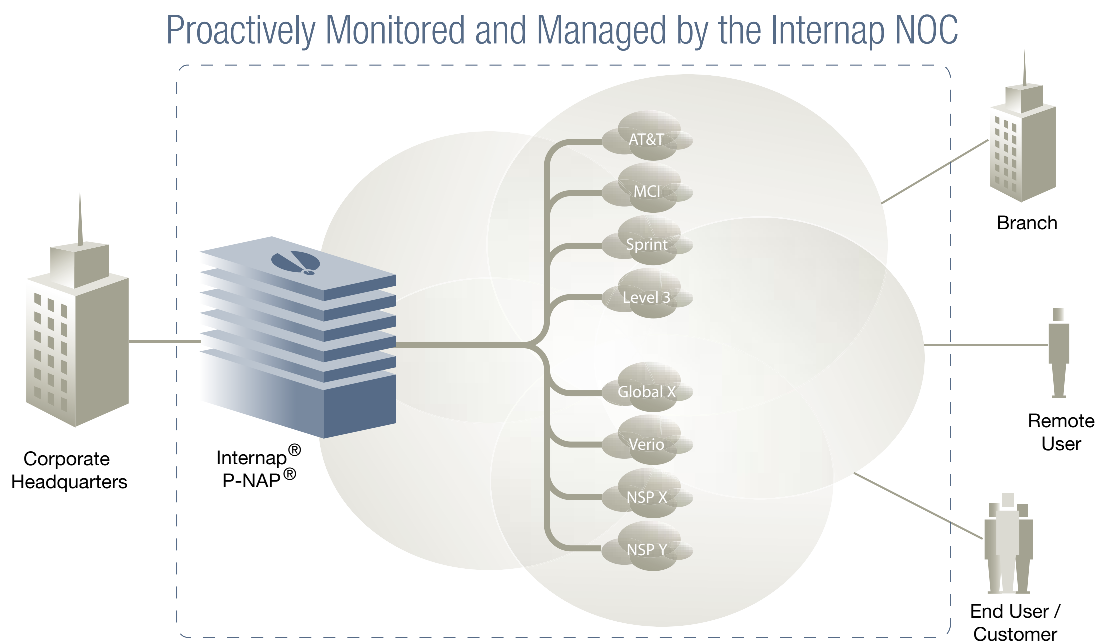
# thrive

(we're hard at work)

2005 ANNUAL REPORT

# COMPANY PROFILE

Internap is a market leader of intelligent route control solutions that bring reliability, performance and security to the Internet. The Company's patented and patent-pending technologies address the inherent weaknesses of the Internet, enabling enterprises to take full advantage of the benefits of deploying business-critical applications such as e-commerce, Voice-over-IP (VoIP), video-conferencing and streaming audio/video across the Internet. Through a portfolio of high-performance Internet Protocol (IP) solutions, customers can bypass congestion points, overcome routing inefficiencies and optimize performance of their applications.



## Our Management Team

Far Right: James P. DeBlasio, President and Chief Executive Officer

Left to Right: Eric Klinker (standing), Eric Suddith (sitting), Andrew Albrecht, David Abrahamson, David Buckel, Dorothy An and Bob Smith

# TO OUR STOCKHOLDERS:

Look up the word "thrive" and you will read descriptions such as growing, healthy and successful. It is time for such words to be associated with Internap. However, before an enterprise can really thrive, it must survive and stabilize. We believe that we are well on our way, but there remains much work to be done.

When I accepted the position of CEO in the latter part of 2005, it was not with the intent to manage to the status quo. Rather, I asked this organization to join me in a commitment to achieve sustained profitability and to deliver long overdue value to our stockholders.

Today, those who arrive at Internap each morning are working harder and smarter than ever to realize this goal. An enviable strategic position and considerable competitive strengths support their efforts and serve as reminders that Internap can succeed.

The original proposition upon which Internap was founded – that the Internet is inherently a dynamic, unpredictable and chaotic medium – is still as true today as it was ten years ago. What has changed is the Internet's growth in relevance to critical business applications. According to Forrester Research, by the year 2010 more than $315 billion in strategic transactions per year are expected to occur via the Internet, and most will involve far more complex applications than a decade ago. This includes business that can only be conducted through an online network such as e-commerce, gaming, online financial transactions, software downloads, VoIP and IPTV. Through our patented technology and intellectual expertise, Internap is a leading supplier that offers a full-service solution for IP optimization, which we believe ideally positions us to take advantage of opportunities within this multi-billion dollar marketplace.

To truly appreciate this position, look no further than our base of more than 2,000 customers. Many of these long-standing customers are industry leaders and household names, as well as emerging Internet-based companies that have impacted the way technology is used today. The depth and breadth of this base reflects the attractiveness

of our key market differentiators – a service proposition that offers a 100% guarantee for reliability and quality and a focus on end-to-end service, from professional consulting and solution implementation to ongoing award-winning technical support. Together, these components bring a level of expertise that we believe is simply unmatched in the marketplace.

### Financial Improvements Continue in 2005

Internap ended 2005 on a positive note, with a significant level of momentum in the fourth quarter. Financial performance for the year included:

- Revenues grew 6.3% over 2004 to $153.7 million.
- Gross margins[1] were 47%, consistent with 2004.
- Operating expenses, excluding the direct cost of revenues, decreased 9%.
- Net loss was $5.0 million, representing a $13.1 million, or 73%, improvement over 2004.
- Total customers grew 8.4% to 2,092 customers at year-end.
- Customer network usage jumped 54% year-over-year.

These results are significant accomplishments and demonstrate the positive direction in which the Company is headed. However, we are focused on additional progress.

[1] *Defined as revenue less direct cost of network divided by revenues.*

During the fourth quarter of 2005, we added $1.3 million in new monthly recurring revenue, an increase of 40% versus the third quarter of 2005. This represented 397 new orders in the fourth quarter of 2005, up 13% from the previous quarter. Also during the fourth quarter, we counted 60 net new customers versus 13 in the third quarter. These improvements are the result of redeploying our sales force to concentrate on key vertical markets in which we have an existing specialty, namely retail, finance, gaming, media and travel. This shift in sales strategy is a good example of how better focus can produce markedly improved results.

Our owned and leased data centers, network operation centers and professional consulting services continue to provide us with a complete package to augment our IP business and offer customers a complete solution. A successful strategy, for example, has been the bundling of our IP services with our data centers. This type of product grouping experienced 40% growth in annual revenue over the past year and demonstrates how colocation can be a means to drive growth in our core bandwidth business.

### A Mandate for Profitability

Clearly, Internap has a strong foundation – strategic relevancy, a world-class portfolio of technology solutions, a large and loyal customer base, an experienced team of experts and a set of improving financial and operational metrics. The imperative for our Company is to maximize these strengths in order to generate renewed stockholder value. This effort is well underway, characterized by new levels of discipline and focus to eliminate unnecessary costs. Our objective is to achieve a cost structure that generates greater operating leverage so that an increased percentage of every incremental revenue dollar can drop to the bottom line. At the same time, we also are improving operational efficiencies to create processes that can sustain a more cost-effective environment. Accountability is *key* to these efforts, with every action driven down to the level of individual responsibility.

Our operational plan in 2006 focuses on three vital areas. First, we must stabilize and fortify the core business by continuing to expand our customer base, drive customer

**Fortify The Core Business**
- Expand Customer Base
- Drive Customer Renewals
- Mitigate Customer Churn
- Broaden Customer Offerings

**Execute With Excellence**
- Increase & Focus Marketing Efforts
- Reduce Network Costs
- Increase Cash Flows from Operations

**Create A Winning Environment**
- Attract & Retain Leading Talent
- Ensure Internap Is Employer of Choice
- Maintain High Percentage of Front-Line Positions
- Instill & Reward a Passion for Winning

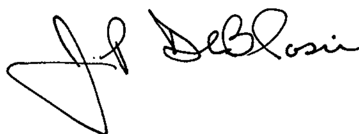
## 2006 Operational Plan and Strategy

renewals and mitigate customer churn. At the same time, we will continue to explore the addition of new products and services to broaden our customer offerings. Second, we must execute from a position of excellence. There can be no exceptions. From reducing network costs to better focusing product and service marketing, we must raise every aspect of our game. Finally, we must ensure that Internap fosters a winning environment for our employees. Consider that approximately 88% of our employees interact directly with customers. This is an impressive statistic and competitive advantage, which challenges us to ensure that we constantly attract and retain top talent.

These initiatives are necessary to bring Internap to profitability. Once profitable, however, the real work begins as we evaluate opportunities – both organic and strategic ones – that will hasten top-line growth. These opportunities include selling more solutions and bandwidth to our existing customer base, increasing our points of presence through a network of data centers and P-NAPs® and intensifying marketing efforts. We will also be strategically looking at new technologies and solutions that can leverage our existing business.

In closing, I must extend my personal appreciation to our board of directors and our employees, all of whom share my personal commitment to see Internap not only succeed, but thrive. On behalf of everyone at Internap, I also extend thanks to our exceptionally loyal customers and to those stockholders who have stood by the Company during the past ten years. We are energized by the challenge and opportunity to execute our plans and realize our goals during 2006. As the results of these efforts unfold, we intend to provide stockholders with increased visibility and insight into the business. We look forward to frequent communication to update you on our progress toward making Internap a thriving enterprise that delivers renewed value to all its stockholders.

Sincerely,



James P. DeBlasio

President and Chief Executive Officer

We can make this company

# perform

(we're selling best-in-class IP services)

## Internap Has Over 2,000 Customers In Key Market Segments

The Internet that exists today can represent a company's biggest opportunity, as well as its biggest challenge. As the Web grows more complex, so do the business-critical applications that depend upon it – applications such as e-commerce, streaming audio/video, VoIP and virtual private networks (VPNs). The unpredictable, often chaotic nature of the Internet can make the deployment of these applications challenging. Speed, congestion and availability can have profound revenue and cost implications and can even threaten the overall viability of a business.

Ten years ago, when use of the Internet was in its infancy, Internap revolutionized the way businesses can use the Internet with the introduction of its Performance IP™ service, which was created to address difficulties such as latency and packet loss that can plague conventional Internet connectivity. Our P-NAP architecture, combined with our intelligent route control technology, offers unmatched reliability and speed by identifying optimal data paths for customers to connect with suppliers, customers and other critical stakeholders. A decade later, amid a much more complex environment, this technology remains unsurpassed, as does the service level agreement that backs it up – a 100% up-time performance guarantee and on-demand, 24/7 access to certified network engineers in our Network Operations Centers (NOCs). These engineers possess the requisite global view and information to quickly resolve performance issues.

Market-leading technology and service guarantees, however, are just the start of the Internap value proposition that now includes an entire suite of high-performance IP solutions. With these products and services, Internap offers customers a single source for IP technology, data center services and consultative expertise. The advanced technologies address application performance issues such as control, speed, delivery and reach. Internap data centers increase application performance by providing a stable, more dependable infrastructure, while lowering total ownership costs and minimizing application risks. And because every business has unique requirements, Internap Professional Services is available to assess, design and implement customized solutions to help maximize return on investment.

These broad and best-in-class offerings enable us to bundle products and services in order to drive the core bandwidth business. In doing so, we ensure peak performance for our customers and for our stockholders.

## Network Performance Challenges

A "Send" command is no guarantee of performance on the Internet today. A recent Internap study shows that nearly 35% of Internet traffic used paths of insufficient quality and would benefit from the Company's technology service solutions. This is no surprise, given that according to Internap's study, traditional Internet technology on average runs 30% below optimum performance and endures more than 40% packet loss. And according to Gartner, latency is also responsible for up to 95% of application delays. Traditional solutions, such as increasing bandwidth or traditional multi-homing, have proven to be inadequate. Constantly acquiring or updating technology is costly and requires expertise. Combined, these factors create a compelling demand scenario for Internap's comprehensive technology solutions and service expertise.

We can make this company

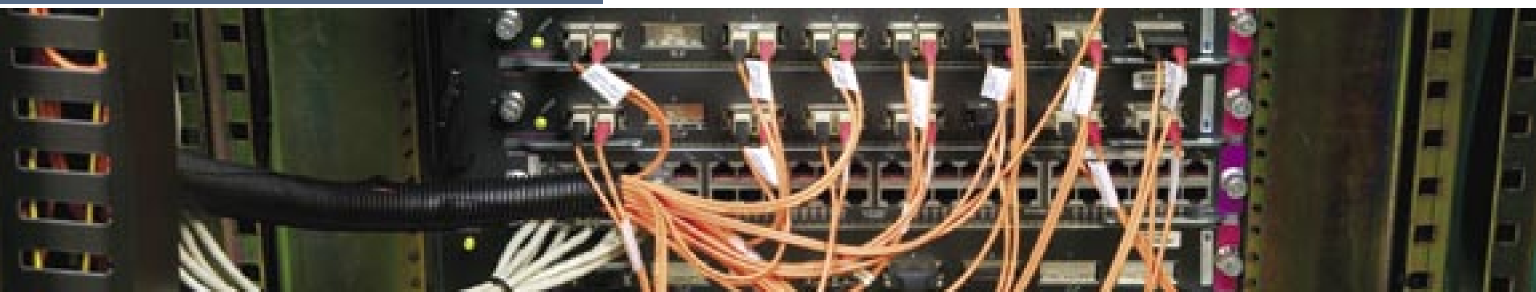
# focus

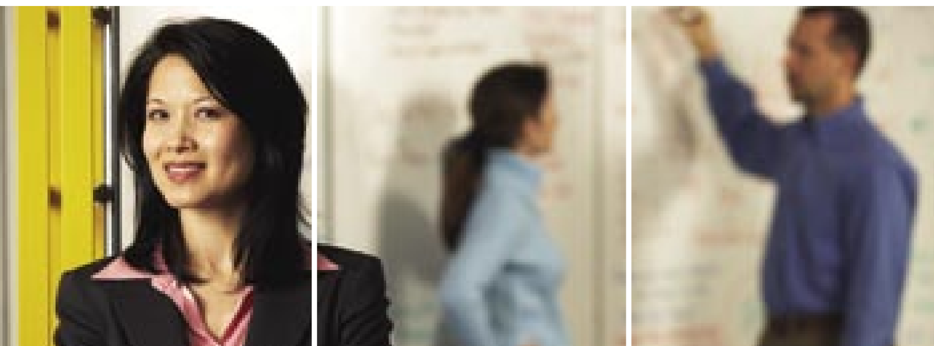
(our best assets are not on the balance sheet)

## 88% of Internap's Employees Are Front-Line Customer Service and Engineering Focused

A multi-billion dollar, Internet-based enterprise experiences a dramatic slowdown in connectivity. Every second that a network is down costs revenue and possibly customers. How much is it worth to make one call and speak to an engineer who can quickly diagnose and resolve the issue? Another business wants to move mission-critical IT functions from a costly private network to the public Internet. Proper planning and design can mitigate risks associated with this shift. How much is it worth to have years of Internet optimization experience lead the effort? The answers to these and similar questions may be hard to quantify, but the issues are real and require specialized IP expertise. At Internap, this type of intellectual capital resides with our people, who are a vital and intangible asset to our Company.

The talent, commitment and experience of our people have not only added value by helping us secure and retain an exceptionally loyal customer base, but also serve as the foundation of Internap Professional Services, a team of individuals who have extensive experience in IP and WAN optimization technologies. This team, combined with customer support engineers in our NOCs, are a formidable competitive advantage for us and contribute to the premium level of our product and service offerings. As a result, Internap can position itself in the marketplace not simply as a provider of bandwidth, but rather as a strategic





partner to resolve critical IP issues. Indeed, our consultative role and outsourced solutions are a major point of differentiation.

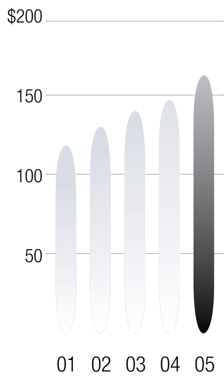
Internap's client-driven approach takes every customer's unique combination of network and application requirements, technical infrastructure and internal service support needs into account. This formula has helped to create a reputation for a high level of customer service that sets us apart from the competition.

Whether it is our core Performance IP services, data center services or the deployment of advanced technologies to address specialized performance issues, the Internap solution is always focused on the specific needs of our more than 2,000 customers.

## Award-Winning Customer Service

In 2005, Internap Professional Services received the prestigious Achievement in Customer Excellence (ACE) Award for its client-driven approach to service. Based on overall customer relationships and technical support, the award revealed a superior client approval rating above 90%. The award serves as a testament to Internap's commitment to addressing each customer's unique needs and hiring the best and brightest minds in the industry.

2005 ACE Award
*Achievement in Customer Excellence*
CustomerSat



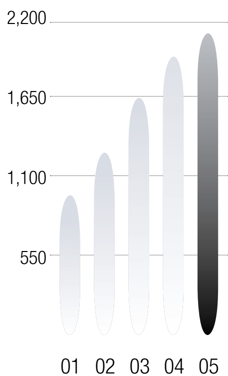

**Revenue** (figures in $ millions)

Intensified marketing, product development and customer penetration have generated increased revenue.

We can make this company

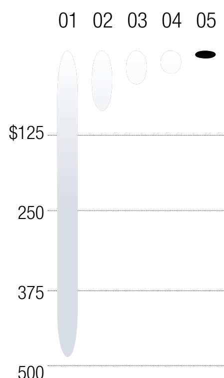
# deliver

(discipline is key)




**Customer Growth**

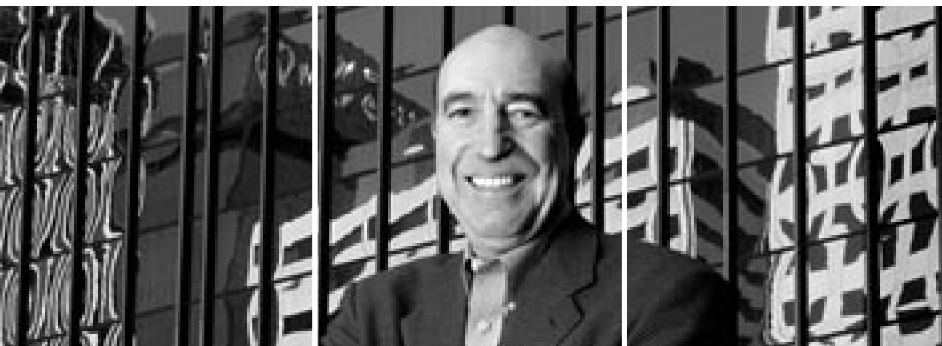
Our growing customer base continues to include Fortune 1000 companies who rely on Internap to optimize performance.




**Net Loss** (figures in $ millions)

A new level of operational efficiency and a strong focus on top line growth have resulted in improved company performance.

From winning new business to improving efficiencies in operating our business, every endeavor is focused on achieving and sustaining profitability. This effort requires attacking both sides of the income statement in a disciplined fashion. Operational efficiencies and increased scale help reduce the expense side of the equation. Capital deployment in return-driven marketing campaigns, strategic product development and deeper customer penetration should also help grow revenue. Individual accountability and compensation are tied closely to our goals, and we are focused on improving operating cash flow. Most important, Internap believes strongly in the value of its technology, people and business model, and we are determined to put each of these to work for our stockholders.



# A Message From Gene Eidenberg

Chairman of the Board

Dear Fellow Stockholders,

2005 was a year of important transition for Internap. In November, Internap's board of directors appointed James DeBlasio as President and Chief Executive Officer of your Company. Jim is no stranger to Internap, having been a valued member of Internap's board since 2003 and having served as Chairman of the Audit Committee until his appointment as the Company's new President and CEO. Jim accepted the board's invitation following a 20-year career with AT&T and Lucent Technologies.

We believe that Jim's leadership has positioned the Company to take advantage of growing momentum in our business sector, as many companies are showing increased interest in the advantages Internap can bring to their business.

Driven primarily by innovative e-business models that require higher network capacity and solutions that can support complex applications, the demand for Internet connectivity and associated services is showing healthy growth. These developments, along with increased broadband penetration and other market trends, have helped to create a favorable environment for Internap's bundled Internet and data center services.

Today, we believe that Internap is poised to take advantage of this evolving landscape to achieve and sustain long-term success. In the past six months, the board has seen a new level of energy within the Company and is confident that Internap is on track to achieving value for its stockholders. Every member of the board is grateful for your continued support of the Company.

Sincerely,

Gene Eidenberg

## 2005 Financial Information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The consolidated statement of operations data and other financial data presented below were prepared using the consolidated financial statements of Internap for the five years ended December 31, 2005. You should read this selected consolidated financial data together with the Consolidated Financial Statements and related Notes contained in this Report and in our 2004 Annual Report on Form 10-K report filed with the SEC, as well as the section of this Report and of our 2004 Annual Report on Form 10-K entitled, "Management's Discussion and Analysis of Financial Condition and Results of Operations."

| | Year Ended December 31, | | | | |
|---|---|---|---|---|---|
| (In thousands, except per share data) | 2005 | 2004 | 2003 | 2002 | 2001 |
| **Consolidated Statement of Operations Data:** | | | | | |
| Revenue | $153,717 | $144,546 | $138,580 | $132,487 | $ 117,404 |
| Costs and expense: | | | | | |
| Direct cost of revenue, exclusive of depreciation and amortization, shown below | 81,958 | 76,990 | 78,200 | 85,734 | 101,545 |
| Customer support | 10,670 | 10,180 | 9,483 | 12,913 | 21,480 |
| Product development | 4,864 | 6,412 | 6,982 | 7,447 | 12,233 |
| Sales and marketing | 25,864 | 23,411 | 21,491 | 21,641 | 38,151 |
| General and administrative | 20,096 | 24,772 | 16,711 | 20,907 | 44,787 |
| Depreciation and amortization | 14,737 | 15,461 | 33,869 | 49,659 | 48,576 |
| Amortization of goodwill[(1)] and other intangible assets | 577 | 579 | 3,352 | 5,626 | 38,116 |
| Amortization of deferred stock compensation | 60 | – | 390 | 260 | 4,217 |
| Pre-acquisition liability adjustment | – | – | (1,313) | – | – |
| Lease termination expense | – | – | – | 804 | – |
| Restructuring cost (benefit)[(2)] | 44 | 3,644 | 1,084 | (2,857) | 62,974 |
| Impairment of goodwill and other intangible assets[(3)] | – | – | – | – | 195,986 |
| (Gain) loss on sales and retirements of property and equipment | (19) | (3) | (53) | 3,722 | 2,802 |
| Total operating costs and expense | 158,851 | 161,446 | 170,196 | 205,856 | 570,867 |
| Loss from operations | (5,134) | (16,900) | (31,616) | (73,369) | (453,463) |
| Other (income) expense | (170) | 1,162 | 2,985 | 2,299 | 26,465 |
| Net loss | (4,964) | (18,062) | (34,601) | (75,668) | (479,928) |
| Less deemed dividend related to beneficial conversion feature[(4)] | – | – | (34,576) | – | – |
| Net loss attributable to common stockholders | $ (4,964) | $ (18,062) | $ (69,177) | $ (75,668) | $(479,928) |
| Basic and diluted net loss per share | $ (0.01) | $ (0.06) | $ (0.40) | $ (0.49) | $ (3.19) |
| Weighted average shares used in computing basic and diluted net loss per share[(4)] | 339,387 | 287,315 | 174,602 | 155,545 | 150,328 |

# SELECTED FINANCIAL DATA

| (In thousands) | As of December 31, 2005 | 2004 | 2003 | 2002 | 2001 |
|---|---|---|---|---|---|
| **Consolidated Balance Sheet Data:** | | | | | |
| Cash, cash equivalents and short-term marketable investments | $ 40,494 | $ 45,985 | $ 18,885 | $ 25,219 | $ 82,306 |
| Non-current marketable investments | – | 4,656 | – | – | – |
| Total assets | 155,369 | 168,149 | 135,839 | 166,334 | 279,294 |
| Notes payable and capital lease obligations, less current portion | 7,903 | 12,837 | 12,742 | 22,739 | 11,184 |
| Series A convertible preferred stock (5) | – | – | – | 79,790 | 86,314 |
| Total stockholders' equity | 109,728 | 113,738 | 70,524 | (4,228) | 63,429 |

| (In thousands) | Year Ended December 31, 2005 | 2004 | 2003 | 2002 | 2001 |
|---|---|---|---|---|---|
| **Other Financial Data:** | | | | | |
| Purchases of property and equipment | $(10,161) | $(13,066) | $ (3,799) | $ (8,632) | $ (32,094) |
| Net cash provided by (used in) operating activities | 5,846 | (1,150) | (11,175) | (40,331) | (123,105) |
| Net cash (used in) provided by investing activities | (9,781) | (29,659) | 561 | 9,581 | 12,292 |
| Net cash (used in) provided by financing activities | (5,454) | 45,747 | 4,280 | (7,582) | 72,204 |

(1) We adopted Statement of Financial Accounting Standard (SFAS) No. 142, "Goodwill and Other Intangible Assets" during 2002. Accordingly, effective January 1, 2002, goodwill is no longer amortized and is instead reviewed for impairment annually, or more frequently, if indications of impairment arise.

(2) Restructuring cost (benefit) relates to restructuring programs in which management determined to exit certain non-strategic real estate lease and license arrangements, consolidate network access points and streamline the operating cost structure.

(3) In 2000, we acquired CO Space, Inc. and the purchase price was allocated to net tangible assets and identifiable intangible assets and goodwill. In 2001, the estimated fair value of certain assets acquired was less than their recorded amounts, and an impairment charge was recorded for $196.0 million.

(4) In August 2003, we completed a private placement of our common stock which resulted in a decrease of the conversion price of our series A preferred stock to $0.95 per share and an increase in the number of shares of common stock issuable upon conversion of all shares of series A preferred stock by 34.5 million shares. We recorded a deemed dividend of $34.6 million in connection with the conversion price adjustment, which is attributable to the additional incremental number of shares of common stock issuable upon conversion of our series A preferred stock.

(5) In July 2003, we amended the deemed liquidation provisions of our charter to eliminate the events that could result in payment to the series A preferred stockholders such that the events giving rise to payment would be within our control. As a result, 2,887,661 shares of our series A preferred stock, with a recorded value of $78.6 million, were reclassified from mezzanine financing to stockholders' equity during 2003. Effective September 14, 2004, all shares of our outstanding series A convertible preferred stock were mandatorily converted into common stock in accordance with the terms of our Certificate of Incorporation.

The following discussion should be read in conjunction with the consolidated financial statements and accompanying notes of this annual report.

## OVERVIEW

We market products and services that provide managed and premise-based IP and route optimization technologies that enable business-critical applications such as e-commerce, CRM, video and audio streaming, VoIP, VPNs, and supply chain management. Our product and service offerings are complemented by IP access solutions such as data center services, CDN and managed security. At December 31, 2005, we delivered services through our 38 network access points, across North America, London, and the Asia-Pacific region including Tokyo and Sydney, Australia. Internap's Private Network Access Points (P-NAP®) feature direct high-speed connections to major Internet backbones such as AT&T, Sprint, Verizon (formerly MCI), Savvis, Global Crossing Telecommunications and Level 3 Communications.

The key characteristic that differentiates us from our competition is our portfolio of patented and patent-pending route optimization solutions that address the inherent weaknesses of the Internet and overcome the inefficiencies of traditional IP connectivity options. Our intelligent routing technology can facilitate traffic over multiple carriers, as opposed to just one carrier's network, to ensure highly reliable performance over the Internet.

We believe our unique carrier-neutral approach provides better performance, control and reliability compared to conventional Internet connectivity alternatives. Our service level agreements guarantee performance across the entire Internet in the United States, excluding local connections, whereas providers of conventional Internet connectivity typically only guarantee performance on their own network. Internap serves customers in a variety of industries including financial services, entertainment and media, travel, e-commerce, retail and technology. As of December 31, 2005, we provided our services to approximately 2,100 customers in the United States and abroad, including several Fortune 1000 and mid-tier enterprises.

## HIGHLIGHTS AND OUTLOOK

- *Due to the nature of the services we provide, we generally price our Internet connectivity services at a premium to the services offered by conventional Internet connectivity service providers.* We believe customers with business-critical Internet applications 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 our high performance managed Internet connectivity services.

- *Our success in executing our premium pricing strategy depends, to a significant degree, on our ability to differentiate our connectivity solutions from lower cost alternatives.* The key measures of our success in achieving this differentiation are revenue and customer growth. During 2005, we added more than 150 net new customers, bringing our total to approximately 2,100 enterprise customers as of December 31, 2005. Revenue for the year ended December 31, 2005 increased 6% to $153.7 million, compared to revenue of $144.5 million for the year ended December 31, 2004.

- *Solidified management team is focused on achieving profitability and revenue by leveraging operating efficiencies.* In November 2005, James P. DeBlasio, a 20-year technology veteran and former Lucent executive, was appointed CEO. Through a renewed emphasis on aggressive cost containment our management team will focus on reducing net losses and driving gross profit to improve shareholder value.

- *We intend to increase revenue by leveraging the capabilities of our existing network access points.* In our existing markets, we realize incremental margins as new customers are added. Additional volume in an existing market allows improved utilization of existing facilities and an improved ability to cost-effectively predict and acquire additional network capacity. Conversely, decreases in the number of customers in an established market lead to decreased facility utilization and increase the possibility that direct network resources are not cost-efficiently employed. These factors have a direct bearing on our financial position and results of operations.

- *We also intend to increase revenue by expanding our geographic coverage in key markets in the United States and abroad.* As we enter new geographic markets, operating results will be affected by increased expense for hiring, training and managing new employees, acquiring and implementing new systems and expense for new facilities. Our ability to generate increased revenue depends on the success of our cost control measures as we expand our geographic coverage.

- *We believe that our data center services will continue to be drivers of revenue in 2006.* During 2005, we focused on selling, investing in and managing data center services. In order to meet the current and future anticipated demand for our data center services, we invested more than $10 million in 2005 to upgrade and expand our existing facilities. Of the 85,064 total square feet of data center space directly operated by Internap, approximately 71% was utilized as of December 31, 2005. We have 38,894 total square feet of data center space operated under agreements with third parties of which approximately 87% was utilized as of December 31, 2005. During the year, we also focused on bundling our IP and data center services. Our approach to expanding data center capabilities is needs driven, as it serves to enhance our customers' access to Internap's core

IP services. We believe this bundling brings great value to our customers, as evidenced by the fact that approximately 95% of our data center customers also purchase IP services.

- *We sell approximately two-thirds of new monthly recurring revenue to existing customers.* Selling new monthly recurring revenue to existing customers allows us to guard against customer loss.

- *While we have limited our execution of traditional advertising over the past year, we are focused on increasing brand awareness through appropriate marketing vehicles.* We will continue to develop integrated marketing campaigns that identify qualified leads, generate interest and promote business benefits among key audiences. We will also conduct public relations efforts focused on securing third party recognition of our products and services from the media and industry analysts. Our marketing organization is also responsible for creating our product strategy based upon primary and secondary market research and the advancement of new technologies.

## BUSINESS COMBINATIONS

On October 1, 2003, we completed our acquisition of netVmg, Inc. (netVmg). The acquisition was recorded using the purchase method of accounting under SFAS No. 141, "Business Combinations." The aggregate purchase price of the acquired company, plus related charges, was $13.7 million and was comprised of 345,905 shares of our series A preferred stock, acquisition costs and warrants to purchase 1.5 million shares of our common stock.

On October 15, 2003, we completed our acquisition of Sockeye Networks, Inc. (Sockeye). The acquisition was recorded using the purchase method of accounting under SFAS No. 141. The aggregate purchase price of the acquired company, plus related charges, was $1.9 million and was comprised of 1.4 million shares of our common stock and acquisition costs.

## CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expense, and related disclosure of contingent assets and liabilities. On an ongoing basis, we evaluate our estimates, including those summarized below. 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 our consolidated financial statements.

**Revenue recognition.** The majority of our revenue is derived from high-performance Internet connectivity and related data center services. Our revenue is 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. Ancillary services include data center services, CDN, server management and installation services, virtual private networking services, managed security services, data backup, and remote storage and restoration services. We also offer T-1 and fractional DS-3 connections at fixed rates.

We recognize revenue 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. Contracts and sales or purchase orders are generally used to determine the existence of an arrangement. We test for availability or use shipping documents when applicable to verify delivery of our product or service. We assess whether the fee is fixed or determinable based on the payment terms associated with the transaction and whether the sales price is subject to refund or adjustment.

Deferred revenue consists of revenue for services to be delivered in the future and consists primarily of advance billings, which are amortized over the respective service period. Revenue associated with billings for installation of customer network equipment are deferred and amortized over the estimated life of the customer relationship (generally two years), as the installation service is integral to our primary service offering and does not have value to a customer on a stand-alone basis. Deferred post-contract customer support (PCS) associated with sales of our FCP solution and similar products are amortized ratably over the contract period (generally one year).

**Customer credit risk.** We routinely review the creditworthiness of our customers. If we determine that collection of service revenue 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. The allowance for doubtful accounts is based upon specific and general customer information, which also includes estimates based on management's best understanding of the customers' ability to pay. Customers' ability to pay takes into consideration payment history, legal status (i.e., bankruptcy), and the status of services we are providing.

Once all collection efforts have been exhausted, we write the uncollectible balance off against the allowance for doubtful accounts. We also estimate a reserve for sales adjustments, which reduces net accounts receivable and revenue. The reserve for sales adjustments is based upon specific and general customer information, including outstanding promotional credits, customer disputes, credit adjustments not yet processed through the billing system and historical activity. If the financial condition of our customers were to deteriorate, or management becomes aware of new information impacting a customer's credit risk, additional allowances may be required.

**Accounting for leases and leasehold improvements.** We record leases as capital or operating leases and account for leasehold improvements in accordance with SFAS No. 13, "Accounting for Leases" and related literature. Rent expense for operating leases is recorded in accordance with FASB Technical Bulletin Financial Accounting Standards Board (FTB) No. 88-1, "Issues Relating to Accounting for Leases." This FTB requires lease agreements that include periods of free rent or other incentives, specific escalating lease payments, or both, to be recorded on a straight-line or other systematic basis over the initial lease term and those renewal periods that are reasonably assured. The difference between rent expense and rent paid is recorded as deferred rent in non-current liabilities in the consolidated balance sheets.

**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 have a $1.2 million equity investment at December 31, 2005 in Aventail Corporation (Aventail), an early-stage, privately held company, after having reduced the balance for an impairment loss of $4.8 million in 2001. The carrying value of our investment in Aventail is recorded in non-current investments in our consolidated balance sheet.

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 we have 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, 2005, Internap Japan Co, Ltd. (Internap Japan), our joint venture with NTT-ME Corporation of Japan and another NTT affiliate, qualifies for equity method accounting. We record our proportional share of the income and losses of Internap Japan one month in arrears on the consolidated balance sheets as a component of non-current investments and as other income, net on the consolidated statement of operations.

Investments in marketable securities primarily include high credit quality corporate debt securities and U.S. Government Agency debt securities. These investments are classified as available for sale and are recorded at fair value with changes in fair value reflected in other comprehensive income.

**Goodwill.** We recorded goodwill as a result of our acquisitions of CO Space, VPNX.com, netVmg, and Sockeye. We account for goodwill under SFAS No. 142, "Goodwill and Other Intangible Assets." This statement requires an impairment-only approach to accounting for goodwill. The SFAS No. 142 goodwill impairment model is a two-step process. First, it requires a comparison of the book value of net assets to the fair value of the related operations that have goodwill assigned to them. If the fair value is determined to be less than book value, a second step is performed to compute the amount of the impairment. In this process, a fair value for goodwill is estimated, based in part on the fair value of the operations used in the first step, and is compared to the carrying value for goodwill. Any shortfall of the fair value below carrying value represents the amount of goodwill impairment. SFAS No. 142 requires goodwill to be tested for impairment annually at the same time every year and when an event occurs or circumstances change such that it is reasonably possible that impairment may exist. We selected August 1 as our annual testing date.

To assist us in estimating the fair value for purposes of completing the first step of the SFAS No. 142 analysis, we engaged a professional business valuation and appraisal firm who utilized discounted cash flow valuation methods and the guideline company method for reasonableness. The forecasts of future cash flows was based on our best estimate of future revenue, operating costs and general market conditions, and was subject to review and approval by senior management. Both approaches to determining fair value depend on our stock price since market capitalization will impact the discount rate to be applied as well as a market multiple analyses. Changes in the forecast could cause us to either pass or fail the first step test and could result in the impairment of goodwill.

**Accruals for disputed telecommunication costs.** In delivering our services, we rely on a number of Internet network, telecommunication and other vendors. We work directly with these vendors to provision services such as establishing, modifying or discontinuing services for our customers. Because of the volume of activity, billing disputes inevitably arise. These disputes typically stem from disagreements concerning the starting and ending dates of service, quoted rates, usage and various other factors. For potential billing errors made in the vendor's favor, for example a duplicate billing, we initiate a formal dispute with the vendor and record the related cost and liability on a range of 5% to 100% of the disputed amount, depending on our assessment of the likely outcome of the dispute. Conversely, for billing errors in our favor, such as the vendor's failure to invoice us for new service, we record an estimate for the

related cost and liability based on the full amount that we should have been invoiced. Disputed costs, both in the vendors' favor and our favor, are researched and discussed with vendors on an ongoing basis until ultimately resolved. Estimates are periodically reviewed by management and modified in light of new information or developments, if any. Conversely, any resolved disputes which will result in a credit over the disputed amounts are recognized in the appropriate month when the resolution has been determined. Because estimates regarding disputed costs include assessments of uncertain outcomes, such estimates are inherently vulnerable to changes due to unforeseen circumstances that could materially and adversely affect our results of operations and cash flows.

**Accrued liabilities.** Similar to accruals for disputed telecommunications costs above, it is necessary for us to estimate other significant costs such as utilities and sales, use, telecommunications and other taxes. These estimates are often necessary either because invoices for services are not received on a timely basis from our vendors or by virtue of the complexity surrounding the costs. In every instance in which an estimate is necessary, we record the related cost and liability based on all available facts and circumstances, including but not limited to historical trends, related usage, forecasts and quotes. Estimates are periodically reviewed by management and modified in light of new information or developments, if any. Because estimates regarding accrued liabilities include assessments of uncertain outcomes, such estimates are inherently vulnerable to changes due to unforeseen circumstances that could materially and adversely affect our results of operations and cash flows.

**Restructuring liability.** When circumstances warrant, we may elect to exit certain business activities or change the manner in which we conduct ongoing operations. When such a change is made, management will estimate the costs to exit a business or restructure ongoing operations. The components of the estimates may include estimates and assumptions regarding the timing and costs of future events and activities that represent management's best expectations based on known facts and circumstances at the time of estimation. Management periodically reviews its restructuring estimates and assumptions relative to new information, if any, of which it becomes aware. Should circumstances warrant, management will adjust its previous estimates to reflect what it then believes to be a more accurate representation of expected future costs. Because management's estimates and assumptions regarding restructuring costs include probabilities of future events, such estimates are inherently vulnerable to changes due to unforeseen circumstances, changes in market conditions, regulatory changes, changes in existing business practices and other circumstances that could materially and adversely affect our results of operations. A 10% change in our restructuring estimates in a future period, compared to the $6.3 million restructuring liability at December 31, 2005 would result in an $0.6 million expense or benefit in the statement of operations during the period in which the change in estimate occurred.

**Deferred taxes.** We record a valuation allowance to reduce our deferred tax assets to the amount that is more likely than not to be realized. Since inception we have recorded a valuation allowance equal to our net deferred tax assets. Although we consider the potential for future taxable income and ongoing prudent and feasible tax planning strategies in assessing the need for the valuation allowance, in the event we determine we would be able to realize our deferred tax assets in the future in excess of our net recorded amount, an adjustment to the valuation allowance would increase income in the period such determination was made.

## RECENT ACCOUNTING PRONOUNCEMENTS

In June 2005, the FASB issued SFAS No. 154, "Accounting for Changes and Error Corrections – A Replacement of APB Opinion No. 20 and FASB Statement No.3" to prescribe the related accounting and disclosures. The provisions of SFAS No. 154 are effective for changes and error corrections made in fiscal years beginning after December 15, 2005. We will adopt this pronouncement on January 1, 2006.

In December 2004, the FASB issued SFAS No. 123 (revised 2004), "Share-Based Payment," which is known as SFAS No. 123(R). SFAS No. 123(R) replaces SFAS No. 123, "Accounting for Stock-Based Compensation," as amended by SFAS No. 148, "Accounting for Stock-Based Compensation – Transition and Disclosure – an Amendment of FASB Statement No. 123." Among other things, SFAS No. 123(R) eliminates the alternative to use the intrinsic value method of accounting for stock-based compensation. SFAS No. 123(R) requires public entities to recognize compensation expense for awards of equity instruments to employees based on the grant-date fair value of the awards. On March 29, 2005, the SEC issued Staff Accounting Bulletin (SAB) No. 107, providing the SEC Staff's view regarding the interaction between SFAS No. 123(R) and certain SEC rules and regulations, and the valuation of share-based payment arrangements. On April 15, 2005, the SEC amended Rule 4-01(a) of Regulation S-X, extending the effective date of SFAS No. 123(R) to the first annual reporting period of the registrant's first fiscal year beginning on or after June 15, 2005.

We will adopt the provisions of SFAS No. 123(R), subsequent FASB Staff Positions, and guidance in SAB No. 107, beginning in the first quarter of 2006. We are evaluating the requirements under SFAS No. 123(R) and expect the adoption to have a significant adverse impact on our consolidated statements of operations and net income per share, comparable to our pro forma disclosure under SFAS No. 123. However, the actual effect on net income or loss and earnings or loss per share after adopting SFAS No. 123(R) will vary depending upon the number of options granted in 2006 compared to prior years. In addition, we will also recognize compensation expense related to our employee stock purchase plan for the six-month purchase period ending June 30, 2006. We have modified our employee stock purchase plan to make it a non-compensatory

plan for all purchase periods subsequent to June 30, 2006. Based on the level of participation and volatility of our stock in 2005, we estimate that compensation expense will be less than $0.1 million per purchase period in 2006.

## RESULTS OF OPERATIONS

*Revenue* is 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 related data center services. In addition to our connectivity and data center services, we also provide premise-based route optimization products and other ancillary services, such as CDN, server management and installation services, virtual private networking services, managed security services, data backup, remote storage and restoration services.

*Direct cost of revenue* is comprised primarily of:

- costs for connecting to and accessing Internet network service providers and competitive local exchange providers;
- costs related to operating and maintaining network access points and data centers;
- costs incurred for providing additional third-party services to our customers and;
- costs of Flow Control Platform solution and similar products sold.

To the extent a network access point is located a distance from the respective Internet network service providers, we may incur additional local loop charges on a recurring basis. Connectivity costs vary depending on customer demands and pricing variables while network access point facility costs are generally fixed in nature. Direct cost of revenue does not include compensation, depreciation or amortization.

*Customer support costs* consist primarily of employee compensation costs for employees engaged in connecting customers to our network, installing customer equipment into network access point facilities, and servicing customers through our network operations 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 for software to be sold, leased or otherwise marketed are capitalized upon establishing technological feasibility and ending when the software is available for general release to customers. 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, tradeshows, direct response programs, new service point launch events, management of our website and other promotional costs.

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

The revenue and income potential of our business and market is unproven, and our limited operating history makes it difficult to evaluate our prospects. Although we have been in existence since 1996, we have incurred significant operational restructurings in recent years, which have included substantial changes in our senior management team, a reduction in headcount from a high of 860 employees to 334 employees at December 31, 2005, streamlining our cost structure, consolidating network access points, terminating certain non-strategic real estate leases and license arrangements and moving our corporate office from Seattle, Washington to Atlanta, Georgia to further reduce costs. We have incurred net losses in each quarterly and annual period since we began operations in May 1996. As of December 31, 2005, our accumulated deficit was $860.1 million.

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

| | Year Ended December 31, | | |
|---|---|---|---|
| | **2005** | 2004 | 2003 |
| Revenue | **100%** | 100% | 100% |
| Costs and expense: | | | |
| Direct cost of revenue, exclusive of depreciation and amortization shown below | **53** | 53 | 56 |
| Customer support | **7** | 7 | 7 |
| Product development | **3** | 5 | 5 |
| Sales and marketing | **17** | 16 | 16 |
| General and administrative | **13** | 17 | 12 |
| Depreciation and amortization | **10** | 11 | 27 |
| Restructuring costs | **–** | 3 | 1 |
| Other operating expense | **–** | – | (1) |
| Total operating costs and expense | **103** | 112 | 123 |
| Loss from operations | **(3)** | (12) | (23) |
| Total other expense, net | **–** | 1 | 2 |
| Net loss | **(3)%** | (13)% | (25)% |

## Years Ended December 31, 2005 and 2004

**Revenue.** Revenue for 2005 increased $9.1 million, or 6%, from $144.5 million for the year ended December 31, 2004 to $153.7 million for the year ended December 31, 2005 summarized as follows (in thousands):

| | Year Ended December 31, | |
|---|---|---|
| | **2005** | 2004 |
| Revenue: | | |
| IP Services | **$ 99,848** | $101,103 |
| Data Center Services | **36,226** | 25,737 |
| CDN, Edge Appliance and Other | **17,643** | 17,706 |
| | **$153,717** | $144,546 |

The increase in total revenue was primarily attributable to increases in data center services revenue of $10.5 million, or 41%, to $36.2 million. This increase principally results from growth in new and existing customers as we have expanded our available data center space. A generally positive technology services environment along with a continued focus on selling and managing data center services also contributed to the revenue increase compared to the year ended December 31, 2004. Similar to past years, revenue for the three months ending December 31, 2005 was also modestly enhanced by our customers' increased holiday traffic, much of which was subject to "bursting rates" for exceeding rate caps. Revenue from our Edge Appliance products contributed $4.2 million of revenue for the year ended December 31, 2005 compared to $2.7 million for the prior year. Offsetting the increase in revenue from data center services and Edge Appliance products were decreases of $1.3 million from IP connectivity services and decreases of $0.9 million in non-recurring and other revenue. Although the number of IP customers and volume has increased during the year ended December 31, 2005, revenue from IP connectivity services continues to decrease as a result of repricing of our customer base. Non-recurring and other revenue includes termination fees and service revenue from VPN, managed security, managing customer premise equipment, and data storage services.

Our customer base increased by more than 150 customers to approximately 2,100 at December 31, 2005, an 8% increase from December 31, 2004. While our customer base grew from a year ago, revenue per customer continued to decrease due to price reductions in charges for our Internet connectivity services necessitated by general market conditions. We expect a continuing trend of future revenue increases to include an increasing percentage of revenue from non-connectivity products and services than in the past, particularly from data centers and the sale of our FCP solution and other Edge Appliance technology.

One of our largest data center customer's contract expired as of December 31, 2005 and was not renewed due largely to the customer's financial constraints. Because of the customer's financial status, substantially all of the customer's uncollected 2005 revenue and accounts receivable were reserved as services were invoiced. At December 31, 2005, we believe the financial statements accurately reflect collectible revenue and accounts receivable for this customer. In spite of the loss of this customer, we fully anticipate the lost revenue to be more than replaced from new and existing customers.

**Direct cost of revenue.** Direct cost of revenue increased from $77.0 million for the year ended December 31, 2004 to $82.0 million for the year ended December 31, 2005, representing an increase of 6%. Our gross margins, defined as revenue less direct cost of revenue excluding depreciation and amortization expense, improved to $71.8 million for the year ended December 31, 2005 compared to $67.6 million for the same period in 2004. This increase in gross margin is a result of our leveraging fixed data center and other service point facility costs over an increased customer base and negotiating lower rates with service providers.

The increase of $5.0 million in direct cost of revenues was primarily due to increased costs related to expanded data centers, representing $10.7 million, offset by decreases in costs from our IP connectivity services of $3.5 million due to favorable contract negotiations with service providers and improved network efficiencies. The increase was also offset by decreased expenses related to P-NAP® facility costs and decreased CDN expense of $1.1 million each.

Connectivity costs vary based upon customer traffic and other demand-based pricing variables. Data center costs have substantial fixed cost components, primarily for rent, but also significant demand-based pricing variables. Edge Appliance and CDN and other costs associated with reseller arrangements are generally variable in nature. We expect all of these costs to continue to increase during 2006 as revenue increases. Data center services are giving us access to new customers in which we can bundle hosting and connectivity services together, potentially generating greater combined gross margins. At December 31, 2005, we had approximately 124,000 square feet of data center space with a utilization rate of approximately 76%.

**Customer support.** Customer support expense increased 5% from $10.2 million for the year ended December 31, 2004 to $10.7 million for the year ended December 31, 2005. This increase of $0.5 million is comparable to revenue growth and was primarily driven by compensation and benefits of $0.3 million for higher staffing levels, along with increases of $0.2 million in costs for outside professional services.

**Product development.** Product development costs for the year ended December 31, 2005 decreased 23% to $4.9 million from $6.4 million for the year ended December 31, 2004. The decrease of $1.5 million was primarily driven by a decrease of $1.6 million in compensation and employee benefits, along with a $0.2 million decrease in office equipment maintenance costs. The decrease in compensation and employee

benefit costs were related to organizational changes that allowed us to reprioritize projects and more efficiently utilize certain employees. The decrease in product development costs is also attributed to the capitalization of certain project development costs in 2005. These decreases were partially offset by an increase in outside professional service expense of $0.3 million.

**Sales and marketing.** Sales and marketing costs for the year ended December 31, 2005 increased 11% to $25.9 million from $23.4 million for the year ended December 31, 2004 due to an increased focus for marketing Edge Appliances and technology and expansion in the Asia-Pacific region. The net increase of $2.5 million was primarily due to increases in commissions and other compensation expense of $2.1 million as well as increases in outside professional services totaling $0.4 million, and a $0.5 million increase in facility expense. These increases were partially offset by decreases in marketing-related expenses of $0.4 million.

**General and administrative.** General and administrative costs for the year ended December 31, 2005 decreased 19% to $20.1 million from $24.8 million for the year ended December 31, 2004. The decrease of $4.7 million primarily reflects a $2.7 million gross reduction in taxes, licenses, and fees, a $1.7 million decrease in outside professional services, $1.3 million reduction in facility, communication, and office equipment, repairs, and maintenance expense, and a $1.0 million decrease in bad debt expense. These reductions were partially offset by increases of $2.0 million in employee compensation and benefits.

The reduction in taxes, licenses and fees related to the combination of (1) an accrual in July 2004 for an assessment from the New York State Department of Taxation and Finance for $1.4 million, including interest and penalties, resulting from an audit of our state franchise tax returns for the years 2000–2002 and (2) a reduction of the accrual in April 2005 when we became aware that the assessment had been reduced to $0.1 million, including interest and with penalties waived. The substantial decrease from the original assessment was a result of including the weighted averages of investment capital and subsidiary capital, along with business capital, used in New York in determining the apportionment factor. The original assessment was based solely on an apportionment of business capital, while investment capital and subsidiary capital both have significantly lower apportionment percentages to New York.

The decrease in outside professional services of $1.7 million is largely due to substantially less use of consultants and contractors in 2005 compared to the Sarbanes-Oxley initiatives and implementation in 2004. The improvement in facility and related costs are attributed to focused cost controls and a much more centrally-managed purchasing function. The reduction in bad debt expense is due largely to an accrual for a large customer balance in 2004 along with more favorable collections experience in 2005.

**Depreciation and amortization.** Depreciation and amortization, including other intangible assets, for the year ended December 31, 2005 decreased 4% to $15.3 million compared to $16.0 million for the year ended December 31, 2004. The decrease of $0.7 million was primarily due to assets becoming fully depreciated during 2005, which were not replaced by the same level of purchases of property and equipment as during prior years.

**Restructuring cost.** For the year ended December 31, 2005 we incurred less than $0.1 million of additional restructuring costs. These additional costs were primarily the result of a change in estimated expenses related to real estate obligations.

For the year ended December 31, 2004, the net charge of $3.6 million to restructuring resulted from an increase of $5.3 million relating to real estate obligations offset by a reduction of $1.7 million pertaining to network infrastructure and other obligations. After reviewing the analysis in the third quarter of 2004, management concluded that the facilities remaining in the restructuring accrual were taking longer than expected to sublease and those that were subleased resulted in lower than expected sublease rates. Consequently, the projected obligations exceeded the unadjusted liability by $5.3 million over the remaining lease terms. During the quarter ended September 30, 2004, all remaining contractual obligations for network infrastructure and other costs included in the restructuring were satisfied and we reduced the remaining recorded liability for the obligations from $1.7 million to zero.

## Years Ended December 31, 2004 and 2003

| | Year Ended December 31, | |
|---|---|---|
| | 2004 | 2003 |
| Revenue: | | |
| IP Services | $101,103 | $100,474 |
| Data Center Services | 25,737 | 20,697 |
| CDN, Edge Appliance and Other | 17,706 | 17,409 |
| | $144,546 | $138,580 |

**Revenue.** Revenue for 2004 increased $5.9 million from $138.6 million for the year ended December 31, 2003 to $144.5 million for the year ended December 31, 2004, an increase of 4%. Our largest increase in revenue came from data center services, which increased $5.0 million, or 24%, to $25.7 million for 2004 compared to $20.7 million for 2003 and our Edge Appliance products contributed $2.7 million of revenue for the year ended December 31, 2004 compared to $0.7 million for the prior year. Revenue for IP connectivity services increased slightly to $101.1 million from $100.5 million for the years ended December 31, 2004 and 2003, respectively, in spite of continued industry-wide intense pricing pressures.

These overall increases in revenue were primarily due to an increase in our customer base of approximately 291 customers, a 16% increase. While our customer base grew from a year ago, revenue per customer decreased due to price reductions in charges for our Internet connectivity services necessitated by general market conditions. We expect the composition of any future revenue increases will include an increasing percentage of revenue from non-connectivity products and services than in the past, particularly from the sale of our Edge Appliance technology, which includes our FCP solution.

**Direct cost of revenue.** Direct cost of revenue decreased from $78.2 million for the year ended December 31, 2003 to $77.0 million for the year ended December 31, 2004, representing a decrease of 2%. For the year ended December 31, 2004, our revenue less direct cost of revenue improved to $67.5 million compared to $60.4 million for the same period in 2003. This increase is a result of our leveraging of fixed data center and other service point facility costs over an increased customer base and negotiating lower rates with service providers. The decrease of $1.2 million in direct cost of revenues was due to reduced network service provider costs and lower local loop pass-through costs of $8.2 million. Off-setting the decrease in network service provider costs and lower local loop pass-through costs were an increase in data center services expense of $3.1 million due to the increased usage of these services by our customers, along with increases in channel, technology, and preferred colocation partner product cost of $1.8 million. An additional increase of $1.5 million in direct cost of revenue is attributed to resale of network equipment, resulting from acquisitions completed by us in 2003, along with an increase of $0.4 million pertaining to facilities costs.

Connectivity costs vary based upon customer traffic and other demand-based pricing variables and are expected to continue to decrease during 2005, even with modest revenue growth, due to the full-year effect of pricing improvements negotiated during 2004. CDN and other costs associated with reseller arrangements are generally variable in nature. We expect these costs to continue to increase during 2005 as revenue increases.

**Customer support.** Customer support expense increased 7% from $9.5 million for the year ended December 31, 2003 to $10.2 million for the year ended December 31, 2004. This increase of $0.7 million was primarily driven by compensation and benefits of $0.8 million for higher staffing levels, along with decreases of $0.2 million in communications.

**Product development.** Product development costs for the year ended December 31, 2004 decreased 9% to $6.4 million from $7.0 million for the year ended December 31, 2003. The net decrease of $0.6 million primarily reflects the redeployment of technical resources from product support to network support in general and administrative expense offset by new hiring for other responsibilities.

**Sales and marketing.** Sales and marketing costs for the year ended December 31, 2004 increased 9% to $23.4 million from $21.5 million for the year ended December 31, 2003. This increase of $1.9 million was primarily due to an increase in quota-bearing resources as well as the commensurate expenses associated with the new hires. A portion of these increases can also be attributed to increased training and productivity improvements.

**General and administrative.** General and administrative costs for the year ended December 31, 2004 increased 49% to $24.8 million from $16.7 million for the year ended December 31, 2003. The increase of $8.1 million primarily reflects increases of $4.2 million in outside professional services, $1.3 million in office equipment repairs and maintenance, $0.8 million in employee compensation, $0.4 million in tax, license, and fees and $0.4 million in communications costs. Consulting and outside professional services principally include compliance costs related to the Sarbanes-Oxley Act of 2002. Also included in the increase is the $1.7 million from redeployment of certain technical resources from product development to network support.

**Depreciation and amortization.** Depreciation and amortization, including other intangible assets, for the year ended December 31, 2004 decreased 57% to $16.0 million compared to $37.2 million for the year ended December 31, 2003. The decrease of $21.2 million was primarily due to assets becoming fully depreciated during 2004, which were not replaced by the same level of purchases of property and equipment as during prior years.

**Restructuring cost (benefit).** We incurred restructuring costs of $3.6 million during the year ended December 31, 2004 as a result of a comprehensive analysis of the remaining accrued restructuring liability. During the quarter ended September 30, 2004, a new sublease was negotiated on one abandoned property and new terms involving a reconfiguration of usable and abandoned space were negotiated with the lessor on another abandoned property, both of which were included in the original restructuring. The last of our restructured network infrastructure obligations was also terminated during the quarter ended September 30, 2004. The net charge to restructuring resulted from an increase of $5.3 million relating to real estate obligations offset by a reduction of $1.7 million pertaining to network infrastructure and other obligations.

After reviewing the analysis in the third quarter of 2004, management concluded that the facilities remaining in the restructuring accrual are taking longer than expected to sublease and those that were subleased resulted in lower than expected sublease rates. Consequently, the currently projected obligations exceeded the unadjusted liability by

$5.3 million over the remaining lease terms, with the last commitment expiring in July 2015. All of these leases arose from our 2000 acquisition of CO Space. The network infrastructure obligations represented amounts to be incurred under contractual obligations in existence at the time the restructuring plan was initiated.

During the quarter ended September 30, 2004, all other remaining contractual obligations for network infrastructure and other costs included in the restructuring were satisfied and we reduced the remaining recorded liability for the obligations from $1.7 million to zero.

Restructuring costs were $1.1 million for 2003 reflecting non-cash restructuring plan adjustments and write-downs net of additional 2003 restructuring and impairment charges.

**Other expense, net.** Other expense, net consists of interest income, interest and financing expense, investment losses and other non-operating expense. Other expense, net for the year ended December 31, 2004 decreased to $1.2 million from $3.0 million for the year ended December 31, 2004. The decrease is due primarily to $1.0 million less interest expense from carrying less debt than in the prior year.

## LIQUIDITY AND CAPITAL RESOURCES

### Cash Flow for the Years Ended December 31, 2005, 2004, and 2003

**Net cash from operating activities.** Net cash provided by operating activities was $5.8 million for the year ended December 31, 2005, and was primarily due to the net loss of $5.0 million adjusted for non-cash items of $20.1 million offset by changes in working capital items of $9.3 million. The changes in working capital items include net use of cash for accounts payable of $5.4 million, accounts receivable of $3.6 million, accrued restructuring of $1.9 million, and $0.2 million of inventory, prepaid expense and other assets. These were offset by net sources of cash in accrued liabilities of $0.8 million and deferred revenue of $1.0 million. The increase in receivables at December 31, 2005 compared to December 31, 2004 was related to the 6% increase in revenue. The decrease in payables is primarily related to a general decrease in expenses when compared to last year.

Net cash used in operating activities was $1.2 million for the year ended December 31, 2004, and was primarily due to the net loss of $18.1 million adjusted for non-cash items of $20.8 million offset by changes in working capital items of $3.9 million. The changes in working capital items include net use of cash for accounts receivable of $3.8 million, deferred revenue of $1.7 million, and accrued liabilities of $1.3 million. These were offset by net sources of cash in inventory, prepaid expense and other assets of $1.6 million, accounts payable of $0.9 million and accrued restructuring costs of $0.5 million. The increase in receivables at December 31, 2004 compared to December 31, 2003 was related to the 4% increase in revenue compared to the prior year as day's sales outstanding increased to 41 from 39 days. The increase in payables is primarily related to more stringent cash controls in 2004 compared to 2003.

Net cash used in operating activities was $11.2 million for the year ended December 31, 2003, and was primarily due to the net loss of $34.6 million adjusted for non-cash items of $41.7 million, offset by net uses of cash for accrued restructuring costs of $6.7 million, accounts payable of $5.9 million, deferred revenue of $4.5 million, accounts receivable of $2.7 million and accrued liabilities of $1.1 million. These uses of cash were offset by a $2.6 million decrease in inventory, prepaid expense and other assets. The increase in receivables at December 31, 2003 compared to December 31, 2002 was related to the 5% increase in revenue compared to the prior year as day's sales outstanding remained constant at 39 days. The decrease in payables is primarily related to a lower overall level of operating expense in 2003 compared to 2002.

**Net cash from investing activities.** Net cash used in investing activities for the year ended December 31, 2005 was $9.8 million primarily due to capital expenditures of $10.2 million. Our capital expenditures were principally comprised of leasehold improvements related to the upgrade of several data center facilities.

Net cash used in investing activities for the year ended December 31, 2004 was $29.7 million and primarily consisted of capital expenditures of $13.1 million and total investments in marketable securities of $16.8 million, partially offset by proceeds from disposal of property and equipment and a reduction in restricted cash of $0.1 million. Our capital expenditures were principally comprised of the buy-out of capital leases from a primary supplier of network equipment during the third quarter and build-outs of data center and office space in the latter-half of the year.

Net cash provided by investing activities for the year ended December 31, 2003 was $0.6 million and primarily consisted of net cash received from acquired businesses of $2.3 million and a reduction in restricted cash of $2.1 million, partially offset by purchases of property and equipment of $3.8 million. The purchase of property and equipment related to the purchase of assets for our network infrastructure and the cost related to the relocation of nine network access points.

**Net cash from financing activities.** Since our inception, we have financed our operations primarily through the issuance of our equity securities, capital leases and bank loans. See "Liquidity" below. Net cash used in financing activities for the year ended December 31, 2005 was $5.4 million. Cash used in financing activity included principal payments on notes payable of $6.5 million and payments on capital lease obligations of $0.5 million. These payments were partially offset by proceeds received from the exercise of stock options of $1.5 million. As a result of these

activities, we had $12.0 million in notes payable and $0.8 million in capital lease obligations as of December 31, 2005 with $4.9 million in notes payable and capital leases scheduled as due within the next 12 months.

Net cash provided by financing activities for the year ended December 31, 2004 was $45.7 million. In September 2004, we negotiated the buy-out of all remaining lease schedules under a master lease agreement with a primary supplier of network equipment. Under the terms of the buy-out agreement, we paid the supplier $19.7 million, representing remaining capital lease payment obligations, end-of-lease asset values and sales tax. The $19.7 million buy-out was paid with $2.2 million in cash on hand and the proceeds from the new $17.5 million term loan from a bank.

On March 4, 2004, we sold 40.25 million shares of our common stock in a public offering at a purchase price of $1.50 per share which resulted in net proceeds to us of $55.9 million after deducting underwriting discounts and commissions and offering expense. We continue to use the net proceeds from the offering for general corporate purposes. General corporate purposes primarily include capital investments in our network access point infrastructure and systems, expansion of data center facilities and repayment of debt and capital lease obligations. General corporate purposes could also include potential acquisitions of complementary businesses or technologies. In addition, we received $5.0 million from the exercise of stock options and warrants during the year ended December 31, 2004. Cash used in financing activities included $24.3 million toward reducing our notes payable and aforementioned capital lease obligations and $8.4 million to repay the outstanding balance on our revolving credit facility.

Net cash provided by financing activities for the year ended December 31, 2003 was $4.3 million. Cash provided included net proceeds from issuance of common stock of $9.3 million and proceeds from exercise of stock options and warrants of $4.0 million. Net cash provided by financing activities was reduced by principal payments on notes payable of $4.6 million, payments on capital lease obligations of $2.8 million and a $1.6 million net reduction in our revolving credit facility. The net proceeds of $9.3 million from issuance of common stock was received in August 2003 when we completed the sale, pursuant to a private placement, of 10.65 million shares of our common stock, par value $0.001 per share, at a price of $0.95 per share.

Capital equipment leases have been used since inception to finance the majority of our networking equipment located in our network access points other than leasehold improvements related to our data center facilities. Payments under capital lease agreements totaled $0.6 million, $20.3 million and $2.8 million for the years ended December 31, 2005, 2004 and 2003, respectively.

## LIQUIDITY

We have a history of quarterly and annual period net losses. We incurred net losses of $5.0 million, $18.1 million and $34.6 million for the years ended December 31, 2005, 2004 and 2003, respectively. As of December 31, 2005, our accumulated deficit was $860.1 million. We may incur additional operating losses in the future. Given the competitive and evolving nature of the industry in which we operate, we cannot guarantee that we will sustain or increase profitability on a quarterly or annual basis. Our failure to do so would adversely affect our business, including our ability to raise additional funds.

Although we experienced positive operating cash flow for the year ended December 31, 2005, we have a history of negative operating cash flow and have depended upon equity and debt financings, as well as borrowings under our credit facilities, to meet our cash requirements. In 2006, we expect a steady increase in cash flows from operations based on current projections in our 2006 business plan. We expect to meet our cash requirements in 2006 through a combination of cash from operating cash flows, existing cash, cash equivalents and short-term investments in marketable securities, borrowings under our credit facilities and proceeds from our public offering in March of 2004. 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 our cash requirements vary materially from those currently planned, if our cost reduction initiatives have unanticipated adverse effects on our business, 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 that we will be able to obtain additional financing on commercially favorable terms, or at all. Provisions in our existing credit facility limit our ability to incur additional indebtedness.

**Revolving credit facility.** At December 31, 2005, we had a $10.0 million revolving credit facility and a $17.5 million term loan under a loan and security agreement with a bank. The agreement was reviewed and amended as of December 27, 2005 to reduce the amount available for borrowing under the revolving credit agreement from $15.0 million to $10.0 million, increase letter of credit sub-limit from $5.0 million to $6.0 million, to extend the expiration date of the revolving credit facility from December 27, 2005 to December 27, 2006 and update loan covenants.

Availability under the revolving credit facility is based on 80% of eligible accounts receivable plus 50% of unrestricted cash and marketable investments. As of December 31, 2005, $4.1 million of letters of credit were issued, and we had available $5.9 million in borrowing capacity under the revolving credit facility.

The credit facility contains certain covenants, including covenants that restrict our ability to incur further indebtedness. The December 28, 2005 changes to the loan covenants include the elimination of the minimum Cash EBITDA requirement, as defined by the agreement, and the addition of a minimum tangible net worth requirement.

As of December 31, 2005, we were in compliance with the various loan covenants. We were in violation of a previous loan covenant that required a minimum Cash EBITDA, as defined in the credit facility, for the three-month period ended September 30, 2005 by $1.3 million. The violation resulted primarily from our continued expansion of data center facilities that caused the minimum Cash EBITDA for the period to be less than the level required under the agreement. On November 3, 2005, we received a formal waiver of the covenant violation. As discussed above, the agreement was amended as of December 27, 2005 to eliminate the minimum Cash EBITDA requirement.

**Note payable to financial institutions.** The $17.5 million term loan noted with the revolving credit facility above has a fixed interest rate of 7.5% and is due in 48 equal monthly installments of principal plus interest through September 1, 2008. The balance outstanding at December 31, 2005 was $12.0 million. Proceeds from the loan were used to purchase assets recorded as capital leases under a master agreement with a primary supplier of networking equipment. The loan is secured by all of our assets, except patents.

**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. Network commitments primarily represent purchase commitments made to our largest bandwidth vendors and contractual payments to license data center space used for resale to customers. Our ability to improve cash used in operations in the future would be negatively impacted if we do 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 as of December 31, 2005 (in thousands):

| | Payments Due by Period | | | | |
|---|---|---|---|---|---|
| | Total | Less Than 1 year | 1-3 Years | 3-5 Years | More Than 5 years |
| Note payable [1] | $ 12,031 | $ 4,375 | $ 7,656 | $ – | $ – |
| Capital lease obligations [2] | 860 | 607 | 253 | – | – |
| Operating lease commitments | 102,912 | 9,824 | 19,389 | 12,008 | 61,691 |
| Service commitments | 13,676 | 6,110 | 5,534 | 2,032 | – |
| | $128,479 | $20,916 | $32,832 | $14,040 | $61,691 |

(1) Note payable does not include interest expense of $0.7 million and $0.5 million due in less than one year and between one and three years, respectively.

(2) Capital lease obligations include imputed interest expense of less than $0.1 million.

**Common and preferred stock.** Effective September 14, 2004, all shares of our outstanding series A convertible preferred stock were mandatorily converted into common stock in accordance with the terms of our Certificate of Incorporation. An aggregate of 1.8 million shares of convertible preferred stock with a recorded value of $51.8 million was converted into 56.2 million shares of common stock during the quarter ended September 30, 2004. Accordingly, we had no shares of series A convertible preferred stock outstanding subsequent to the mandatory conversion. The mandatory conversion had no effect on the outstanding warrants to purchase common stock that were issued in conjunction with the series A preferred stock.

On March 4, 2004, we sold 40.25 million shares of our common stock in a public offering at a purchase price of $1.50 per share which resulted in net proceeds to us of $55.9 million, after deducting underwriting discounts and commissions and offering expense. We continue to use the net proceeds from the offering for general corporate purposes. General corporate purposes primarily include capital investments in our network access point infrastructure and systems, expansion of data center facilities and repayment of debt and capital lease obligations. General corporate purposes could also include potential acquisitions of complementary businesses or technologies.

On August 22, 2003, we completed a private placement of 10.65 million shares of our common stock at a price of $0.95 per share. We received $9.5 million, net of issuance costs. Because we issued shares of our common stock in the private placement at a price below the conversion price of the series A preferred stock at that time, the number of shares of common stock into which the outstanding shares of series A preferred stock were convertible increased by 34.5 million shares. In accordance with generally accepted accounting principles, we recorded a deemed dividend of $34.6 million, which was attributable to the additional incremental number of shares of common stock issuable upon conversion of the series A preferred stock.

**Lease facilities.** Since our inception, we have financed the purchase of substantial network routing equipment using capital leases with a primary supplier. As discussed below, we negotiated the buy-out of all remaining lease schedules under a master lease agreement with the primary supplier in September 2004. Our future minimum lease payments on remaining capital lease obligations at December 31, 2005 totaled $0.9 million, with $0.8 million representing the present value of minimum lease payments.

The negotiated buy-out of all remaining lease schedules under the master lease agreement with the supplier of network equipment included a cash payment of $19.7 million, comprising remaining capital lease obligations as of September 30, 2004, along with end-of-lease asset values and sales tax, resulting in a $2.2 million increase to fixed assets. The $19.7 million buy-out was funded through $2.2 million in cash on hand and the proceeds from the aforementioned $17.5 million term loan from a bank. As of December 31, 2005, our other remaining capital lease has an expiration date of June 2007.

## RESTRUCTURING AND IMPAIRMENT COSTS

With overcapacity created in the Internet connectivity market and IP services market, we implemented restructuring plans that resulted in significant charges in 2001 and 2002 for real estate and network infrastructure obligations, personnel and other charges. Additional charges were also incurred during 2003 and 2004 as we continued to evaluate our restructuring reserve. We may incur additional charges in future periods.

**2003 Restructuring costs.** For the year ended December 31, 2003, we incurred $1.1 million in restructuring costs which primarily represented retention bonuses and moving expenses related to the relocation of our corporate office to Atlanta, Georgia from Seattle, Washington.

**2004 Restructuring costs.** We incurred net additional restructuring costs of $3.6 million during 2004 as a result of a comprehensive analysis of the remaining accrued restructuring liability. After reviewing the analysis, management concluded that the facilities remaining in the restructuring accrual were taking longer than expected to sublease and those that were subleased resulted in lower than expected sublease rates. Consequently, the projected obligations exceeded the unadjusted liability by $5.3 million over the remaining lease terms, with the last commitment expiring in July 2015. During the quarter ended September 30, 2004, all other remaining contractual obligations for network infrastructure and other costs included in the restructuring were satisfied and we reduced the remaining recorded liability for the obligations from $1.7 million to zero.

**2005 Restructuring costs.** Restructuring charges totaling less than $0.1 million during 2005 primarily resulted from a change in estimated expenses related to real estate obligations.

The following table displays the activity and balances for restructuring and asset impairment activity for 2003 (in thousands):

| | December 31, 2002 Restructuring Liability | Restructuring Charge | Cash Reductions | December 31, 2003 Restructuring Liability |
|---|---|---|---|---|
| Restructuring costs activity for 2001 restructuring charge: | | | | |
| Real estate obligations | $10,319 | $ – | $(4,476) | $5,843 |
| Network infrastructure obligations | 1,297 | | (172) | 1,125 |
| Other | 1,008 | – | (141) | 867 |
| Restructuring costs activity for 2002 restructuring charge: | | | | |
| Real estate obligations | 1,800 | – | (1,800) | – |
| Personnel | – | 1,084 | (1,084) | – |
| Other | 100 | – | (100) | – |
| | 14,524 | 1,084 | (7,773) | 7,835 |
| Net asset write-downs for 2002 restructuring charge | (139) | – | – | (139) |
| | $14,385 | $1,084 | $(7,773) | $7,696 |

The $1.1 million recorded during 2003 as restructuring reserves related to general and administrative costs.

The following table displays the activity and balances for restructuring and asset impairment activity for 2004 (in thousands):

| | December 31, 2003 Restructuring Liability | Restructuring Charge (Benefit) | Cash Reductions | December 31, 2004 Restructuring Liability |
|---|---|---|---|---|
| Restructuring costs activity for 2001 restructuring charge: | | | | |
| Real estate obligations | $5,843 | $5,323 | $(3,013) | $8,153 |
| Network infrastructure obligations | 1,125 | (951) | (174) | – |
| Other | 867 | (867) | – | – |
| | 7,835 | 3,505 | (3,187) | 8,153 |
| Net asset write-downs for 2002 restructuring charge | (139) | 139 | – | – |
| | $7,696 | $3,644 | $(3,187) | $8,153 |

Of the $5.3 million recorded during 2004 as additional real estate restructuring charges, $3.0 million related to the direct cost of revenue and $2.3 million related to general and administrative costs.

The following table displays the activity and balances for restructuring and asset impairment activity for 2005 (in thousands):

| | December 31, 2004 Restructuring Liability | Restructuring Charge | Cash Reductions | December 31, 2005 Restructuring Liability |
|---|---|---|---|---|
| Restructuring costs activity for 2001 restructuring charge: | | | | |
| Real estate obligations | $8,153 | $44 | $(1,920) | $6,277 |

## OFF-BALANCE SHEET ARRANGEMENTS

As discussed in note 5 to the consolidated financial statements, we maintain a 51% ownership interest in Internap Japan, a joint venture with NTT-ME Corporation of Japan and another NTT affiliate. 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, revenue and expense would be consolidated (due to certain minority interest protections afforded to our joint venture partners).

As discussed in note 14 to the consolidated financial statements, there were warrants outstanding to purchase 15.0 million shares of our common stock at an exercise price of $0.95 per share as of December 31, 2005.

## QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

**Cash and cash equivalents.** We maintain cash and short-term deposits at our financial institutions. Due to the short-term nature of our deposits, they are recorded on the balance sheet at fair value. As of December 31, 2005, all of our cash equivalents mature within three months.

**Other investments.** We have a $1.2 million equity investment in Aventail, an early stage, privately held company, after having reduced the balance for an impairment loss of $4.8 million in 2001. This strategic investment is inherently risky, in part because the market for the products or services being offered or developed by Aventail has not been proven. Because of risk associated with this investment, we could lose our entire initial investment in Aventail. Furthermore we have invested $4.1 million in Internap Japan, our joint venture with NTT-ME Corporation and another NTT affiliate. This investment is accounted for using the equity-method and to date we have recognized $3.6 million in equity-method losses, representing our proportionate share of the aggregate joint venture losses and income. Furthermore, the joint venture investment is subject to foreign currency exchange rate risk. In addition, the market for services being offered by Internap Japan has not been proven and may never materialize.

**Notes payable.** As of December 31, 2005 we had notes payable recorded at their present value of $12.0 million bearing a rate of interest which we believe is commensurate with their associated market risk.

**Capital leases.** As of December 31, 2005 we had capital leases recorded at $0.8 million reflecting the present value of future lease payments. We believe the interest rates used in calculating the present values of these lease payments are a reasonable approximation of fair value and their associated market risk is minimal.

**Credit facility.** As of December 31, 2005 we had $5.9 million available under our revolving credit facility with a bank, and the balance outstanding under the $17.5 million term loan was $12.0 million. The interest rate for the loan was fixed at 7.5%. The interest rate under the revolving credit facility is variable and was 8% at December 31, 2005. We believe these interest rates are reasonable approximations of fair value and the market risk is minimal.

**Interest rate risk.** Our objective in managing interest rate risk is to maintain favorable long-term fixed rate or a balance of fixed and variable rate debt that will lower our overall borrowing costs within reasonable risk parameters. Currently, our strategy for managing interest rate risk does not include the use of derivative securities. The table below presents principal cash flows by expected maturity dates for our debt obligations that extend beyond one year as of December 31, 2005 (dollars in thousands):

| | 2006 | 2007 | 2008 | Fair Value |
|---|---|---|---|---|
| Long-term debt: | | | | |
| Term loan | $4,375 | $4,375 | $3,281 | $12,031 |
| Interest rate | 7.5% | 7.5% | 7.5% | 7.5% |

**Foreign currency risk.** Substantially all of our revenue is currently in United States dollars and from customers primarily in the United States. Therefore, we do not believe we currently have any significant direct foreign currency exchange rate risk.

# CONSOLIDATED BALANCE SHEETS

| (In thousands, except per share amounts) | December 31, 2005 | 2004 |
|---|---|---|
| **ASSETS** | | |
| Current assets: | | |
| Cash and cash equivalents | **$ 24,434** | $ 33,823 |
| Restricted cash | **–** | 76 |
| Short-term investments in marketable securities | **16,060** | 12,162 |
| Accounts receivable, net of allowance of $963 and $1,124, respectively | **19,128** | 16,943 |
| Inventory | **779** | 345 |
| Prepaid expenses and other assets | **2,957** | 3,202 |
| Total current assets | **63,358** | 66,551 |
| Property and equipment, net | **50,072** | 54,378 |
| Investments | **1,999** | 6,693 |
| Intangible assets, net | **2,329** | 2,898 |
| Goodwill | **36,314** | 36,314 |
| Deposits and other assets | **1,297** | 1,315 |
| | **$155,369** | $168,149 |
| **LIABILITIES AND STOCKHOLDERS' EQUITY** | | |
| Current liabilities: | | |
| Notes payable, current portion | **$ 4,375** | $ 6,483 |
| Accounts payable | **5,766** | 11,129 |
| Accrued liabilities | **7,267** | 7,269 |
| Deferred revenue, current portion | **2,737** | 1,826 |
| Capital lease obligations, current portion | **559** | 512 |
| Restructuring liability, current portion | **1,202** | 2,397 |
| Total current liabilities | **21,906** | 29,616 |
| Notes payable, less current portion | **7,656** | 12,031 |
| Deferred revenue, less current portion | **533** | 421 |
| Capital lease obligations, less current portion | **247** | 806 |
| Restructuring liability, less current portion | **5,075** | 5,756 |
| Deferred rent | **9,185** | 5,781 |
| Other long-term liabilities | **1,039** | – |
| Total liabilities | **45,641** | 54,411 |
| Commitments and contingencies | | |
| Stockholders' equity: | | |
| Series A convertible preferred stock, $0.001 par value, 3,500 shares designated, no shares issued or outstanding | **–** | – |
| Common stock, $0.001 par value, 600,000 shares authorized, 341,677 and 338,148 shares issued and outstanding, respectively | **342** | 338 |
| Additional paid-in capital | **969,913** | 967,951 |
| Deferred stock compensation | **(420)** | – |
| Accumulated deficit | **(860,112)** | (855,148) |
| Accumulated items of other comprehensive income | **5** | 597 |
| Total stockholders' equity | **109,728** | 113,738 |
| | **$155,369** | $168,149 |

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

# CONSOLIDATED STATEMENTS OF OPERATIONS

| (In thousands, except per share amounts) | Year Ended December 31, 2005 | 2004 | 2003 |
|---|---|---|---|
| Revenue | $153,717 | $144,546 | $138,580 |
| Costs and expense: | | | |
| Direct cost of revenue, exclusive of depreciation and amortization, shown below | 81,958 | 76,990 | 78,200 |
| Customer support | 10,670 | 10,180 | 9,483 |
| Product development | 4,864 | 6,412 | 6,982 |
| Sales and marketing | 25,864 | 23,411 | 21,491 |
| General and administrative | 20,096 | 24,772 | 16,711 |
| Depreciation and amortization | 15,314 | 16,040 | 37,221 |
| Amortization of deferred stock compensation | 60 | – | 390 |
| Pre-acquisition liability adjustment | – | – | (1,313) |
| Restructuring costs | 44 | 3,644 | 1,084 |
| Gain on disposals of property and equipment | (19) | (3) | (53) |
| Total operating costs and expense | 158,851 | 161,446 | 170,196 |
| Loss from operations | (5,134) | (16,900) | (31,616) |
| Non-operating (income) expense: | | | |
| Interest expense | 1,373 | 1,981 | 2,981 |
| Interest income | (1,284) | (665) | (823) |
| Other, net | (259) | (154) | 827 |
| Total non-operating (income) expense | (170) | 1,162 | 2,985 |
| Net loss | (4,964) | (18,062) | (34,601) |
| Less deemed dividend related to beneficial conversion feature | – | – | (34,576) |
| Net loss attributable to common stockholders | $ (4,964) | $ (18,062) | $ (69,177) |
| Basic and diluted net loss per share | $ (0.01) | $ (0.06) | $ (0.40) |
| Weighted average shares used in computing basic and diluted net loss per share | 339,387 | 287,315 | 174,602 |

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

# CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY AND COMPREHENSIVE LOSS

For the Three Years Ended December 31, 2005

| | Series A Convertible Preferred Stock | | Common Stock | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| (In thousands) | Shares | Par Value | Shares | Par Value | Additional Paid-In Capital | Deferred Stock Compensation | Accumulated Deficit | Accumulated Items of Comprehensive Income (Loss) | Total Stockholders' Equity |
| Balance, January 1, 2003 | – | $ – | 160,094 | $160 | $798,344 | $(396) | $(802,485) | $ 149 | $ (4,228) |
| Net loss | – | – | – | – | – | – | (34,601) | – | (34,601) |
| Other comprehensive income | – | – | – | – | – | – | – | 151 | 151 |
| Total comprehensive loss | | | | | | | | | (34,450) |
| Conversion of Series A convertible preferred stock into common stock before reclassification to stockholders' equity | – | – | 953 | 1 | 1,201 | – | – | – | 1,202 |
| Reclassification of preferred stock to stockholders' equity | 2,888 | 78,589 | – | – | – | – | – | – | 78,589 |
| Conversion of Series A convertible preferred stock into common stock after reclassification to stockholders' equity | (1,483) | (40,338) | 49,668 | 50 | 40,288 | – | – | – | – |
| Amortization of deferred stock compensation and reversal for terminated employees | – | – | – | – | (6) | 396 | – | – | 390 |
| Stock compensation plans and warrant activity | – | – | 3,689 | 4 | 2,084 | – | – | – | 2,088 |
| Issuance of common stock to non-employees | – | – | 12,926 | 13 | 11,480 | – | – | – | 11,493 |
| Issuance of stock in conjunction with acquisitions | 346 | 13,590 | 1,421 | 1 | 1,849 | – | – | – | 15,440 |
| Record embedded beneficial conversion feature charge related to Series A preferred stock | – | (34,576) | – | – | 34,576 | – | – | – | – |
| Amortize deemed dividend related to beneficial conversion feature | – | 34,576 | – | – | (34,576) | – | – | – | – |
| Balance, December 31, 2003 | 1,751 | 51,841 | 228,751 | 229 | 855,240 | – | (837,086) | 300 | 70,524 |
| Net loss | – | – | – | – | – | – | (18,062) | – | (18,062) |
| Other comprehensive income | – | – | – | – | – | – | – | 297 | 297 |
| Total comprehensive loss | | | | | | | | | (17,765) |
| Conversion of Series A convertible preferred stock | (1,751) | (51,841) | 58,994 | 59 | 51,782 | – | – | – | – |
| Issuance of common stock, net of issuance cost | – | – | 40,250 | 40 | 55,892 | – | – | – | 55,932 |
| Stock compensation plans and warrant activity | – | – | 10,153 | 10 | 5,037 | – | – | – | 5,047 |
| Balance, December 31, 2004 | – | – | 338,148 | 338 | 967,951 | – | (855,148) | 597 | 113,738 |
| Net loss | – | – | – | – | – | – | (4,964) | – | (4,964) |
| Other comprehensive loss | – | – | – | – | – | – | – | (592) | (592) |
| Total comprehensive loss | | | | | | | | | (5,556) |
| Deferred stock compensation grant | – | – | – | – | 480 | (480) | – | – | – |
| Amortization of deferred stock compensation | | | | | | 60 | | | 60 |
| Stock compensation plans activity | – | – | 3,529 | 4 | 1,482 | – | – | – | 1,486 |
| **Balance, December 31, 2005** | **–** | **$ –** | **341,677** | **$342** | **$969,913** | **$(420)** | **$(860,112)** | **$ 5** | **$109,728** |

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

# CONSOLIDATED STATEMENTS OF CASH FLOWS

| (In thousands) | Year Ended December 31, 2005 | 2004 | 2003 |
|---|---|---|---|
| **Cash flows from operating activities:** | | | |
| Net loss | $ (4,964) | $(18,062) | $(34,601) |
| Adjustments to reconcile net loss to net cash provided by (used in) operating activities: | | | |
| Depreciation and amortization | 15,314 | 16,040 | 37,221 |
| Gain on disposal of property and equipment, net | (19) | (3) | (53) |
| Provision for doubtful accounts | 1,431 | 2,415 | 2,435 |
| (Gain) loss on equity-method investment, net | (83) | 390 | 827 |
| Non-cash interest expense on capital lease obligations | – | 904 | 1,304 |
| Non-cash changes in deferred rent | 2,690 | 879 | 915 |
| Lease incentives | 713 | – | – |
| Pre-acquisition liability adjustment | – | – | (1,313) |
| Non-cash compensation expense | 75 | – | 390 |
| Other, net | (44) | 176 | – |
| Changes in operating assets and liabilities, net of the effect of acquisitions: | | | |
| Accounts receivable | (3,616) | (3,771) | (2,704) |
| Inventory, prepaid expense and other assets | (170) | 1,633 | 2,583 |
| Accounts payable | (5,433) | 851 | (5,941) |
| Accrued liabilities | 805 | (1,316) | (1,115) |
| Deferred revenue | 1,023 | (1,743) | (4,461) |
| Accrued restructuring | (1,876) | 457 | (6,662) |
| Net cash flows provided by (used in) operating activities | 5,846 | (1,150) | (11,175) |
| **Cash flows from investing activities:** | | | |
| Purchases of property and equipment | (10,161) | (13,066) | (3,799) |
| Proceeds from disposal of property and equipment | 17 | 51 | – |
| Reduction of restricted cash | 76 | 49 | 2,053 |
| Purchase of investments in marketable securities | (18,710) | (16,753) | – |
| Maturities of marketable securities | 19,350 | – | – |
| Net cash received from acquired businesses | – | – | 2,307 |
| Other, net | (353) | 60 | – |
| Net cash flows (used in) provided by investing activities | (9,781) | (29,659) | 561 |
| **Cash flows from financing activities:** | | | |
| Change in revolving credit facility | – | (8,392) | (1,608) |
| Proceeds from notes payable | – | 17,500 | – |
| Principal payments on notes payable | (6,483) | (4,051) | (4,645) |
| Payments on capital lease obligations | (512) | (20,289) | (2,801) |
| Proceeds from issuance of common stock, net of issuance costs | – | 55,932 | 9,299 |
| Proceeds from stock options, employee stock purchase plan, and exercise of warrants | 1,471 | 5,047 | 4,035 |
| Other, net | 70 | – | – |
| Net cash flows (used in) provided by financing activities | (5,454) | 45,747 | 4,280 |
| Net (decrease) increase in cash and cash equivalents | (9,389) | 14,938 | (6,334) |
| Cash and cash equivalents at beginning of period | 33,823 | 18,885 | 25,219 |
| Cash and cash equivalents at end of period | $ 24,434 | $ 33,823 | $ 18,885 |
| **Supplemental disclosure of cash flow information:** | | | |
| Cash paid for interest, net of amounts capitalized | $ 1,223 | $ 1,767 | $ 1,170 |
| Non-cash acquisition of property and equipment | 971 | 1,597 | 125 |
| Change in accounts payable attributable to purchases of property and equipment | (381) | (2,733) | (7) |
| Issuance of stock related to capital lease amendment | – | – | 250 |
| Deferred stock compensation grant | 480 | – | – |
| Conversion of preferred stock to common stock | – | 51,841 | 41,540 |
| Value of stock issued for acquisitions | – | – | 15,440 |

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

## 1. DESCRIPTION OF THE COMPANY AND NATURE OF OPERATIONS

Internap Network Services Corporation ("Internap," "we," "us," "our" or the "Company") provides high performance, managed Internet connectivity solutions to business customers who require guaranteed network availability and high performance levels for business-critical applications, such as e-commerce, customer relationship management (CRM), multimedia streaming, Voice over Internet Protocol (VoIP), virtual private networks (VPNs) and supply chain management. We deliver services through our 38 network access points, which feature multiple direct high-speed connections to major Internet networks.

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 significant net operating losses since inception. During 2005, we incurred net losses of $5.0 million. As of December 31, 2005, we have an accumulated deficit of $860.1 million. We have taken various steps to control our costs, including decreasing the size of our workforce, terminating certain real estate leases and commitments, making process enhancements and renegotiating network contracts for more favorable pricing and terms.

On March 4, 2004, we sold 40.25 million shares of our common stock in a public offering at a purchase price of $1.50 per share which resulted in net proceeds to us of $55.9 million, after deducting underwriting discounts and commissions and offering expense. We continue to use the net proceeds from the offering for general corporate purposes. General corporate purposes primarily include capital investments in our network access point infrastructure and systems, expansion of data center facilities and repayment of debt and capital lease obligations. General corporate purposes could also include potential acquisitions of complementary businesses or technologies.

Effective September 14, 2004, all shares of our outstanding series A convertible preferred stock were mandatorily converted into common stock in accordance with the terms of our Certificate of Incorporation. An aggregate of 1.7 million shares of convertible preferred stock with a recorded value of $49.6 million was converted into 56.2 million shares of common stock upon the mandatory conversion. Accordingly, we had no shares of series A convertible preferred stock outstanding subsequent to the mandatory conversion. The mandatory conversion had no effect on the outstanding warrants to purchase common stock that were issued in conjunction with the series A preferred stock.

Our liquidity and capital requirements depend on several factors, including the rate of market acceptance of our services, the ability to expand and retain our customer base, the rate of expansion of new data centers and Private Network Access Points, (P-NAP®s), our ability to execute our current business plan and other factors. If we fail to generate sufficient cash flow from operations, we may require additional financing sooner than anticipated. We cannot assure such financing will be available on commercially favorable terms or at all.

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### 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 and all majority owned subsidiaries. Significant inter-company transactions have been eliminated in consolidation.

### Estimates and assumptions

Our consolidated financial statements 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, revenue and expense, and related disclosure of contingent assets and liabilities. On an ongoing basis, we evaluate our estimates, including those related to revenue recognition, doubtful accounts, cost-basis 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.

### Cash and cash equivalents

We consider all highly liquid investments purchased with an original 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, 2004 we had placed $0.1 million in restricted cash accounts to collateralize letters of credit with financial institutions. These amounts are reported separately as restricted cash and are classified as current or non-current assets based on their respective maturity dates. There were no restricted cash accounts as of December 31, 2005.

## Investments in marketable securities

Marketable securities primarily include high credit quality corporate debt securities and U.S. Government Agency debt securities. Management determines the appropriate classification of marketable securities at the time of purchase. At December 31, 2005 and 2004, all marketable securities are classified as available-for-sale. Available-for-sale securities are carried at fair value, with the unrealized gains and losses reported in other comprehensive income. Our marketable securities are reviewed each reporting period for declines in value that are considered to be other-than temporary and, if appropriate, written down to their estimated fair value. Realized gains and losses and declines in value judged to be other-than-temporary on available-for-sale securities are included in other non-operating income (expense) in the consolidated statements of operations. The cost of securities sold is based on the specific identification method. Interest and dividends on securities classified as available-for-sale are included in interest income in the consolidated statements of operations.

## Other 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 have a $1.2 million equity investment at December 31, 2005 in Aventail Corporation (Aventail), an early stage, privately held company, after having reduced the balance for an impairment loss of $4.8 million in 2001. The carrying value of our investment in Aventail is recorded in non-current investments in the accompanying consolidated balance sheet.

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 we have 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, 2005, Internap Japan Co. Ltd. (Internap Japan), our joint venture with NTT-ME Corporation of Japan and another NTT affiliate, qualifies for equity method accounting. We record our proportional share of the income and losses of Internap Japan one month in arrears on the consolidated balance sheets as a component of non-current investments and our share of Internap Japan's losses and income as other income, net on the consolidated statement of operations.

## Fair value of financial instruments

Our short-term financial instruments, including cash and cash equivalents, accounts receivable, accounts payable, notes payable, and capital lease obligations are carried at cost. The cost of our short-term financial instruments approximate fair value due to their relatively short maturities. Our marketable investments are designated as available for sale and are recorded at fair value with changes in fair value reflected in other comprehensive income. 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.

Management evaluates outstanding accounts receivable each period for collectibility. This evaluation involves assessing the aging of the amounts due to the Company and reviewing the credit-worthiness of customers. Based on this evaluation, we record an allowance for accounts receivable that are estimated to not be collectible.

## Credit risk

Financial instruments that potentially subject us to a concentration of credit risk principally consist of cash, cash equivalents, marketable securities and trade receivables. We currently invest the majority of our cash in money market funds and maintain them with financial institutions with high credit ratings. We also invest in debt instruments of the U.S. government and its agencies and corporate issuers with high credit ratings. As part of our cash management process, we perform periodic evaluations of the relative credit ratings of these financial institutions. We have not experienced any credit losses on our cash, cash equivalents or marketable securities.

## Inventory

Inventory is carried at the lower of cost or market using the first-in, first-out method. Cost includes materials related to the production of our Flow Control Platform (FCP) and our Flow Control Xcelerator (FCX) solutions.

## 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 lease term. Estimated useful lives used for network equipment are generally three years; furniture, equipment and software are three to seven years; and leasehold improvements are seven years or over the lease term, depending on the nature of the improvement, but in no event beyond the lease term. The duration of

lease obligations and commitments range from 24 months for certain networking equipment to 240 months for certain facility leases. 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 disposals of property and equipment are charged to operations.

## Leases and leasehold improvements

We record leases as capital or operating leases and account for leasehold improvements in accordance with Statement of Financial Accounting Standards (SFAS) No. 13, "Accounting for Leases" and related literature. Rent expense for operating leases is recorded in accordance with Financial Accounting Standards Board (FASB) Technical Bulletin (FTB) No. 88-1, "Issues Relating to Accounting for Leases." This FTB requires lease agreements that include periods of free rent or other incentives, specific escalating lease payments, or both, to be recorded on a straight-line or other systematic basis over the initial lease term and those renewal periods that are reasonably assured. The difference between rent expense and rent paid is recorded as deferred rent in non-current liabilities in the consolidated balance sheets.

## Research and product development costs

Product development costs are primarily related to network engineering costs associated with changes to the functionality of our proprietary services and network architecture. Such costs that do not qualify for capitalization as software development are expensed as incurred. Research and development costs, which are included in product development cost and are expensed as incurred, primarily consist of compensation related to our development and enhancement of IP Routing Technology, the FCP and BusinessNet acceleration technologies. Research and development costs were $2.9 million, $2.4 million and $1.5 million for the years ended December 31, 2005, 2004 and 2003, respectively.

## Costs of computer software development

For the year ended December 31, 2005 we capitalized $0.4 million of costs for internally developed software in accordance with SFAS No. 86, "Accounting for the Costs of Computer Software to Be Sold, Leased or Otherwise Marketed." No amounts were capitalized for the year ended December 31, 2004 or 2003.

In accordance with the American Institute of Certified Public Accountants' Statement of Position 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. We capitalized $1.9 million in internal software development costs for the year ended December 31, 2004. We did not capitalize any costs for the years ended December 31, 2005 or 2003.

## Goodwill and other intangible assets

In accordance with SFAS No. 142 "Goodwill and Other Intangible Assets," we review our goodwill for impairment annually, or more frequently, if facts and circumstances warrant a review. The provisions of SFAS No. 142 require that a two-step test be performed to assess goodwill for impairment. First, the fair value of each reporting unit is compared to its carrying value. If the fair value exceeds the carrying value, goodwill is not impaired and no further testing is performed. The second step is performed if the carrying value exceeds the fair value. The implied fair value of the reporting unit's goodwill must be determined and compared to the carrying value of the goodwill. If the carrying value of a reporting unit's goodwill exceeds its implied fair value, an impairment loss equal to the difference will be recorded. We completed our annual goodwill impairment test as of August 1, 2005 and determined that the carrying amount of goodwill was not impaired.

Other acquired intangible assets, including developed technologies and patents, have finite lives and we have recorded these assets at cost less accumulated amortization. Amortization is calculated on a straight-line basis over the estimated economic useful life of the assets, which is three to seven years for developed technologies and 15 years for patents.

## 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 charged to operations 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

As of December 31, 2005, we had three active stock-based employee compensation plans, which are described more fully in note 15. We have adopted the disclosure only provisions of SFAS No. 123, "Accounting for Stock-Based Compensation" and therefore account for the plans under the recognition and measurement principles of Accounting Principles Board (APB) Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations. The following table illustrates the effect on net loss and loss per share if we had applied the fair value recognition provisions of SFAS No. 123 to stock-based employee compensation (in thousands, except per share amounts).

| | Year Ended December 31, | | |
|---|---|---|---|
| | **2005** | 2004 | 2003 |
| Net loss, as reported | **$ (4,964)** | $(18,062) | $(34,601) |
| Add: stock-based employee compensation expense included in reported net loss | **75** | – | 390 |
| Adjust: total stock-based employee compensation expense determined under fair value based method for all awards | **(9,678)** | (15,364) | (8,362) |
| Pro forma net loss | **$(14,567)** | $(33,426) | $(42,573) |
| Loss per share: | | | |
| Basic and diluted – as reported | **$ (0.01)** | $ (0.06) | $ (0.40) |
| Basic and diluted – pro forma | **(0.04)** | (0.12) | (0.44) |

As described in note 15, our newly appointed President and Chief Executive Officer was awarded 1.0 million shares of restricted stock on September 30, 2005. For the year ended December 31, 2005, the amortization related to this restricted stock grant was $60,000. In conjunction with providing transition services in December 2005, the Vice Chair of our Board of Directors was granted 36,586 shares of fully-vested restricted stock with an aggregate value of $15,000. The expense related to these shares is included in general and administrative expenses on the consolidated statement of income for the year ended December 31, 2005.

The $9.7 million, $15.4 million, and $8.4 million increases to the pro forma employee compensation expense during 2005, 2004 and 2003, respectively, were inclusive of reductions for the effect related to options cancelled as a result of employee terminations, offset by amortization of compensation determined under the fair-value based method.

The fair value of options granted in each year during the three years ended December 31, 2005 was estimated at the date of grant using the Black-Scholes model assuming no expected dividends and the following weighted average assumptions:

| | Year Ended December 31, | | |
|---|---|---|---|
| | **2005** | 2004 | 2003 |
| Risk free interest rate | **4.22%** | 4.27% | 4.01% |
| Volatility | **118%** | 142% | 144% |
| Expected life | **4 years** | 4 years | 4 years |

## Revenue recognition and concentration of credit risk

The majority of our revenue is derived from high-performance Internet connectivity and related data center services. 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 data center services, 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 revenue when persuasive evidence of an arrangement exists, the product, service or software license has been delivered, the fees are fixed or determinable and collectibility is probable. Contracts and sales or purchase orders are used to determine the existence of an arrangement. We test for availability or use shipping documents when applicable to verify delivery of our services, products or software licenses. We assess whether the fee is fixed or determinable based on the payment terms associated with the transaction and whether the sales price is subject to refund or adjustment.

Deferred revenue consists of revenue for services to be delivered in the future and consists primarily of advance billings, which are amortized over the respective service period. Revenue associated with billings for installation of customer network equipment are deferred and amortized over the estimated life of the customer relationship (generally two years), as the installation service is integral to our primary service offering and does not have value to a customer on a stand-alone basis. Deferred post-contract customer support associated with sales of our FCP solution and similar products are amortized ratably over the contract period (generally one year).

We routinely review the creditworthiness of our customers. If we determine that collection of service revenue 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. The allowance for doubtful accounts is based upon specific and general customer information,

which also includes estimates based on management's best understanding of our customers' ability to pay. Customers' ability to pay takes into consideration payment history, legal status (i.e., bankruptcy), and the status of services we are providing. Once all collection efforts have been exhausted, we write the uncollectible balance off against the allowance for doubtful accounts. We also estimate a reserve for sales adjustments, which reduces net accounts receivable and revenue. The reserve for sales adjustments is based upon specific and general customer information, including outstanding promotional credits, customer disputes, credit adjustments not yet processed through the billing system and historical activity. If the financial condition of our customers were to deteriorate, or management becomes aware of new information impacting a customer's credit risk, additional allowances may be required.

## Advertising costs

We expense all advertising costs as they are incurred. Advertising costs for 2005, 2004 and 2003 were $0.2 million, $1.3 million and $0.9 million, 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. We have excluded all outstanding convertible preferred stock and outstanding options and warrants to purchase common stock from the calculation of diluted net loss per share, as such securities are anti-dilutive for all periods presented (in thousands, except per share amounts).

| | Year Ended December 31, | | |
|---|---|---|---|
| | 2005 | 2004 | 2003 |
| Net loss | $ (4,964) | $(18,062) | $(34,601) |
| Less deemed dividend related to beneficial conversion feature | – | – | (34,576) |
| Net loss attributable to common stockholders | $ (4,964) | $(18,062) | $(69,177) |
| Basic and diluted: | | | |
| Weighted average shares of common stock outstanding used in computing basic and diluted net loss per share | 339,387 | 287,315 | 174,602 |
| Basic and diluted net loss per share | $ (0.01) | $ (0.06) | $ (0.40) |
| Anti-dilutive securities not included in diluted net loss per share calculation: | | | |
| Series A convertible preferred stock | – | – | 58,994 |
| Options to purchase common stock | 35,562 | 43,949 | 39,161 |
| Restricted stock | 1,000 | – | – |
| Warrants to purchase common stock | 14,998 | 14,998 | 17,133 |
| | 51,560 | 58,947 | 115,288 |

## Segment information

We use the management approach for determining which, if any, of our products and services, 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 any 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, 2005, product revenue was not significant nor were long-lived assets located and revenue generated outside the United States.

## Recent accounting pronouncements

In June 2005, FASB issued SFAS No. 154, "Accounting for Changes and Error Corrections – A Replacement of APB Opinion No. 20 and FASB Statement No.3" to prescribe the related accounting and disclosures. The provisions of SFAS No. 154 are effective for changes and error corrections made in fiscal years beginning after December 15, 2005. We will adopt this pronouncement on January 1, 2006.

In December 2004, FASB issued SFAS No. 123 (revised 2004), "Share-Based Payment," which is known as SFAS No. 123(R). SFAS No. 123(R) replaces SFAS No. 123, as amended by SFAS No. 148, "Accounting for Stock-Based Compensation – Transition and Disclosure – an Amendment of FASB Statement No. 123." Among other things, SFAS No. 123(R) eliminates the alternative to use the intrinsic value method of accounting for stock-based compensation. SFAS No. 123(R) requires public entities to recognize compensation expense for awards of equity instruments to employees based on the grant-date fair value of the awards. On March 29, 2005, the SEC issued Staff Accounting Bulletin (SAB) No. 107, providing the SEC Staff's view regarding the interaction between SFAS No. 123(R) and certain SEC rules and regulations, and the valuation of share-based payment arrangements. On April 15, 2005, the SEC amended Rule 4-01(a) of Regulation S-X, extending the effective date of SFAS No. 123(R) to the first annual reporting period of the registrant's first fiscal year beginning on or after June 15, 2005.

We will adopt the provisions of SFAS No. 123(R), subsequent FASB Staff Positions, and guidance in SAB No. 107, beginning in the first quarter of 2006. We are evaluating the requirements under SFAS No. 123(R) and expect the adoption to have a significant adverse impact on our consolidated statements of operations and net income per share, comparable to our pro forma disclosure under SFAS No. 123. See "Stock-Based Compensation" above for the pro forma net loss and net loss per share amounts, for years 2003 through 2005, as if we had used a fair-value-based method similar to the methods required under

SFAS No. 123(R) to measure compensation expense for employee stock incentive awards. However, the actual effect on net income or loss and earnings or loss per share after adopting SFAS No. 123(R) will vary depending upon the number of options granted in 2006 compared to prior years. In addition, we will also recognize compensation expense related to our employee stock purchase plan for the six-month purchase period ending June 30, 2006. We have modified our employee stock purchase plan to make it a non-compensatory plan for all purchase periods subsequent to June 30, 2006.

## 3. IMPAIRMENT AND RESTRUCTURING COSTS

With overcapacity created in the Internet connectivity market and IP Services market, we implemented restructuring plans that resulted in significant charges in 2001 and 2002. Additional charges were also incurred during 2003 and 2004 as we continued to evaluate our restructuring reserve.

For the year ended December 31, 2003, we incurred $1.1 million in restructuring costs which primarily represented retention bonuses and moving expense related to the relocation of our corporate office to Atlanta, Georgia from Seattle, Washington.

We incurred net additional restructuring costs of $3.6 million during 2004 as a result of a comprehensive analysis of the remaining accrued restructuring liability. After reviewing the analysis, management concluded that the facilities remaining in the restructuring accrual were taking longer than expected to sublease and those that were subleased resulted in lower than expected sublease rates. Consequently, the projected obligations exceeded the unadjusted liability by $5.3 million over the remaining lease terms, with the last commitment expiring in July 2015. During the quarter ended September 30, 2004, all other remaining contractual obligations for network infrastructure and other costs included in the restructuring were satisfied and we reduced the remaining recorded liability for the obligations from $1.7 million to zero.

The following table displays the activity and balances for restructuring and asset impairment activity for 2003 (in thousands):

| | December 31, 2002 Restructuring Liability | Restructuring Charge | Cash Reductions | December 31, 2003 Restructuring Liability |
|---|---|---|---|---|
| Restructuring costs activity for 2001 restructuring charge: | | | | |
| Real estate obligations | $10,319 | $ – | $(4,476) | $5,843 |
| Network infrastructure obligations | 1,297 | | (172) | 1,125 |
| Other | 1,008 | – | (141) | 867 |
| Restructuring costs activity for 2002 restructuring charge: | | | | |
| Real estate obligations | 1,800 | – | (1,800) | – |
| Personnel | – | 1,084 | (1,084) | – |
| Other | 100 | – | (100) | – |
| | 14,524 | 1,084 | (7,773) | 7,835 |
| Net asset write-downs for 2002 restructuring charge | (139) | – | – | (139) |
| | $14,385 | $1,084 | $(7,773) | $7,696 |

The $1.1 million recorded during 2003 as restructuring reserves related to general and administrative costs.

The following table displays the activity and balances for restructuring and asset impairment activity for 2004 (in thousands):

| | December 31, 2003 Restructuring Liability | Restructuring Charge (Benefit) | Cash Reductions | December 31, 2004 Restructuring Liability |
|---|---|---|---|---|
| Restructuring costs activity for 2001 restructuring charge: | | | | |
| Real estate obligations | $5,843 | $5,323 | $(3,013) | $8,153 |
| Network infrastructure obligations | 1,125 | (951) | (174) | – |
| Other | 867 | (867) | – | – |
| | 7,835 | 3,505 | (3,187) | 8,153 |
| Net asset write-downs for 2002 restructuring charge | (139) | 139 | – | – |
| | $7,696 | $3,644 | $(3,187) | $8,153 |

Of the $5.3 million recorded during 2004 as additional real estate restructuring charges, $3.0 million related to the direct cost of revenue and $2.3 million related to general and administrative costs.

The following table displays the activity and balances for restructuring and asset impairment activity for 2005 (in thousands):

| | December 31, 2004 Restructuring Liability | Restructuring Charge | Cash Reductions | **December 31, 2005 Restructuring Liability** |
|---|---|---|---|---|
| Restructuring costs activity for 2001 restructuring charge: | | | | |
| Real estate obligations | $8,153 | $44 | $(1,920) | **$6,277** |

Restructuring charges totaling less than $0.1 million during 2005 primarily resulted from a change in estimated expenses related to real estate obligations.

## 4. BUSINESS COMBINATIONS

On October 1, 2003, we completed our acquisition of netVmg, Inc. (netVmg) which enables customers to manage Internet traffic cost, performance and operations decisions directly from their corporate locations. The acquisition was recorded using the purchase method of accounting under SFAS No. 141, "Business Combinations." The aggregate purchase price of the acquired company, plus related charges, was $13.7 million and was comprised of 0.3 million shares of our preferred stock, acquisition costs and warrants to purchase 1.5 million shares of our common stock.

The purchase price allocation for netVmg was as follows (in thousands):

| | |
|---|---|
| Cash acquired | $ 1,443 |
| Restricted cash | 105 |
| Inventory | 421 |
| Property and equipment | 531 |
| Other tangible assets | 80 |
| Tangible assets acquired | 2,580 |
| Product technology | 3,311 |
| Goodwill | 8,216 |
| Intangible assets acquired | 11,527 |
| Total assets acquired | $14,107 |
| Acquisition expense incurred | $ 79 |
| Liabilities assumed | 438 |
| Value of stock issued | 13,590 |
| Total liabilities assumed and preferred stock issued | $14,107 |

On October 15, 2003, we completed our acquisition of Sockeye Networks, Inc., (Sockeye). The acquisition was recorded using the purchase method of accounting under SFAS No. 141. The aggregate purchase price of the acquired company, plus related charges, was $1.9 million and was comprised of 1,420,775 shares of our common stock and acquisition costs.

The purchase price allocation for Sockeye was as follows (in thousands):

| | |
|---|---|
| Cash acquired | $ 864 |
| Restricted cash | 20 |
| Property and equipment | 291 |
| Other tangible assets | 109 |
| Tangible assets acquired | 1,284 |
| Goodwill | 926 |
| Total assets acquired | $2,210 |
| Acquisition expense incurred | $ 79 |
| Liabilities assumed | 281 |
| Value of stock issued | 1,850 |
| Total liabilities assumed and common stock issued | $2,210 |

In accordance with SFAS No. 141, all identifiable assets were assigned a portion of the purchase price of the acquired companies on the basis of their respective fair values. Intangible assets other than goodwill are amortized over their average estimated useful lives of three to seven years (with a weighted-average life of 6.5 years). The value assigned to the identifiable intangible assets was based on an analysis performed by an independent third party as of the date of the acquisitions. Pro forma results of operations have not been presented because the effects of these acquisitions were not material on either an individual or aggregate basis to our results of operations. Goodwill is not deductible for tax purposes from either of the acquisitions.

As part of our acquisition of CO Space, Inc (CO Space) on June 20, 2000, we recorded a pre-acquisition liability of $1.3 million for network equipment purchased by CO Space. During 2003, we reevaluated the likelihood of settling the liability related to this equipment and concluded that a contingent obligation no longer exists. Therefore, the liability was eliminated resulting in a one-time reduction in costs and expense of $1.3 million.

# NOTES

Notes to Consolidated Financial Statements

## 5. INVESTMENTS

We maintain a 51% ownership interest in Internap Japan, a joint venture with NTT-ME Corporation of Japan and another NTT affiliate. 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, revenue and expense would be consolidated (due to certain minority interest protections afforded to our joint venture partners). 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 APB Opinion No. 18 "The Equity Method of Accounting for Investments in Common Stock" and consistent with Emerging Issues Task Force No. 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."

Our investment activity in the joint venture is as follows (in thousands):

| | 2005 | 2004 | 2003 |
|---|---|---|---|
| Investment balance, January 1, | $861 | $1,195 | $1,870 |
| Proportional share of net income (loss) | 83 | (390) | (827) |
| Unrealized foreign currency translation (loss) gain, net | (121) | 56 | 152 |
| Investment balance, December 31, | $823 | $ 861 | $1,195 |

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 expense. On February 22, 2000, pursuant to an investment agreement, we purchased 588,236 shares of Aventail series D preferred stock at $10.20 per share for a total cash investment of $6.0 million. Aventail is a privately held enterprise for which no active market for its securities exists. In connection with Aventail's 2001 round of financing, we concluded that our investment in Aventail had experienced a decline in value that was other than temporary. As a result, during 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, 2005.

Investments in marketable securities primarily include high credit quality corporate debt securities and U.S. Government Agency debt securities. These investments are classified as available for sale and are recorded at fair value with changes in fair value reflected in other comprehensive income. All proceeds were from the maturity of the securities, not from sales. Accordingly, we have not recognized any realized gains or losses.

Summaries of our investments in marketable securities are as follows (in thousands):

| | As of December 31, 2005 | | |
|---|---|---|---|
| | Cost Basis | Unrealized Loss | Recorded Value |
| Short-term investments in marketable securities | $16,113 | $(53) | $16,060 |

| | As of December 31, 2004 | | |
|---|---|---|---|
| | Cost Basis | Unrealized Gain (Loss) | Recorded Value |
| Short-term investments in marketable securities | $12,083 | $ 79 | $12,162 |
| Investments in marketable securities, non-current | 4,671 | (15) | 4,656 |
| | $16,754 | $ 64 | $16,818 |

During the years ended December 31, 2005 and 2004, we recorded a net unrealized holding loss of $0.1 million and a net unrealized holding gain of less than $0.1 million, respectively.

## 6. PROPERTY AND EQUIPMENT

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

| | December 31, | |
|---|---|---|
| | 2005 | 2004 |
| Network equipment | $ 87,467 | $ 95,149 |
| Network equipment under capital lease | 1,596 | 1,596 |
| Furniture, equipment and software | 31,571 | 32,319 |
| Leasehold improvements | 73,124 | 63,314 |
| Property and equipment, gross | 193,758 | 192,378 |
| Less: Accumulated depreciation and amortization ($843 and $310 related to capital leases at December 31, 2005 and 2004, respectively) | (143,686) | (138,000) |
| | $ 50,072 | $ 54,378 |

During 2005 and 2004, $8.4 million and $3.5 million of fully depreciated assets were retired. Depreciation and amortization expense for property and equipment was $14.7 million, $15.5 million, and $33.9 million during 2005, 2004, and 2003, respectively.

## 7. GOODWILL AND OTHER INTANGIBLE ASSETS

We perform our annual goodwill impairment test as of August 1 of each calendar year. With the assistance of a third party valuation expert, we estimated the fair value of our reporting units utilizing a discounted cash flow method. Based on the results of these analyses our goodwill was not impaired as of August 1, 2005.

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 is 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 us. As of December 31, 2005 and 2004, the recorded amount of goodwill totaled $36.3 million.

Generally, any adjustments made as a result of the impairment testing are required to be recognized as operating expense. We will continue to perform our annual impairment testing as of August 1 each year absent any impairment indicators that may cause more frequent analysis, as required by SFAS No. 142 “Goodwill and Other Intangible Assets.”

The components of our amortizing intangible assets are as follows (in thousands):

| | December 31, 2005 | | December 31, 2004 | |
|---|---|---|---|---|
| | Gross Carrying Amount | Accumulated Amortization | Gross Carrying Amount | Accumulated Amortization |
| Contract based | **$14,518** | **$(14,263)** | $14,518 | $(14,234) |
| Technology based | **5,911** | **(3,837)** | 5,911 | (3,297) |
| | **$20,429** | **$(18,100)** | $20,429 | $(17,531) |

Amortization expense for identifiable intangible assets during 2005, 2004 and 2003 was $0.6 million, $0.6 million and $3.4 million, respectively. Estimated amortization expense for the next five years and thereafter is as follows as of December 31, 2005 (in thousands):

| | |
|---|---|
| 2006 | $ 544 |
| 2007 | 443 |
| 2008 | 443 |
| 2009 | 443 |
| 2010 | 339 |
| Thereafter | 117 |
| | $2,329 |

## 8. ACCRUED LIABILITIES

Accrued liabilities consist of the following (in thousands):

| | December 31, | |
|---|---|---|
| | **2005** | 2004 |
| Taxes | **$1,753** | $4,051 |
| Compensation payable | **2,463** | 1,225 |
| Network commitments | **305** | 608 |
| Insurance payable | **639** | 303 |
| Other | **2,107** | 1,082 |
| | **$7,267** | $7,269 |

## 9. REVOLVING CREDIT FACILITY AND NOTES PAYABLE

Notes payable consist of the following (in thousands):

| | December 31, | |
|---|---|---|
| | **2005** | 2004 |
| Notes payable to financial institutions | **$12,031** | $18,073 |
| Notes payable to vendors | **–** | 441 |
| Notes payable | **$12,031** | $18,514 |

At December 31, 2005, we had a $10.0 million revolving credit facility and a $17.5 million term loan under a loan and security agreement with a bank. The agreement was amended as of December 27, 2005, to reduce the amount available for borrowing under the revolving credit agreement from $15.0 million to $10.0 million, increase letter of credit sub-limit from $5.0 million to $6.0 million, to extend the expiration date of the revolving credit facility from December 28, 2005 to December 27, 2006 and update loan covenants.

Availability under the revolving credit facility is based on 80% of eligible accounts receivable plus 50% of unrestricted cash and marketable investments. As of December 31, 2005, $4.1 million of letters of credit were issued, and we had available $5.9 million in borrowing capacity under the revolving credit facility.

The credit facility contains certain covenants, including covenants that restrict our ability to incur further indebtedness. The December 27, 2005 changes to the loan covenants include the elimination of the minimum Cash EBITDA requirement, as defined by the agreement, and the addition of a minimum tangible net worth requirement.

As of December 31, 2005, we were in compliance with the various loan covenants.

We were in violation of a previous loan covenant that required a minimum Cash EBITDA, as defined in the credit facility, for the three-month period ended September 30, 2005 by $1.3 million. The violation resulted primarily from our continued expansion of data center facilities that caused the minimum Cash EBITDA for the period to be less than the level required under the agreement. On November 3, 2005, we received a formal waiver of the covenant violation. As discussed above, the agreement was amended as of December 27, 2005 to eliminate the minimum Cash EBITDA requirement.

The term loan under the security agreement noted above has a fixed interest rate of 7.5% and is due in 48 equal monthly installments of principal plus interest through September 1, 2008. The balance outstanding under the term loan was $12.0 million and $16.4 million at December 31, 2005 and 2004, respectively. The loan was used to purchase assets previously recorded as capital leases under a master agreement with a primary supplier of networking equipment. At December 31, 2004, an additional $2.1 million was outstanding under other loan agreements that were subsequently repaid during 2005. The loan is secured by all of our assets, except patents.

The maturity of the term loan at December 31, 2005 is as follows (in thousands):

| | |
|---|---|
| 2006 | $ 4,375 |
| 2007 | 4,375 |
| 2008 | 3,281 |
| Total maturities and principal payments | 12,031 |
| Less: current portion | (4,375) |
| | $ 7,656 |

The carrying value of our notes payable as of December 31, 2005, approximates fair value as the interest rates approximate current market rates of similar debt obligations.

## 10. CAPITAL LEASES

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 related lease agreement. On September 30, 2004, management negotiated the buy-out of all remaining lease schedules under a master lease agreement with a primary supplier of network equipment. Under the terms of the buy-out agreement, we paid $19.7 million, comprising remaining capital lease obligations as of September 30, 2004, along with end-of-lease asset values and sales tax, resulting in a $2.2 million increase to fixed assets. The $19.7 million buy-out was funded through $2.2 million in cash on hand and the proceeds from a $17.5 million term loan from a bank (note 9). As of December 31, 2005, our other remaining capital lease has an expiration date of June 2007.

Future minimum capital lease payments together with the present value of the minimum lease payments as of December 31, 2005, are as follows (in thousands):

| | |
|---|---|
| 2006 | $ 607 |
| 2007 | 253 |
| Remaining capital lease payments | 860 |
| Less: amounts representing imputed interest | (54) |
| Present value of minimum lease payments | 806 |
| Less: current portion | (559) |
| | $ 247 |

## 11. 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.

Reconciliations of the provision (benefit) for income taxes to the amount compiled by applying the statutory federal income tax rate to loss before income taxes is as follows:

| | Year Ended December 31, | | |
|---|---|---|---|
| | **2005** | 2004 | 2003 |
| Federal income tax benefit at statutory rates | **(34)%** | (34)% | (34)% |
| State income tax benefit at statutory rates | **(4)** | (4) | (4) |
| Foreign operating losses at statutory rates | **–** | – | 1 |
| Stock compensation expense | **–** | – | (1) |
| Other, net | **1** | 1 | 1 |
| Change in valuation allowance | **37** | 37 | 37 |
| Effective tax rate | **0%** | 0% | 0% |

Temporary differences between the financial statement carrying amounts and tax bases of assets and liabilities that give rise to significant portions of deferred taxes relate to the following at December 31 (in thousands):

| | 2005 | 2004 |
|---|---|---|
| Current deferred income tax assets: | | |
| Provision for doubtful accounts | $ 329 | $ 402 |
| Deferred revenue | 860 | 682 |
| Accrued compensation | 433 | 157 |
| Restructuring costs | 457 | 911 |
| Capital loss carryforwards | 5,383 | – |
| Other | 854 | 672 |
| Current deferred income tax assets | 8,316 | 2,824 |
| Less: Valuation allowance | (8,263) | (2,806) |
| | 53 | 18 |
| Non-current deferred income tax assets: | | |
| Net operating loss carryforwards | 133,917 | 132,181 |
| Capital loss carryforwards | – | 5,383 |
| Property and equipment | 22,738 | 23,372 |
| Investments | 1,824 | 1,824 |
| Deferred revenue, less current portion | 367 | 150 |
| Restructuring costs, less current portion | 1,438 | 2,187 |
| Deferred rent | 3,413 | 2,120 |
| Non-current deferred income tax assets | 163,697 | 167,217 |
| Less: Valuation allowance | (162,667) | (166,176) |
| | 1,030 | 1,041 |
| Non-current deferred income tax liabilities: | | |
| Purchased intangibles | (1,083) | (1,059) |
| Non-current deferred income tax liabilities, net | (53) | (18) |
| Net deferred tax assets (liabilities) | $ – | $ – |

Current and non-current deferred taxes have been recorded on a net basis in the accompanying balance sheet. As of December 31, 2005 we have net operating loss carryforwards and capital loss carryforwards of approximately $560.6 million and $14.0 million, respectively. The net operating loss carryforwards expire from 2012 through 2025. The capital loss carryforwards expire in 2006. Utilization of net operating losses and capital loss carryforwards are subject to the limitations imposed by Section 382 of the Internal Revenue Code. Under this provision, we will be precluded from utilizing approximately $222.1 million of our net operating and capital losses. The occurrence of additional changes in ownership pursuant to Section 382 of the Internal Revenue Code may have the impact of additional limitations on the use of our net operating losses. 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 assets 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.

## 12. EMPLOYEE RETIREMENT PLAN

We sponsor a defined contribution retirement savings plan that qualifies under Section 401(k) of the Internal Revenue Code. Plan participants may elect to have a portion of their pre-tax compensation contributed to the plan, subject to certain guidelines issued by the Internal Revenue Service. Employer contributions are discretionary and were $0.6 million and $0.2 million for 2005 and 2004, respectively. No employer contributions were made during 2003.

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

### Operating leases

We, as a lessee, have entered into leasing arrangements relating to office and service point rental space and office equipment that are classified as operating leases. Future minimum lease payments on non-cancelable operating leases are as follows at December 31, 2005 (in thousands):

| | |
|---|---|
| 2006 | $ 9,824 |
| 2007 | 9,828 |
| 2008 | 9,561 |
| 2009 | 7,486 |
| 2010 | 4,522 |
| Thereafter | 61,691 |
| | $102,912 |

Rent expense was $13.6 million, $12.9 million and $13.1 million for the years ended December 31, 2005, 2004 and 2003, respectively. Sub-lease income, recorded as a reduction of rent expense, was $0.2 million, $0.3 million and $0.3 million during the years ended December 31, 2005, 2004 and 2003, respectively.

### Service commitments

We have entered into service commitment contracts with Internet network service providers to provide interconnection services and data center providers to provide space for our customers. In conjunction with rate negotiations during 2005, we eliminated several long-term minimum commitments compared to prior years. Future minimum payments under these service commitments having terms in excess of one year are as follows at December 31, 2005 (in thousands):

| | |
|---|---|
| 2006 | $ 6,110 |
| 2007 | 2,765 |
| 2008 | 2,769 |
| 2009 | 2,032 |
| | $13,676 |

### Vendor disputes

In delivering our services, we rely on a number of Internet network, telecommunication and other vendors. We work directly with these vendors to provision services such as establishing, modifying or discontinuing services for our customers. Because of the volume of activity, billing disputes inevitably arise. These disputes typically stem from disagreements concerning the starting and ending dates of service, quoted rates, usage and various other factors. Disputed costs, both in the vendors' favor and our favor, are researched and discussed with vendors on an ongoing basis until ultimately resolved. We record the cost and a liability based on our estimate of the most likely outcome of the dispute. These estimates are periodically reviewed by management and modified in light of new information or developments, if any. Because estimates regarding disputed costs include assessments of uncertain outcomes, such estimates are inherently vulnerable to changes due to unforeseen circumstances that could materially and adversely affect our results of operations and cash flows.

### Concentrations of risk

We participate in a highly volatile industry that is characterized by strong competition for market share. We, 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 depend on other companies to supply various key elements of our infrastructure including the network access local loops between our network access points and our Internet network service providers and the local loops between our network access 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. Furthermore, we do not carry significant inventories of the products we purchase, and we have no guaranteed supply arrangements with our vendors. A loss of a significant vendor could delay build-out of our infrastructure and increase our costs. If our limited source of suppliers fails to provide products or services that comply with evolving Internet standards or that interoperate with other products or services we use in our network infrastructure, we may be unable to meet all or a portion of our customer service commitments, which could adversely affect our business, results of operations and financial condition.

### 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 our financial condition, results of operations or cash flows.

In July 2004, we received an assessment from the New York State Department of Taxation and Finance for $1.4 million, including interest and penalties, resulting from an audit of our state franchise tax returns for the years 2000–2002. The assessment related to an unpaid license fee due upon our entry into the state for the privilege of doing business in the state. Management recorded its best estimate of the probable liability resulting from the assessment in accrued liabilities and general and administrative expense as of June 30, 2004 and engaged a professional service provider to initiate an appeal. In April 2005, management became aware that the assessment had been reduced to $0.1 million including interest and with penalties waived. The substantial decrease from the original assessment resulted from including the weighted averages of investment capital and subsidiary capital, along with business capital, used in New York in determining the apportionment factor. The original assessment was based solely on an apportionment of business capital, while investment capital and subsidiary capital both have significantly lower apportionment percentages to New York. The adjustment for the revised New York assessment, as well as other tax accruals based on our best estimate of probable liabilities, resulted in a reduction of non-income based tax expenses of approximately $1.7 million as of March 31, 2005. These tax adjustments are reflected in accrued liabilities and general and administrative expense in the accompanying financial statements.

## 14. CONVERTIBLE PREFERRED STOCK AND STOCKHOLDERS' EQUITY

### Convertible preferred stock

Effective September 14, 2004, all shares of our outstanding series A convertible preferred stock were mandatorily converted into common stock in accordance with the terms of our Certificate of Incorporation. An aggregate of 1.7 million shares of convertible preferred stock with a recorded value of $49.6 million was converted into 56.2 million shares of common stock. Accordingly, as of December 31, 2004, we had no shares of series A convertible preferred stock outstanding. The mandatory conversion had no effect on the outstanding warrants to purchase common stock that were issued in conjunction with the series A preferred stock.

The series A preferred stock was initially reported as mezzanine financing because holders of the series A preferred stock had rights to receive payment of shares under specific circumstances which were deemed to be outside our control. In July 2003, we amended the deemed liquidation provisions of our charter to eliminate the events that could result in payment to the series A preferred stockholders such that the events giving rise to payment would be within our control. As a result, 2.9 million shares of our series A preferred stock, with a recorded value of $78.6 million, were reclassified from mezzanine financing to stockholders' equity during 2003.

The August 2003 common stock private placement discussed below resulted in a decrease of the conversion price of our series A preferred stock to $0.95 per share and an increase in the number of shares of common stock issuable upon conversion of all shares of series A preferred stock by 34.5 million shares. We recorded a deemed dividend of $34.6 million in 2003, which is attributable to the additional incremental number of shares the series A preferred stock convertible into common stock. Also as a result of the private placement, under the terms of the common stock warrants issued on September 14, 2001 by us in connection with issuance of the series A preferred stock, the exercise price for the warrants to purchase 17.3 million shares of our common stock was adjusted from $1.48 per share of common stock to $0.95 per share.

During 2003, series A stockholders converted 1.5 million shares of series A preferred stock into 50.6 million shares of common stock at a recorded value of $41.5 million. Including the mandatory conversion on September 14, 2004, 1.8 million shares of series A preferred stock were converted in to 59.0 million shares of common stock at a recorded value of $51.8 million during 2004.

## Common stock

On February 18, 2004, our common stock began trading on the American Stock Exchange (AMEX), under the symbol "IIP." We voluntarily delisted our common stock from the NASDAQ SmallCap Market effective February 17, 2004.

On March 4, 2004, we sold 40.25 million shares of our common stock in a public offering at a purchase price of $1.50 per share which resulted in net proceeds to us of $55.9 million, after deducting underwriting discounts and commissions and offering expense. We continue to use the net proceeds from the offering for general corporate purposes. General corporate purposes primarily include capital investments in our network access point infrastructure and systems, expansion of data center facilities and repayment of debt and capital lease obligations. General corporate purposes could also include potential acquisitions of complementary businesses or technologies.

On August 22, 2003, we issued 10.65 million shares of our common stock in a private placement at a price of $0.95 per share. We received $9.5 million, net of issuance cost. In addition, in connection with the amendment of a former equipment lease, we issued 0.2 million shares of common stock to the equipment supplier.

On October 15, 2003, in connection with our acquisition of Sockeye and as discussed in note 4, we issued an aggregate of 1.4 million shares of our common stock in a private placement to the stockholders of Sockeye.

## Warrants to purchase common stock

As of December 31, 2005, there were warrants outstanding to purchase 15.0 million shares of our common stock at an exercise price of $0.95 per share.

On September 14, 2001, in conjunction with our series A preferred stock financing, we issued warrants to purchase up to 17.1 million 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 $9.3 million based upon the Black-Scholes model. As a result of the private placement of our common stock in August 2003, the exercise price of the warrants was adjusted to $0.95 per share.

On October 20, 2003, we issued warrants to purchase 0.4 million shares of common stock at an exercise price of $0.95 in connection with a private placement of our common stock. These warrants expire on August 22, 2008.

In connection with our acquisition of netVmg, we granted warrants to purchase an aggregate of 1.5 million shares of our common stock to stockholders of netVmg. These warrants are exercisable if netVmg stockholders participate in a private placement of shares of our common or preferred stock and their participation is in an amount equal to or greater than $4.4 million. Each warrant is exercisable for one share of our common stock at an exercise price of $0.95 per share and expires on October 1, 2006. There was no value allocated to these warrants as of December 31, 2005 or 2004.

Outstanding warrants to purchase shares of common stock at December 31, 2005, are as follows (shares in thousands):

| Year of Expiration | Weighted Average Exercise Price | Shares |
|---|---|---|
| 2006 | $0.95 | 14,657 |
| 2007 | – | – |
| 2008 | 0.95 | 341 |
| | $0.95 | 14,998 |

## 15. STOCK-BASED COMPENSATION PLANS

We have adopted the disclosure only provisions of 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 employee stock options under the fair value method as described in note 2.

### Stock compensation and option plans

On June 23, 2005, we adopted the Internap Network Services Corporation 2005 Stock Compensation Plan (2005 Plan). The 2005 Plan provides for the issuance of stock options, stock appreciation rights, stock grants and stock unit grants to eligible employees and directors and is administered by the compensation committee of the board of directors. A total of 67.9 million shares of stock are reserved for issuance under the 2005 Plan, comprised of 20.0 million shares designated in the 2005 Plan plus 9.7 million shares which remain available for issuance of options and awards and 38.2 million shares of unexercised options under certain preexisting plans. No further grants shall be made under the specified preexisting plans however, each of the specified preexisting plans were made a part of the 2005 Plan so that the shares available for issuance under the 2005 Plan may be issued in connection with grants made under those plans. As of December 31, 2005, there were 34.4 million options outstanding and 31.7 million options available for issuance.

The 2005 Plan also provides that in any calendar year, no eligible employee or director shall be granted an option to purchase more than 5.0 million shares of stock or a stock appreciation right based on the appreciation with respect to more than 5.0 million shares of stock, and no stock grant or stock unit grant shall be made to any eligible employee or director in any calendar year where the fair market value of the stock subject to such grant on the date of the grant exceeds $10.0 million. Furthermore, no more than 5.0 million non-forfeitable shares of stock shall be issued pursuant to stock grants.

The option price for each share of stock subject to an option shall be no less than the fair market value of a share of stock on the date the option is granted; provided, however, if the option is an incentive stock option (ISO) granted to an eligible employee who is a 10% shareholder, the option price for each share of stock subject to such ISO shall be no less than 110% of the fair market value of a share of stock on the date such ISO is granted. Stock options have a maximum term of ten years from the date of grant, except for ISO's granted to an eligible employee who is a 10% shareholder, in which case the maximum term is five years from the date of grant. ISO's may be granted only to eligible employees. Terms for stock appreciation rights are similar to those of options. Upon exercise of a stock appreciation right, the compensation committee of the board of directors shall determine the form of payment as cash, shares of stock issued under the 2005 Plan based on the fair market value of a share of stock on the date of exercise, or a combination of cash and shares.

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 4.0 million shares of Internap's common stock have been reserved for issuance under the Director Plan. Under the terms of the Director Plan, fully-vested and exercisable initial grants of 80,000 shares of our common stock are to be made 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, 2005, there were 1.1 million options outstanding and 2.7 million options available for grant pursuant to the Director Plan.

Options and stock appreciation rights become exercisable in whole or in part from time to time as determined at the date of grant by the compensation committee of the board of directors. Stock options generally vest 25% after one year and ratably over the following three years, except for non-employee directors who usually receive immediately exercisable options. Similarly, conditions, if any, under which stock will be issued under stock grants or cash will be paid under stock unit grants and the conditions under which the interest in any stock that has been issued will become non-forfeitable are determined at the date of grant by the compensation committee. If the only condition to the forfeiture of a stock grant or stock unit grant is the completion of a period of service, the minimum period of service will generally be three years from the date of grant.

On September 30, 2005, pursuant to an employment agreement, our newly appointed President and Chief Operating Officer was granted an option to purchase 5.0 million shares of our common stock and 1.0 million restricted shares of common stock, further discussed below. The exercise price of the option is $0.48 per share, the closing price of our common stock as of the grant date. The option was immediately vested 25% as of the grant date, September 30, 2005, but is restricted from exercise unless and until the executive remains continuously employed with the Company through September 30, 2006. The remaining unvested portion of the option becomes exercisable in four equal annual installments, with the first such annual installment being September 30, 2006.

We have elected to account for stock-based compensation using the intrinsic value method prescribed in APB Opinion No. 25. Accordingly, compensation cost for stock options is measured as the excess, if any, of the fair value of our common stock at the date of grant over the exercise price to be paid to acquire the stock.

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 2.0 million options to purchase shares of common stock. On that date, we agreed to grant the same employees options to purchase 2.0 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 provided, 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, offer 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 the Company on the date of grant. Since we account for stock-based compensation using the intrinsic value method prescribed by APB Opinion No. 25, compensation cost for stock options is measured as the excess, if any, of the fair value of our 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.

Option activity for each of the three years ended 2005 under all of our stock option plans is as follows (shares in thousands):

| | Shares | Weighted Average Exercise Price |
|---|---|---|
| Balance, January 1, 2003 | 23,321 | $2.43 |
| Granted | 25,499 | 1.22 |
| Exercised | (1,974) | 0.89 |
| Cancelled | (7,685) | 3.47 |
| Balance, December 31, 2003 | 39,161 | 1.52 |
| Granted | 16,376 | 1.74 |
| Exercised | (7,502) | 0.57 |
| Cancelled | (4,086) | 2.25 |
| Balance, December 31, 2004 | 43,949 | 1.70 |
| Granted | 9,476 | 0.48 |
| Exercised | (2,017) | 0.45 |
| Cancelled | (15,846) | 1.91 |
| **Balance, December 31, 2005** | **35,562** | **$1.35** |

Options cancelled during the year ended December 31, 2005 included 10.2 million shares for our former Chief Executive Officer and other former members of the executive management team.

The following table summarizes information about options outstanding at December 31, 2005 (shares in thousands):

| | Options Outstanding | | Options Exercisable | |
|---|---|---|---|---|
| Exercise Price | Number of Shares | Weighted Average Remaining Contractual Life (in Years) | Number of Shares | Weighted Average Exercise Price |
| \$0.03–\$0.46 | 5,483 | 6.9 | 4,752 | \$0.34 |
| \$0.47–\$0.52 | 9,320 | 6.7 | 1,138 | 0.48 |
| \$0.53–\$1.23 | 6,315 | 7.3 | 4,549 | 0.94 |
| \$1.27–\$2.00 | 5,777 | 7.1 | 4,924 | 1.50 |
| \$2.15–\$2.78 | 8,211 | 8.0 | 5,315 | 2.25 |
| \$5.00–\$69.88 | 456 | 4.0 | 455 | 19.07 |
| \$0.03–\$69.88 | 35,562 | 7.2 | 21,133 | \$1.63 |

None of our stock options or the underlying shares are subject to any right to repurchase by the Company.

## Employee stock purchase plans

Effective June 15, 2004, we adopted the 2004 Internap Network Services Corporation Employee Stock Purchase Plan (the 2004 ESPP). The purpose of the Plan is to encourage ownership of our common stock by each of our eligible employees by permitting eligible employees to purchase our common stock at a discount. Eligible employees may elect to participate in the Plan for two consecutive calendar quarters, referred to as a "purchase period," at any time during a designated period immediately preceding the purchase period. Purchase periods have been established as the six-month periods ending June 30 and December 31 of each year. A participation election is in effect until it is amended or revoked by the participating employee, which may be done at any time on or before the last day of the purchase period. Participants must authorize us to withhold a minimum of $10.00 per pay period of his or her compensation during the purchase period, subject to a maximum of $12,500 during any purchase period. Contributions under the Plan are permitted only through payroll deductions.

On the last day of each purchase period, participating employee's payroll deductions are automatically used to exercise an "option" to purchase shares of our common stock from us at the purchase price, up to the maximum number of shares permitted under the Plan. In accordance with section 423 of the Internal Revenue Code of 1985, in no event may a participating employee purchase more than $25,000 of common stock under the Plan during any calendar year. The purchase price for shares of common stock under the Plan for a purchase period is the lesser of 85% of the closing sale price per share of common stock on the first day of the offering period or 85% of such closing price on the last day of the purchase period. A total of 1.4 million and 0.5 million shares were issued under the 2004 ESPP during 2005 and 2004, respectively.

The 2004 ESPP was intended to be a non-compensatory plan for both tax and financial reporting purposes. However upon our adoption of SFAS No. 123(R) in the first quarter of 2006, we will recognize compensation expense for the amount of the discount offered on shares purchased in the plan. In January 2006, the plan was amended to change the purchase price from 85% to 95% of the closing sale price per share of common stock on the last day of the purchase period and to eliminate the alternative to use the first day of the offering period as a basis for determining the purchase price. This amendment restores the plan to being non-compensatory for financial reporting purposes and will be effective for the purchase period ending December 31, 2006.

Previously, eligible employees could elect to participate in the 1999 Employee Stock Purchase Plan, which had similar terms to the 2004 ESPP. A total of 6.0 million shares of common stock were reserved for issuance pursuant to the 1999 ESPP, as increased annually, and 6.0 million shares have been issued since adoption. During the years ended December 31, 2004 and 2003, a total of 1.0 million and 1.7 million shares, respectively, were issued under the 1999 ESPP.

### Deferred stock compensation

In addition to stock options, our newly appointed President and Chief Executive Officer was also awarded 1.0 million shares of restricted stock on September 30, 2005. The shares of restricted stock vest 50% as of September 30, 2006 so long as the executive remains continuously employed by the Company through September 30, 2006. The remaining restricted shares vest in three equal annual installments, with the first such annual installment being September 30, 2007. The fair value of the restricted stock was $0.5 million as of the grant date, September 30, 2005, and has been reflected as deferred stock compensation in stockholders' equity in the accompanying balance sheet. Compensation expense will be recognized ratably in accordance with the terms of vesting. The executive's employment agreement provides for accelerated vesting of the restricted stock under certain events of termination of the executive's employment. Amortization of deferred stock compensation was less than $0.1 million for the year ended December 31, 2005.

For the year ended December 31, 2003, amortization of deferred stock compensation was $0.4 million, related to stock options granted to certain employees with exercise prices below the deemed fair value of the stock option. No deferred stock compensation was recognized for the year ended December 31, 2004.

## 16. RELATED PARTY TRANSACTIONS

As discussed in note 5, we have an investment in Aventail, who is also a customer for data center and connectivity services. We invoiced Aventail $0.3 million each year from 2003 through 2005. As of December 31, 2005 and 2004, our outstanding receivable balances with Aventail were less than $0.1 million.

In 2003 and 2004, we engaged Korn/Ferry International, a national executive recruiting firm, to assist in the identification and recruitment of senior executives. For 2003 and 2004 we paid Korn/Ferry $3,178 and $75,000, respectively, in connection with executive placements. Our former 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 expense 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.

## 17. UNAUDITED QUARTERLY RESULTS

The following table sets forth selected unaudited quarterly data for the years ended December 31, 2005 and 2004. 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. The quarterly operating results below are not necessarily indicative of those of future periods (in thousands, except for per share data).

| | Quarter Ended | | | |
|---|---|---|---|---|
| | March 31 | June 30 | September 30 | December 31 |
| **2005** | | | | |
| **Revenue** | **$37,855** | **$37,571** | **$37,999** | **$40,292** |
| **Net loss** | **(570)** | **(1,046)** | **(3,171)** | **(177)** |
| **Basic and diluted net loss per share** | **$ (0.00)** | **$ (0.00)** | **$ (0.01)** | **$ (0.00)** |

| | Quarter Ended | | | |
|---|---|---|---|---|
| | March 31 | June 30 | September 30 | December 31 |
| 2004 | | | | |
| Revenue | $36,250 | $35,999 | $35,151 | $37,146 |
| Net loss | (2,645) | (4,271) | (7,877) | (3,269) |
| Basic and diluted net loss per share | $ (0.01) | $ (0.02) | $ (0.03) | $ (0.01) |

# REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

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

We have completed integrated audits of Internap Network Services Corporation's 2005 and 2004 consolidated financial statements and of its internal control over financial reporting as of December 31, 2005, and an audit of its 2003 consolidated financial statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Our opinions, based on our audits, are presented below.

## Consolidated financial statements

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations, stockholders' equity and comprehensive loss, and cash flows present fairly, in all material respects, the financial position of Internap Network Services Corporation and its subsidiaries at December 31, 2005 and 2004, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2005 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 the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit of financial statements 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.

## Internal control over financial reporting

Also, in our opinion, management's assessment, included in the accompanying Management's Report on Internal Control Over Financial Reporting, that the Company maintained effective internal control over financial reporting as of December 31, 2005 based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), is fairly stated, in all material respects, based on those criteria. Furthermore, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, based on criteria established in *Internal Control – Integrated Framework* issued by the COSO. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express opinions on management's assessment and on the effectiveness of the Company's internal control over financial reporting based on our audit. We conducted our audit of internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. An audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

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

PricewaterhouseCoopers LLP
Atlanta, Georgia
March 6, 2006

# MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rule 13a-15(f). Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Based on our evaluation under the framework in *Internal Control – Integrated Framework* issued by COSO, our management concluded that our internal control over financial reporting was effective as of December 31, 2005. Our management's assessment of the effectiveness of our internal control over financial reporting as of December 31, 2005 has been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm, as stated in their report which is included herein.

# STOCKHOLDER INFORMATION

## Corporate Headquarters

Internap Network Services Corporation
250 Williams Street
Atlanta, GA 30303
404-302-9700
www.internap.com

## Investor Relations

Andrew S. Albrecht
Vice President, Corporate Development/Investor Relations
404-302-9841

## Stock Trading Information

Internap's common stock trades on the American Stock Exchange under the ticker symbol: IIP.

## Independent Registered Public Accounting Firm

PricewaterhouseCoopers LLP
10 Tenth Street, Suite 1400
Atlanta, GA 30309
678-419-1000

## Transfer Agent

American Stock Transfer & Trust Company
59 Maiden Lane
New York, NY 10038
800-937-5449
info@amstock.com

## Form 10-K

A copy of Internap's 2005 Annual Report on Form 10-K for the year ended December 31, 2005, as filed with the Securities and Exchange Commission, is posted to the investor relations section of our website, www.internap.com. A printed copy is available without charge to stockholders upon written request by contacting Investor Relations at our headquarters address.

## Product/Services Information

Information on Internap's products and services can be obtained by contacting our corporate headquarters or visiting our website at: www.internap.com.

## Market and Dividend Information

Internap's common stock is listed on the AMEX under the symbol "IIP" and has traded on the AMEX since February 18, 2004. Our common stock traded on the NASDAQ SmallCap Market from October 4, 2002 until February 17, 2004. Prior to that, our common stock traded on the NASDAQ National Market from September 29, 1999, the date of our initial public offering, until October 4, 2002, when we fell below certain listing criteria of the NASDAQ National Market.

The following table sets forth on a per share basis the high and low closing prices for our common stock on the AMEX or the NASDAQ SmallCap Market, as applicable, during the periods indicated.

| | High | Low |
|---|---|---|
| **Year Ended December 31, 2005** | | |
| **Fourth Quarter** | **$0.51** | **$0.37** |
| **Third Quarter** | **0.57** | **0.44** |
| **Second Quarter** | **0.60** | **0.42** |
| **First Quarter** | **0.94** | **0.52** |
| Year Ended December 31, 2004 | | |
| Fourth Quarter | $1.04 | $0.50 |
| Third Quarter | 1.22 | 0.52 |
| Second Quarter | 1.96 | 1.05 |
| First Quarter | 2.71 | 1.47 |

The Internap beneficial holders as of March 1, 2006 were 36,757.

*We have never declared or paid any cash dividends on our capital stock, and we do not anticipate paying cash dividends in the foreseeable future. We are prohibited from paying cash dividends under covenants contained in our current credit agreement. We currently intend to retain our earnings, if any, for future growth. Future dividends on our common stock, if any, will be at the discretion of our board of directors and will depend on, among other things, our operations, capital requirements and surplus, general financial condition, contractual restrictions and such other factors as our board of directors may deem relevant.*

## Safe Harbor Statement Under the Private Securities Litigation Reform Act of 1995

All statements included or incorporated by reference in this 2005 Annual Report, other than statements or characterizations of historical fact, including, but not limited to, statements regarding our future business prospects, financial position, business strategy, projected levels of growth, projected costs and projected financing needs, are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Those statements are based on the current intent, belief or expectations of Internap and members of our management team and certain assumptions made by us and can often be identified by the use of words such as "may," "will," "seeks," "anticipates," "believes," "estimates," "expects," "projects," "forecasts," "plans," "intends," "should" or similar expressions. Forward-looking statements are not guarantees of future performance and involve risks, uncertainties and assumptions that are difficult to predict. Therefore, our actual results may differ materially from those contemplated by forward-looking statements. Our Annual Report on Form 10-K and other filings with the Securities and Exchange Commission discuss some of the important risk factors that could contribute to such differences or otherwise affect our business, results of operations and financial condition. The forward-looking statements speak only as of the date of this Annual Report. We undertake no obligation to revise or update publicly any forward-looking statement for any reason.

# BOARD OF DIRECTORS

Eugene Eidenberg
Chairman
Strategic Advisor, Granite Venture Associates LLC; and Principal, Hambrecht Quist Venture Associates
Director since: 1997

James P. DeBlasio
President and Chief Executive Officer, Internap
Director since: 2003

Charles B. Coe
Former President, BellSouth Network Services
Director since: 2003

William J. Harding
Managing Member,
Morgan Stanley Venture Partners
Director since: 1999

Fredric W. Harman
General Partner,
Oak Investment Partners
Director since: 1999

Patricia L. Higgins
Former President and Chief Executive Officer,
Switch and Data
Director since: 2004

Kevin L. Ober
Managing Partner,
Divergent Venture Partners
Director since: 1997

Dr. Daniel C. Stanzione
President Emeritus, Bell Laboratories and
former Chief Operating Officer, Lucent Technologies
Director since: 2004

# EXECUTIVE MANAGEMENT TEAM

James P. DeBlasio
President and Chief Executive Officer

David A. Buckel
Vice President and Chief Financial Officer

David L. Abrahamson
Vice President, Sales

Dorothy C. An
Vice President and General Counsel

Robert P. Smith
Vice President and Chief Marketing Officer

J. Eric Klinker
Vice President, Chief Technology Officer and Chief Information Officer

Eric Suddith
Vice President, Operations

Andrew S. Albrecht
Vice President, Corporate Development
and Investor Relations

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