

NAVISITE INC
Form 10-Q
June 09, 2009

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q**

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

For the quarterly period ended April 30, 2009

OR

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

For the transition period from _____ to _____

Commission file number: 000-27597

NAVISITE, INC.

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of
incorporation or organization)

52-2137343

(I.R.S. Employer
Identification No.)

400 Minuteman Road

Andover, Massachusetts

(Address of principal executive offices)

01810

(Zip Code)

(978) 682-8300

(Registrant's telephone number, including area code)

None

(Former name, former address and former fiscal year, if changed since last report)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated
filer

Accelerated filer

Non-accelerated filer

Smaller Reporting
Company

(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

As of June 2, 2009, there were 35,612,544 shares outstanding of the registrant's common stock, par value \$.01 per share.

**NAVISITE, INC.
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FOR THE QUARTER ENDED APRIL 30, 2009**

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

	April 30, 2009	July 31, 2008
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 2,889	\$ 3,261
Accounts receivable, less allowance for doubtful accounts of \$1,160 and \$897 at April 30, 2009 and July 31, 2008, respectively	18,256	18,927
Unbilled accounts receivable	1,804	1,711
Prepaid expenses and other current assets	10,630	11,557
Total current assets	33,579	35,456
Property and equipment, net	33,454	38,141
Intangible assets	23,788	29,290
Goodwill	66,566	66,683
Other assets	4,890	4,258
Restricted cash	1,117	1,885
Total assets	\$ 163,394	\$ 175,713
LIABILITIES AND STOCKHOLDERS EQUITY (DEFICIT)		
Current liabilities:		
Notes payable, current portion	\$ 4,980	\$ 6,100
Capital lease obligations, current portion	3,248	3,166
Accounts payable	5,043	7,033
Accrued expenses and other current liabilities	14,631	13,336
Deferred revenue, deferred other income and customer deposits	4,504	4,163
Total current liabilities	32,406	33,798
Capital lease obligations, less current portion	10,450	14,922
Accrued lease abandonment costs, less current portion	159	428
Deferred tax liability	7,095	5,597
Other long-term liabilities	4,941	4,361
Note payable, less current portion	105,895	107,850
Total liabilities	160,946	166,956
Series A Convertible Preferred Stock, \$0.01 par value; Authorized 5,000 shares; Issued and outstanding: 3,558 at April 30, 2009 and 3,320 at July 31, 2008	30,005	27,529
Commitments and contingencies (Note 11)		
Stockholders' equity (deficit):		
Common stock, \$0.01 par value; Authorized 395,000 shares; Issued and outstanding: 35,607 at April 30, 2009 and 35,232 at July 31, 2008	356	352

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Accumulated other comprehensive (loss) income	(1,279)	253
Additional paid-in capital	485,263	485,086
Accumulated deficit	(511,897)	(504,463)
Total stockholders' equity (deficit)	(27,557)	(18,772)
Total liabilities and stockholders' equity (deficit)	\$ 163,394	\$ 175,713

See accompanying notes to condensed consolidated financial statements.

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NAVISITE, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

(In thousands, except per share amounts)

	Three Months Ended		Nine Months Ended	
	April 30,	April 30,	April 30,	April 30,
	2009	2008	2009	2008
Revenue, net	\$37,193	\$39,249	\$114,519	\$114,112
Revenue, related parties	88	73	282	220
Total revenue, net	37,281	39,322	114,801	114,332
Cost of revenue, excluding depreciation and amortization and restructuring charge	18,803	21,767	60,496	64,360
Depreciation and amortization	6,016	5,526	17,388	14,928
Restructuring charge			209	
Cost of revenue	24,819	27,293	78,093	79,288
Gross profit	12,462	12,029	36,708	35,044
Operating expenses:				
Selling and marketing	4,422	4,538	14,683	14,814
General and administrative	6,295	5,530	17,988	16,650
Restructuring charge			180	
Total operating expenses	10,717	10,068	32,851	31,464
Income from operations	1,745	1,961	3,857	3,580
Other income (expense):				
Interest income	11	38	36	214
Interest expense	(3,608)	(3,179)	(10,411)	(8,845)
Loss on debt extinguishment				(1,651)
Other income (expense), net	2	70	695	547
Loss from continuing operations before income taxes and discontinued operations	(1,850)	(1,110)	(5,823)	(6,155)
Income taxes	(499)	(501)	(1,497)	(1,414)
Loss from continuing operations before discontinued operations	(2,349)	(1,611)	(7,320)	(7,569)
Loss from discontinued operations, net of income taxes	(47)	(106)	(114)	(657)
Net loss	(2,396)	(1,717)	(7,434)	(8,226)
Accretion of preferred stock dividends	(849)	(757)	(2,476)	(1,877)
Net loss attributable to common stockholders	\$ (3,245)	\$ (2,474)	\$ (9,910)	\$ (10,103)
Basic and diluted net loss per common share:				
Loss from continuing operations before discontinued operations attributable to	\$ (0.09)	\$ (0.07)	\$ (0.28)	\$ (0.27)

common stockholders				
Loss from discontinued operations, net of income taxes				(0.02)
Net loss attributable to common stockholders	\$ (0.09)	\$ (0.07)	\$ (0.28)	\$ (0.29)
Basic and diluted weighted average number of common shares outstanding	35,600	35,033	35,466	34,605
Stock-based compensation expense:				
Cost of revenue	\$ 285	\$ 227	\$ 976	\$ 1,419
Selling and marketing	112	135	428	563
General and administrative	322	356	1,052	1,245
Restructuring charge			19	
Total stock-based compensation expense	\$ 719	\$ 718	\$ 2,475	\$ 3,227

See accompanying notes to condensed consolidated financial statements.

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

	Nine Months Ended	
	April 30, 2009	April 30, 2008
Cash flows from operating activities of continuing operations:		
Net loss	\$ (7,434)	\$ (8,226)
Loss from discontinued operations	114	657
Loss from continuing operations before discontinued operations	(7,320)	(7,569)
Adjustments to reconcile net loss to net cash provided by operating activities of continuing operations:		
Depreciation and amortization	17,905	15,472
Mark to market for interest rate cap	91	119
Loss / (Gain) on disposal of assets	12	(1)
Stock based compensation	2,475	3,227
Provision for bad debts	721	308
Deferred income tax expense	1,497	1,414
Loss on debt extinguishment		1,651
Changes in operating assets and liabilities:		
Accounts receivable	(611)	(1,165)
Unbilled accounts receivable	(176)	(1,072)
Prepaid expenses and other current assets, net	1,619	(6,958)
Long-term assets	(29)	39
Accounts payable	(1,797)	2,558
Long-term liabilities	581	120
Accrued expenses, deferred revenue and customer deposits	2,531	(5,525)
Net cash provided by operating activities of continuing operations	17,499	2,618
Cash flows from investing activities of continuing operations:		
Purchase of property and equipment	(9,352)	(8,783)
Cash used for acquisitions, net of cash acquired		(31,364)
Releases of (transfers to) restricted cash	(79)	8,563
Proceeds from the sale of assets		1
Net cash used for investing activities of continuing operations	(9,431)	(31,583)
Cash flows from financing activities of continuing operations:		
Proceeds from exercise of stock options and warrants	181	1,532
Proceeds from notes payable	3,477	28,881
Repayment of notes payable	(7,365)	(3,686)
Debt issuance costs	(1,184)	(1,112)
Payments on capital lease obligations	(3,216)	(2,842)
Net cash (used for) provided by financing activities of continuing operations	(8,107)	22,773
Cash used for operating activities of discontinued operations	(24)	(571)

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Effect of exchange rate changes on cash and cash equivalents	(309)	
Net (decrease) increase in cash and cash equivalents	(372)	(6,763)
Cash and cash equivalents, beginning of period	3,261	11,701
Cash and cash equivalents, end of period	\$ 2,889	\$ 4,938
Supplemental disclosure of cash flow information:		
Cash paid for interest	\$ 9,295	\$ 8,293
Equipment and leasehold improvements acquired under capital leases	\$ 2,492	\$ 16,950
Issuance of Series A Convertible Preferred Stock in connection with netASPx acquisition	\$	\$ 24,873
Accretion of Preferred Stock	\$ 2,476	\$ 1,877

See accompanying notes to condensed consolidated financial statements.

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

(1) Description of Business

NaviSite, Inc. (NaviSite , the Company , we , us or our) provides application management, managed hosting solutions and professional services for mid-market organizations. Leveraging our set of technologies and subject matter expertise, we deliver cost-effective, flexible solutions that provide responsive and predictable levels of service for our customers' businesses. Over 1,400 companies across a variety of industries rely on NaviSite to build, implement and manage their mission-critical systems and applications. NaviSite is a trusted advisor committed to ensuring the long-term success of our customers' business applications and technology strategies. At April 30, 2009, NaviSite had 16 state-of-the-art data centers in the United States and United Kingdom and a network operations center in India. Effective May 1, 2009, NaviSite did not renew one of its data center leases thereby reducing the number of data centers to 15. Substantially all revenue is generated from customers in the United States.

(2) Summary of Significant Accounting Policies**(a) Basis of Presentation and Principles of Consolidation**

The accompanying unaudited condensed consolidated financial statements include the accounts and operations of the Company and its wholly-owned subsidiaries and have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission regarding interim financial reporting. Accordingly, they do not include all of the information and notes required by U.S. generally accepted accounting principles (U.S. GAAP) for complete financial statements and thus should be read in conjunction with the audited consolidated financial statements included in our Annual Report on Form 10-K filed on November 6, 2008. In the opinion of management, the accompanying unaudited condensed consolidated financial statements contain all adjustments, consisting only of those of a normal recurring nature, necessary for a fair presentation of the Company's financial position, results of operations and cash flows at the dates and for the periods indicated. During the third quarter of fiscal 2009, the Company recorded approximately \$0.4 million of adjustments to previously recorded estimates, which decreased revenue by approximately \$0.1 million and decreased gross margin by approximately \$0.3 million or 2.8%. The cumulative effect of these adjustments is deemed immaterial. The results of operations for the three and nine months ended April 30, 2009 are not necessarily indicative of the results expected for the remainder of the fiscal year ending July 31, 2009.

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

(b) Use of Estimates

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reported period. Actual results could differ from those estimates. Significant estimates made by management include the useful lives of fixed assets and intangible assets, the recoverability of long-lived assets, the collectability of receivables, the determination and valuation of goodwill and acquired intangible assets, the determination of revenue and related revenue reserves, the determination of the fair value of stock-based compensation, the determination of the deferred tax valuation allowance, the determination of certain accrued liabilities and other assumptions for sublease and lease abandonment reserves.

(c) Revenue Recognition

Revenue, net consists of monthly fees for application management services, managed hosting solutions, co-location and professional services. Reimbursable expenses charged to clients are included in revenue, net and cost of revenue. Application management, managed hosting solutions and co-location services are billed and recognized as revenue over the term of the contract, generally one to five years. Installation and up-front fees associated with application management, managed hosting solutions and co-location services are billed at the time the installation service is provided and recognized as revenue over the longer of the expected term or the term of the related contract. Payments received in advance of providing services are deferred until the period such services are delivered.

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Revenue from professional services is recognized as services are delivered for time and materials type contracts and using the percentage of completion method for fixed price contracts. For fixed price contracts, progress towards completion is measured by a comparison of the total hours incurred on the project to date to the total estimated hours required upon completion of the project. When current contract estimates indicate that a loss is probable, a provision is made for the total anticipated loss in the current period. Contract losses are determined to be the amount by which the estimated service delivery costs of the contract exceed the estimated revenue that will be generated by the contract. Unbilled accounts receivable represent revenue for services performed that have not yet been billed as of the balance sheet date. Billings in excess of revenue recognized are recorded as deferred revenue until the applicable revenue recognition criteria are met.

In accordance with Emerging Issues Task Force (EITF) Issue No. 00-21, Revenue Arrangements with Multiple Deliverables , when more than one element such as professional services, installation and hosting services are contained in a single arrangement, the Company allocates revenue between the elements based on acceptable fair value allocation methodologies, provided that each element meets the criteria for treatment as a separate unit of accounting. An item is considered a separate unit of accounting if it has value to the customer on a stand alone basis and there is objective and reliable evidence of the fair value of the undelivered items. The fair value of the undelivered elements is determined by the price charged when the element is sold separately, or in cases when the item is not sold separately, by using other acceptable objective evidence. Management applies judgment to ensure appropriate application of EITF 00-21, including the determination of fair value for multiple deliverables, determination of whether undelivered elements are essential to the functionality of delivered elements, and timing of revenue recognition, among others. For those arrangements where the deliverables do not qualify as a separate unit of accounting, revenue from all deliverables are treated as one accounting unit and generally is recognized ratably over the term of the arrangement.

(d) Cash and Cash Equivalents and Restricted Cash

The Company considers all highly liquid securities with original maturities of three months or less to be cash equivalents. The Company had restricted cash of \$1.9 million as of April 30, 2009 and \$1.9 million as of July 31, 2008, including \$0.8 million that was classified as short-term in the April 30, 2009 Condensed Consolidated Balance Sheet and is included in Prepaid expenses and other current assets . At April 30, 2009, restricted cash consists of cash collateral requirements for standby letters of credit associated with several of the Company s facility and equipment leases.

(e) Property and Equipment

Property and equipment are stated at cost. Depreciation is computed using the straight-line method over the estimated useful lives of the assets, which range from three to five years. Leasehold improvements and assets acquired under capital leases that transfer ownership are amortized using the straight-line method over the shorter of the lease term or the estimated useful life of the asset. Assets acquired under capital leases that do not transfer ownership or contain a bargain purchase option are amortized over the lease term. Expenditures for maintenance and repairs are charged to expense as incurred.

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

(f) Long-lived Assets, Goodwill and Other Intangibles

The Company follows the provisions of Statement of Financial Accounting Standards (SFAS) No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* . SFAS No. 144 requires that long-lived assets and certain identifiable intangibles be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to the undiscounted future net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value less cost to sell.

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

(g) Concentration of Credit Risk

Our financial instruments include cash, accounts receivable, obligations under capital leases, a debt agreement, derivative instruments, preferred stock, accounts payable, and accrued expenses. Financial instruments that may subject us to concentrations of credit risk consist primarily of accounts receivable. Concentrations of credit risk with respect to trade receivables are limited due to the large number of customers across many industries that comprise our customer base. No customer accounted for more than 5% of total revenues for the nine months ended April 30, 2009 or more than 5% of total accounts receivable balance as of April 30, 2009.

(h) Comprehensive Income (Loss)

Comprehensive income (loss) is defined as the change in equity of a business enterprise during a period of time from transactions and other events and circumstances from non-owner sources. The Company records the components of comprehensive income (loss), comprised of foreign currency translation adjustments, in the Condensed Consolidated Balance Sheets as a component of Stockholders' Deficit, Accumulated other comprehensive income (loss). For the three and nine months ended April 30, 2009, comprehensive loss totaled approximately \$2.3 million and \$9.0 million, respectively. For the three and nine months ended April 30, 2008, comprehensive loss totaled approximately \$1.8 million and \$8.3 million, respectively.

(i) Advertising Costs

The Company charges advertising costs to expense in the period incurred. Advertising expense for the three and nine months ended April 30, 2009 were approximately \$113,000 and \$321,000, respectively. Advertising expense for the three and nine months ending April 30, 2008 were approximately \$85,000 and \$398,000, respectively.

(j) Income Taxes

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

(k) Stock Based Compensation***Stock Options***

The Company maintains three stock incentive plans under which employees and outside directors have been granted nonqualified stock options to purchase the Company's common stock. Only one plan, the NaviSite 2003 Stock Incentive Plan (2003 Plan), is currently available for new equity award grants. For the Company's employees, options granted are generally exercisable as to 25% of the original number of shares on the sixth month anniversary of the option holder's grant date and, thereafter, in equal amounts monthly over the three year period commencing on the sixth month anniversary of the option holder's grant date, provided that the option holder is employed on each such vesting date. Options granted under the 2003 Plan have a maximum term of ten years.

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The Company's current practice is to grant all options with an exercise price equal to the fair market value of the Company's common stock on the date of grant. During the three and nine months ended April 30, 2009, the Company issued stock options for the purchase of approximately 0.2 million and 0.7 million shares of common stock at a weighted average exercise price per share of \$0.39 and \$1.37, respectively. During the three and nine months ended April 30, 2008, the Company issued stock options for the purchase of approximately 0.3 million and 1.7 million shares of common stock at a weighted average exercise price per share of \$3.26 and \$6.63, respectively.

The fair value of each option issued under the 2003 Plan is estimated on the date of grant using the Black-Scholes Model, based upon the following weighted average assumptions:

	Three Months Ended		Nine Months Ended	
	April 30,		April 30,	
	2009	2008	2009	2008
Expected life (years)	3.0	2.5	2.6	2.5
Expected volatility	102.35%	79.36%	87.44%	83.07%
Expected dividend rate	0.00%	0.00%	0.00%	0.00%
Risk-free interest rate	1.31%	2.17%	1.67%	3.49%

Stock-based compensation expense related to stock options recognized in the Condensed Consolidated Statements of Operations is as follows:

	Three Months Ended		Nine Months Ended	
	April 30,		April 30,	
	(in thousands)		(in thousands)	
	2009	2008	2009	2008
Cost of revenue	\$240	\$189	\$ 813	\$1,381
Selling and marketing	93	115	353	543
General and administrative	128	138	402	771
Total	\$461	\$442	\$1,568	\$2,695

Non-vested Shares

In April 2009, the Company granted 200,000 non-vested shares to a certain executive under the 2003 Plan, at a weighted average grant date fair value of \$0.44. These non-vesting shares carry restrictions as to resale which lapse over time as to 25% of the original number of shares on the sixth month anniversary of the grant date and, thereafter, in equal amounts monthly over the three year period commencing on the sixth month anniversary of the grant date, provided that the holder is employed on each such vesting date.

In December 2008, the Company granted 63,000 non-vested shares to certain members of the Company's Board of Directors under the 2003 Plan, at a weighted average grant date fair value of \$0.37 per share. These non-vested shares carry restrictions as to resale which lapse with time over the twelve month period beginning with the date of grant, provided that such member of the Board of Directors serves on the Board of Directors as of each vesting date. The grant date fair value of the non-vested shares was determined based on the market price of the Company's common stock on the date of grant.

In August 2008, the Company granted approximately 0.8 million non-vested shares of common stock to certain executives under the 2003 Plan, at a weighted average grant date fair value of \$3.29 per share. The grant date fair value of the non-vested shares was determined using Monte Carlo simulations allowing for the incorporation of market based hurdles. These shares are subject to certain vesting criteria: (i) for the first third of the shares, 50% vests upon the Company exceeding a market capitalization of \$182,330,695 for 20 consecutive trading days and the remaining 50% of such one third vests on the one year anniversary thereafter, (ii) for the second third of the shares,

50% vests upon the company exceeding a market capitalization of \$232,330,695 for 20 consecutive trading days and the remaining 50% of such one third vests on the one year anniversary thereafter, (iii) for the final third of the shares, 50% vests upon the Company exceeding a market capitalization of \$282,330,695 for 20 consecutive trading days and the remaining 50% of such one third vests on the one year anniversary thereafter. A participant will only vest in such shares if he or she is employed by the Company on a vesting date. If the vesting criteria is not met at the tenth anniversary of the grant date all unvested shares shall automatically be forfeited to the Company. Compensation expense is being recognized over the derived service period.

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In December 2007, the Company granted 63,000 non-vested shares to certain members of the Company's Board of Directors under the 2003 Plan, at a weighted average grant date fair value of \$5.50 per share. These non-vested shares carry restrictions as to resale which lapse with time over the twelve month period beginning with the date of grant, provided that such member of the Board of Directors serves on the Board of Directors as of each vesting date. The grant date fair value of the non-vested shares was determined based on the market price of the Company's common stock on the date of grant.

In August 2007, the Company granted approximately 0.2 million non-vested shares of common stock to certain executives, under the 2003 Plan, at a weighted average grant date fair value of \$7.93 per share. These non-vested shares carry restrictions which lapse as to one-third of the shares per annum on each of the first, second, and third anniversaries of the date of grant. With respect to 0.1 million of the non-vested shares, there was a potential for the restrictions to lapse on an earlier date as to 100% of the shares if the Company achieved certain revenue and EBITDA targets for its 2008 fiscal year. The targets were not met and the restrictions did not lapse on an accelerated basis. The grant date fair value of the non-vested shares was determined based on the market price of the Company's common stock on the date of grant.

The following table summarizes stock based compensation expense related to non-vested shares under SFAS 123(R) for the three and nine months ended April 30, 2009 and 2008.

	Three Months Ended April 30, (in thousands)		Nine Months Ended April 30, (in thousands)	
	2009	2008	2009	2008
Cost of revenue	\$ 25	\$	\$105	\$
Selling and marketing	13		47	
General and administrative	187	201	643	457
Total	\$225	\$201	\$795	\$457

The non-vested shares are excluded from our issued and outstanding share amounts presented in our Condensed Consolidated Balance Sheet at April 30, 2009.

Employee Stock Purchase Plan (ESPP)

Under the ESPP, employees who elect to participate instruct the Company to withhold a specified amount through payroll deductions during the offering period of six months. On the last business day of each offering period, the amount withheld is used to purchase the Company's common stock at an exercise price equal to 85% of the lower of the market price on the first or last business day of the offering period. During the nine months ended April 30, 2009, the Company issued 0.2 million shares under the ESPP at a price of \$0.34. During the nine months ended April 30, 2008, the Company did not issue any shares under the ESPP.

Compensation expense for the ESPP is recognized over the offering period. The following table summarizes stock based compensation expense related to the ESPP under SFAS 123R for the three and nine months ended April 30, 2009 and 2008.

	Three Months Ended April 30, (in thousands)		Nine Months Ended April 30, (in thousands)	
	2009	2008	2009	2008
Cost of revenue	\$20	\$38	\$ 64	\$38
Selling and marketing	6	20	28	20
General and administrative	7	17	20	17

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Total	\$33	\$75	\$112	\$75
	10		-	

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

The following table sets forth common stock equivalents that are not included in the calculation of diluted net loss per share available to common stockholders because to do so would be anti-dilutive for the periods indicated.

	Three Months Ended April 30, 2009	Three Months Ended April 30, 2008	Nine Months Ended April 30, 2009	Nine Months Ended April 30, 2008
Common stock options		1,280,363	113,079	2,258,111
Common stock warrants	1,169,090	1,196,700	1,188,695	1,201,832
Non-vested stock	88,835		194,233	158,339
Series A Convertible Preferred Stock	3,616,758	3,290,646	3,616,758	3,290,646
Employee Stock Purchase Plan	10,665		284,375	19,212
Total	4,885,348	5,767,709	5,397,140	6,928,140

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(m) Segment Reporting

We currently operate in one segment, managed IT services. The Company's chief operating decision maker reviews financial information at a consolidated level.

(n) Foreign Currency

The functional currencies of our wholly-owned subsidiaries are the local currencies. The financial statements of the subsidiaries are translated into U.S. dollars using period end exchange rates for assets and liabilities and average exchange rates during corresponding periods for revenue, net, cost of revenue and expenses. Translation gains and losses are recorded as a separate component of Stockholders' Equity (Deficit).

(o) Derivative Financial Instruments

Derivative instruments are recorded in the balance sheet as either assets or liabilities, measured at fair value. Changes in fair value are recognized currently in earnings. The Company has utilized interest rate derivatives to mitigate the risk of rising interest rates on a portion of its floating rate debt and has not qualified for hedge accounting. The interest rate differentials to be received under such derivatives are recognized as adjustments to interest expense and the changes in the fair value of the instruments is recognized over the life of the agreements as Other income (expense), net. The principal objectives of the derivative instruments are to minimize the risks and reduce the expenses associated with financing activities. The Company does not use derivative financial instruments for trading purposes.

Fair Value - Effective August 1, 2008, the Company adopted Statement of Financial Accounting Standard No. 157 (*SFAS 157*), (*Fair Value Measurements*), which establishes a framework for measuring fair value and requires enhanced disclosures about fair value measurements. SFAS 157 requires disclosure about how fair value is determined for assets and liabilities and establishes a hierarchy for which these assets and liabilities must be grouped, based on significant levels of inputs as follows:

Level 1 quoted prices in active markets for identical assets or liabilities;

Level 2 quoted prices in active markets for similar assets and liabilities and inputs that are observable for the asset or liability; or

Level 3 unobservable inputs, such as discounted cash flow models or valuations.

The determination of where assets and liabilities fall within this hierarchy is based upon the lowest level of input that is significant to the fair value measurement. The Company's interest rate derivatives required to be measured at fair value on a recurring basis and where they are classified within the hierarchy as of April 30, 2009 are