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The ingredients for broadband success...

COVAD
COMMUNICATIONS GROUP INC

COVAD 2003 ANNUAL REPORT

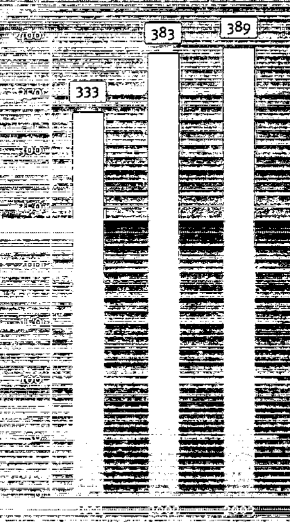
COVAD AT A GLANCE

Our Business:
We are in the business of broadband. Covad is a leading provider of high-speed Internet connectivity and related communications products and services. We offer digital subscriber line (DSL), T1, Virtual Private Network (VPN), Web hosting, dial-up services directly, and bundled voice and data services through our strategic partners. With more than 1,800 collocation facilities, we have the largest national DSL broadband network with coverage in 96 metropolitan statistical areas.

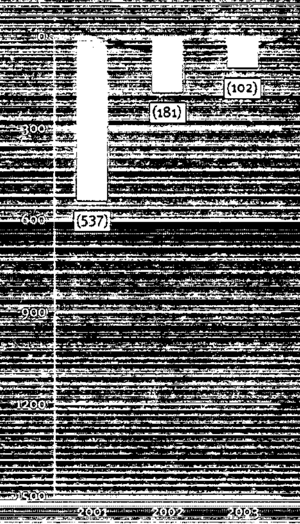
Our Markets:
We utilize both wholesale and direct channels to deliver broadband. Covad serves business and consumer markets, indirectly through our strategic partners, resellers and agents, as well as directly through Covad.net. The majority of our sales are generated by more than 300 resellers, including strategic partners such as ACN, AT&T, America Online, Broadwing, EarthLink, Global Crossing, MCI, MegaPath, SBC, Speakeasy, Sprint, Vartec, XO Communications and Z-Tel.

Our Results:
We exceeded our financial objectives for the year. 2003 was a year of exceptional financial performance combining growth in revenue with aggressive overhead cost reduction. We moved into positive territory on earnings before interest, taxes, depreciation and amortization (EBITDA) one quarter ahead of plan, while delivering 36% growth in subscribers and reducing net loss by approximately 46% to $100 million. As of December 31, 2003, we had approximately 517,000 DSL and other high-speed lines in service.

TOTAL REVENUE



LOSS FROM OPERATIONS



(in millions)

Contents

Covad's critical ingredients

What does it take to succeed in the business of broadband?

No one knows the answer to that question better than Covad. We were the first to commercially deploy DSL in the United States, we own and operate the largest national DSL network and we've just come through a year of dramatic improvement in our financial performance.

So, what does it take to succeed in broadband? It's not just one thing, one person or one asset, it's a mix of critical ingredients that no one else in our industry can claim. Each of these core strengths works with the others to give us flexibility and endurance.

National Network, Best Partners, Smart Systems,
Products People Want, Broadband Expertise

National network

The broadest reach with one reliable network

Our network provides our partners and our direct sales channel with an integrated point for national reach. Instead of juggling multiple regional network relationships, our partners value the simplicity of one seamless source for their connectivity. Enterprise customers count on Covad to connect their distributed locations through the same national infrastructure.

The Covad network is also an engine of future value, with capacity to serve up to four million subscribers and adapt to new products such as Voice over Internet Protocol (VoIP).

Another advantage of our network is reliability. Covad engineers monitor the entire system, end-to-end, on a 24/7 basis. As a facilities-based company, we have the resources to design and maintain the network for long-term performance. It's no coincidence that our reliability is consistently 99.99%.

Looking ahead

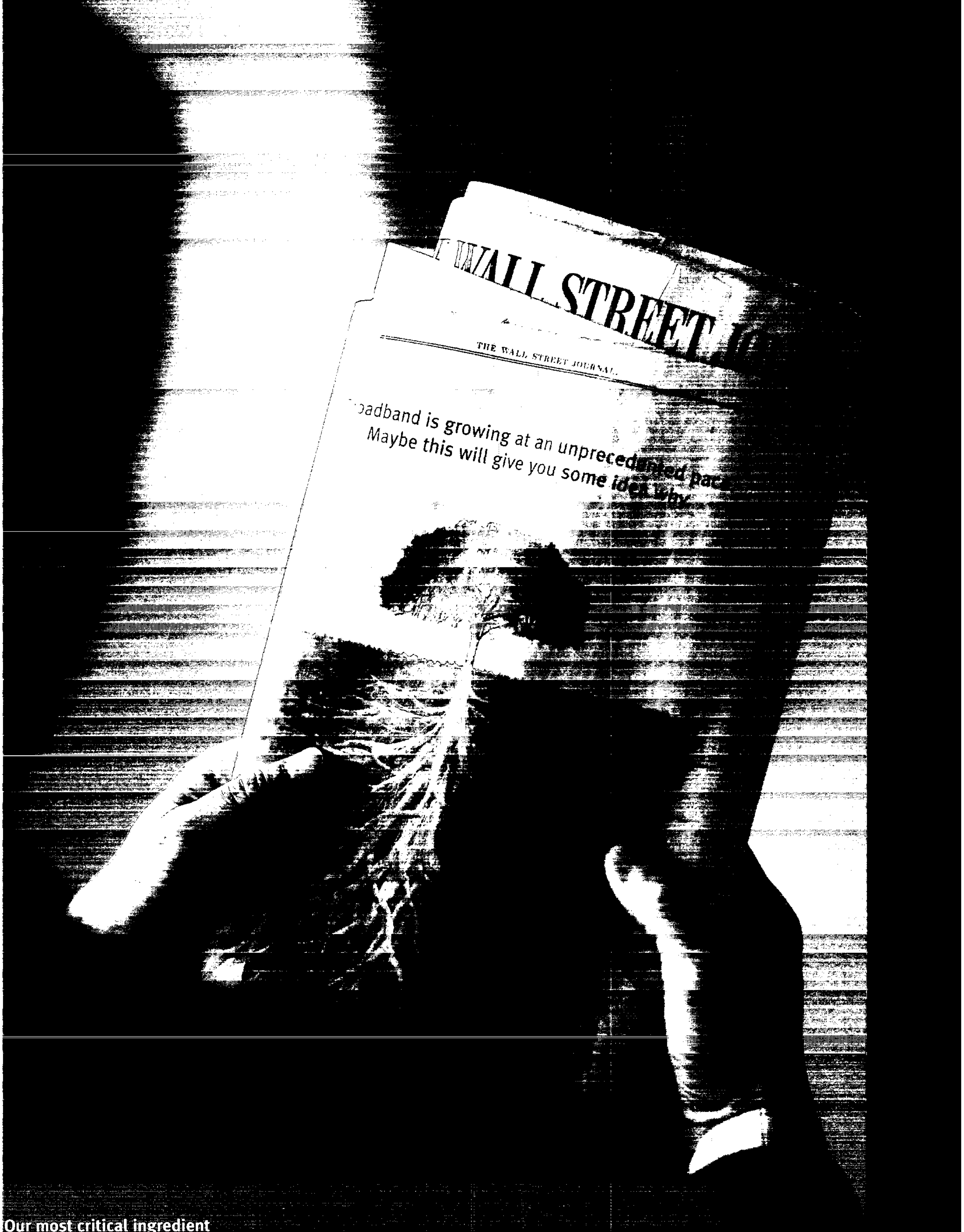
2004 will be a year of strategic network growth. We plan to add approximately 200 central offices, which will give us access to 4.2 million additional homes and businesses. We will let demand drive expansion and will only add capacity where there is potential new business.

We will also launch our VoIP service and are actively exploring our options on alternative technologies for our "last-mile" access to customers.

Key metrics[1]

MSAs *(metropolitan statistical areas)*:	96
COs *(central offices)*:	1,819
Homes and businesses passed:	45 million
Reliability:	99.99%
Total lines:	517,000

[1] As of December 31, 2003



Our most critical ingredient

To really understand the potential of Covad, you've got to understand the deep roots we've put down as a national facilities-based broadband provider. The physical infrastructure we have in place has been designed to accommodate future growth and support new products and services.

The best partners

Supplier of choice for the big names in telecommunications

Major telecommunications companies partner with Covad to provide broadband service for their customers. ACN, AT&T, America Online, Broadwing, EarthLink, Global Crossing, MCI, MegaPath, SBC, Speakeasy, Sprint, VarTec, XO Communications and Z-Tel all rely on us to be their independent ally, allowing them to offer competitively priced broadband services to compete with local phone and cable providers.

These partnerships extend our market reach for greater line growth while limiting the amount of cash we spend on marketing programs. We benefit from our partners' powerful brands and marketing programs and they benefit from the simplicity of one national broadband DSL supplier that understands their needs and the economics of the data business.

In 2003, we added a new dimension to our partnerships with line-splitting arrangements and new products for larger business users, including Frame Relay – an economic broadband solution for enterprises that need to connect multiple locations.

Looking ahead

2004 will see us adding to and deepening these partnerships. Working in collaboration with our partners, we will explore and introduce new products and services, new bundling options and continuous improvements in customer provisioning and service.

Key metrics[2]

Wholesale channel:	
% of lines	86%
% of revenue	77%
2003 subscribers	445,000 lines
(31% annual growth)	
Lines by segment:	
consumer	65%
business	35%

[2] As of December 31, 2003

Win-win relationships

Partnerships add depth and diversity to our customer and channel base, contributing to revenue growth and stability. Our partners include independent IT professionals, Web developers, value-added resellers, business consultants, content providers, full-service ISPs and competitive local and long distance companies selling to consumers, small businesses and large enterprises. We know that when our partners win, we win, so we are always looking for new ways to help make their businesses more competitive and our products and services more attractive.

Smart systems

Fast, cost-effective and award-winning user friendliness

For our partners and end-users, we make it easy to install, use and service Covad's connectivity and communications products with no-touch provisioning, automated order management and award-winning self-installation.

Smart systems are a critical ingredient in our success because they provide superior customer service for our resellers, direct customers and end-users, and lower our costs for installation and service. We've built features into our systems that allow most of our orders to be filled through a convenient, touchless process that is fast and effective.

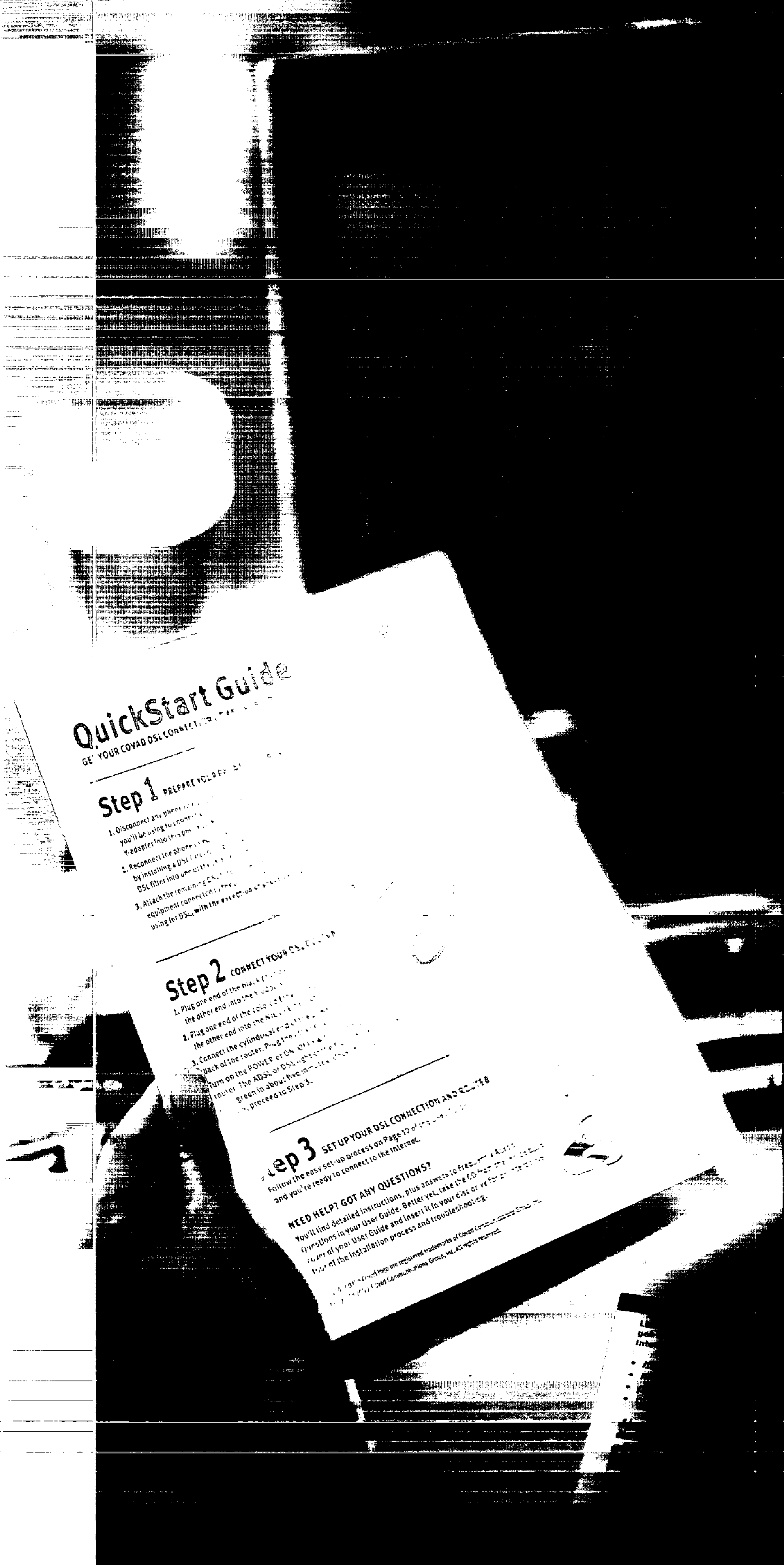
Residential and SOHO customers like the quick self-installation, and for our larger enterprise customers, Covad's Enhanced Services Group (ESG) delivers performance and responsiveness comparable to the large interexchange carriers. For all of our customers, smart billing and account management make it easy to do business with Covad every day.

Looking ahead
We will continue to build systems to improve our processes, customer service and automation. Our seamless Electronic Data Interchange (EDI) with our partners and our new ESG capability are examples of the constant stream of innovations and performance improvements behind our smart systems.

Key metrics

Streamlined system: more than 66% of our ADSL orders are touchless

Front-line capacity: over 270 service vehicles in the field



Award-winning service

Our self-install kit won the prestigious 2003 CNET Editor's Choice Award.

"From lucid instructions to hand-holding software to a smartly designed support site to a range of affordable service plans, Covad wins an Editors' Choice without breaking a sweat."[3]

3 CNET Review 2003

Products people want

Improving the user experience and broadening our revenue base

We have always viewed our business as more than just the connectivity pipeline. Creating and offering products and services that meet customer needs is a vital ingredient in our strategy because it helps users get more from their broadband connection. How do we know what customers want? We are good listeners and we work closely with our partners to understand the priorities of the residential, small business and enterprise user. Covad is continually developing and testing new products in our direct sales channel, which at the end of 2003 represented approximately 25% of our revenue.

Our suite of broadband solutions, including a range of speed options, is a critical ingredient in our success because it enhances and diversifies revenue and helps to retain customers. The innovation and insight we bring to our products help to differentiate us from other connectivity providers.

Looking ahead

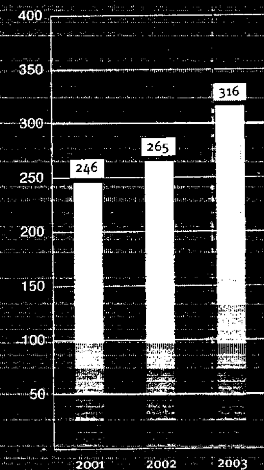
The next major product on the horizon for Covad is VoIP. Customers, from home users to large enterprises, can use VoIP to get more out of their broadband connection by reducing costs through the integration of voice and data services. In the second half of 2004, we will be ready to offer a business-class VoIP service as part of our wholesale bundle and a basic VoIP service for direct sales to businesses.

Key metrics

Our Diverse Product Portfolio:

- DSL and T1 connectivity
- Security firewall, anti-virus and SPAM protection
- Email and Web hosting
- Virtual private networks
- Online account management
- Enterprise and Frame Relay DSL

BROADBAND
SUBSCRIPTION BILLINGS



(in millions)

NOTE – For a reconciliation of Broadband Subscription Billings to Revenue, please refer to page 18.

Performance where it counts

High-performing businesses succeed because they attract the best customers and satisfy even the highest expectations. That's true whether you're selling state-of-the-art racing bikes or Internet connectivity, security and networking. Covad is becoming the broadband provider of choice for small- to medium-sized businesses that know the importance of being the best.

Broadband expertise

We're the experts in how it's delivered, how it's sold and how it's used

Since 1997, we have been dedicated exclusively to broadband. Our know-how touches every aspect of our business: engineering, sales, service, marketing, and research and development.

Our expertise matters to our partners because they know they can rely on us for operational excellence as well as support with marketing, sales and customer retention. Our expertise matters to our business customers because they can count on their broadband connection and on Covad to bring them new products and services that anticipate their needs. Broadband expertise matters because to succeed we've got to keep ahead of the curve, not just in the technology, but in everything from the regulatory environment to the behavior of the end user. As a broadband company, this is something we've always understood.

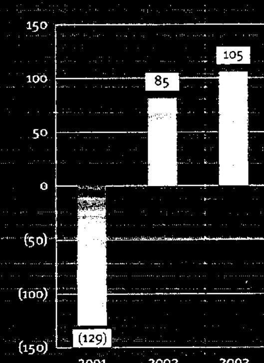
Looking ahead

Covad is always looking ahead and planning for the future with strategic clarity. We believe that broadband penetration will continue to grow, that users will continue to demand more from their broadband connection and that the promise of bundling – multiple products, one bill, one price – will take root. With our network expansion, VoIP introduction and research of last-mile alternatives, we're ready for whatever the future brings.

Key metrics

How do you measure expertise? It's in the growth of our business, the partners who come to us for answers and the new products we develop. It's in our fleet of trucks and service staff, and it's in the recognition that we receive for our operational excellence.

GROSS MARGIN



(in millions)

NOTE – For the calculation of gross margin, please refer to page 18.

Bringing broadband home

Broadband penetration in the residential segment cleared the 20% technology take-off point in 2003 and is expected to grow at a compound annual rate of 30% through 2005.[4]

[4] Park Associates, "Trends in Broadband Adoption 2003"

Broadband works hard for small business

In a recent survey of 479 small businesses, commissioned by Covad and Sprint, 65% of respondents reported using broadband, and half of those still on dial-up are considering an upgrade to broadband.[5]

[5] Equation Research Survey of Small Business, December 2003.

To our shareholders

For Covad, 2003 was a year of breakthroughs. First and foremost, we broke through into positive EBITDA territory in the fourth quarter, one quarter ahead of plan, and reduced our net loss by 46 percent. We moved past the benchmark of one-half million subscriber lines with 36 percent line growth in the year and we secured our position as the broadband supplier of choice for many of the top telecommunications companies in the United States. It was also a breakthrough year for broadband penetration as U.S. adoption cleared 20 percent – often cited as the turning point for new technologies. We even turned the FCC decision on phasing out line-sharing into a breakthrough opportunity by preparing our network for line-splitting and forming new marketing relationships that put us in a strong position for growth.

Through all of this, we remained true to our core values of financial discipline and network strength, with continued overhead cost reduction and maintenance of our network reliability rate of 99.99%.

In a year marked by change, we've proven that our strategy works. We've proven that we have the flexibility to handle the inevitable shifts that characterize our industry, and we have demonstrated that even though broadband is always changing, Covad continues to be in the game – stronger than ever.

Highlights of 2003: Performance under pressure

In 2003, we continued to build the core strengths that differentiate us from the competition and are critical to offering the best broadband experience. These ingredients include our national network, our unparalleled strategic partnerships, our broadband expertise and our relentless focus on improving our own operations and the customer experience. These critical ingredients combined to deliver solid financial performance in 2003.

Healthy revenues and financial discipline in 2003 made us EBITDA positive in the fourth quarter for the first time since inception. Achieving EBITDA profitability one quarter ahead of plan is a testament to the fundamental strength of Covad and the resourcefulness and energy of our employees. More specifically I would like to highlight some key achievements that made this success possible.

We continued to make strategic partnerships a priority and successfully increased both the number and depth of these relationships, adding ACN, Broadwing, Global Crossing, VarTec and Z-Tel as new partners, and expanding our wholesale offering to include Frame Relay and line-splitting. We simultaneously grew our direct sales business, which delivers strong margins and a platform for new product rollouts such as Web hosting, T1 and our next product, VoIP.

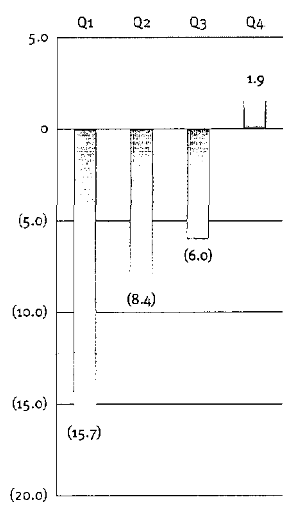
The successful migration of approximately 16,000 Qwest customers to Covad in mid-year gave us a healthy boost to our direct line count at a very attractive cost-of-acquisition. Our direct business keeps us in close contact with small business users, which we see as central to maintaining our status as the experts in broadband.

In the latter part of the year we established new reselling relationships to take us from line-sharing with the ILECs to line-splitting and product bundling with the competitive voice carriers – an enormous task made possible by everyone from our software developers to our network operators, account teams and legal teams. When we say we have broadband expertise, this is the kind of capability we are referring to – to handle immense regulatory and operational complexity under pressure. This transition has put us in a great position for profitable growth in 2004 and beyond.

Always in the background, making our performance possible, is our strict financial discipline and control over operating and capital expenditures. We spend where it counts and save where we can and our financial results reflect this. Lower year-over-year network and product costs have improved our gross margins for the year and we were able to leverage our fixed-cost base to limit capital expenditures.

Covad has come a long way in a short time – from a small player with a good idea, to a national provider with strong prospects. We want our investors, partners and customers to understand why Covad is succeeding and why our fundamentals – our critical ingredients – will continue to be the basis for our success. To this end, we launched a high-profile national campaign with advertisements in The Wall Street Journal and Business Week to increase awareness of our solid performance, unique assets and great partners.

EBITDA CALCULATION 2003



(in millions)

NOTE – For a reconciliation of EBITDA to Net Loss, please refer to page 18.

In summary, we stayed focused on our strategy, adapted to the realities of the business and delivered solid results. These are achievements we can all be proud of and I offer my thanks to our employees for their commitment and to our Board of Directors for their guidance in this breakthrough year.

Outlook for 2004: Managed growth

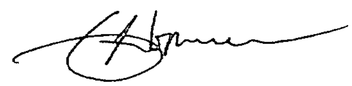
The critical ingredients that helped us prosper in 2003 will be hard at work for us again in 2004 and beyond. We will grow our network footprint by more than 10 percent in response to market and partner demand. We will add depth to our facilities with increased frame access and T1 availability in more of our central offices. We will also expand our services for large enterprises, including Frame Relay, and work closely with our partners to create new bundles that will meet the demand for voice and data on one bill.

We will launch VoIP to the small business segment in 2004. VoIP represents a major opportunity for Covad to grow our revenues and expand our service offerings as a natural extension of Covad's existing infrastructure. From our national last-mile broadband network to our automated provisioning, support and billing, we will leverage our critical ingredients to become a leading turnkey VoIP solution provider in the United States.

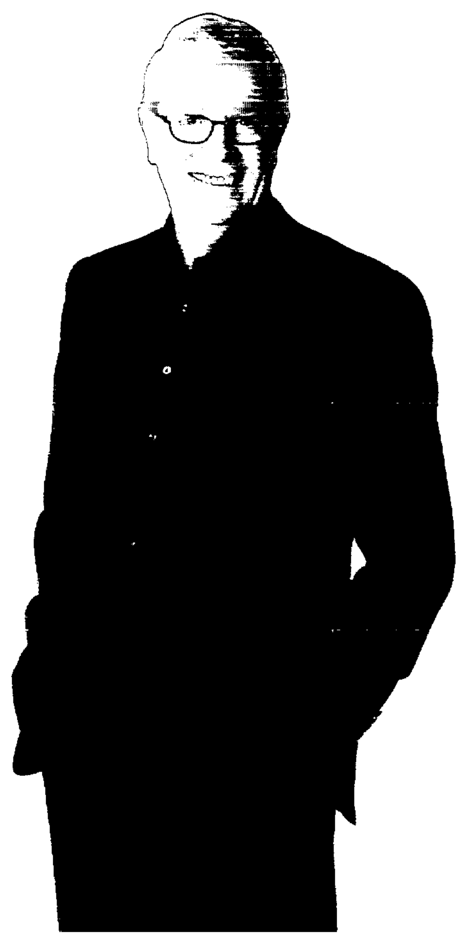
The Covad style of intelligent strategic choices and great execution will deliver another year of strong financial performance.

A bit further out on the horizon is the possibility of launching a Covad "last-mile" alternative, in which we provide the connection with the end customer. To this end, we are well into a program of technical feasibility and financial assessment of what would most likely be a wireless solution to carry our broadband connection to the end user, reducing our dependence on others for customer access. As a facilities-based company, we believe we have the infrastructure and the expertise to go the last mile, giving us a new level of control over our future.

Covad has matured into a company that defies categorization. Are we a technology company with a service mindset or a service company with deep technology roots? We're both, and it's our critical ingredients that make us that way. We've been building these strengths since our earliest days and now they're the key to prospering in 2003, innovating in 2004 and winning in broadband, wherever it's headed.



CHARLES HOFFMAN
PRESIDENT AND CEO



Reconciliation and Footnotes

Reconciliation and Footnotes (Unaudited)

(DOLLARS IN THOUSANDS)

Gross Margin (NOTE 1)	2001	2002	2003
Revenues, net	$ 332,596	$ 383,496	$ 388,851
less: Network and Product Costs	461,875	298,336	283,401
Gross Margin	$ (129,279)	$ 85,160	$ 105,450
% of Revenue	(39%)	22%	27%

Consolidated Revenue Data	2001	2002	2003
Broadband subscription billings (NOTE 3)	245,735	264,975	316,015
High-capacity circuit billings	36,671	27,437	21,402
Dial-up billings	25,027	10,718	5,879
TOTAL BILLINGS, NET	307,433	303,130	343,296
Financially stressed partners (NOTE 4)	(45,961)	8,406	57
Customer rebates and incentives not subject to deferral (NOTE 5)	—	(3,060)	(14,160)
Other revenues, net (NOTE 6)	71,124	75,020	59,658
REVENUES, NET	$ 332,596	$ 383,496	$ 388,851

EBITDA Calculation (NOTE 2)	Three months ended March 31, 2003	June 30, 2003	September 30, 2003	December 31, 2003
Net loss	$ (34,722)	$ (27,287)	$ (25,143)	$ (12,779)
Plus: Other (income) expense, net	392	1,093	1,267	(5,020)
Depreciation and amortization of property and equipment	14,593	13,752	13,054	15,160
Amortization of collocation fees and other intangible assets	3,996	4,024	4,775	4,530
EBITDA (NOTE 2)	$ (15,741)	$ (8,418)	$ (6,047)	$ 1,891

Notes to Unaudited Selected Financial Data

1. Gross margin is calculated by subtracting network and product costs from revenues, net.

2. Management believes that Earnings Before Interest, Taxes, Depreciation and Amortization ("EBITDA"), defined as net loss prior to (i) depreciation and amortization of property and equipment, (ii) amortization of intangible assets and (iii) other income (expense), net, is a useful measure because it provides additional information about the Company's ability to meet future capital expenditures and working capital requirements and fund continued growth. Management also uses EBITDA to evaluate the performance of its business segments and as a factor in its employee bonus program. EBITDA may be defined differently by other companies and should not be used as an alternative to our operating and other financial information as determined under accounting principles generally accepted in the United States. EBITDA is not a prescribed term under accounting principles generally accepted in the United States, does not directly correlate to cash provided by or used in operating activities and should not be considered in isolation, nor as an alternative to more meaningful measures of performance determined in accordance with accounting principles generally accepted in the United States. EBITDA generally excludes the effect of capital costs.

3. Broadband subscription billings is defined as customer bills issued within the period for services provided during such period (or to be provided in future periods). Broadband subscription billings exclude charges for Federal Universal Service Fund ("FUSF") assessments, dial-up services, and high-capacity circuits. Broadband subscription billings include bills issued to customers that are classified as financially distressed and whose revenue is only recognized if cash is received (refer to Note 4 below for a more detailed discussion on accounting for financially distressed partners). Management believes broadband subscription billings is a useful measure for investors as it represents a key indicator of the growth of the Company's core business. Management uses broadband subscription billings to evaluate the performance of its business segments.

4. When the Company determines that (i) the collectibility of a bill issued to a customer is not reasonably assured or (ii) its ability to retain some or all of the payments received from a customer that has filed for bankruptcy protection is not reasonably assured, the customer is classified as "financially distressed" for revenue recognition purposes. A bill issued to a financially distressed customer is recognized as revenue when services are rendered and cash for those services is received, assuming all other criteria for revenue recognition have been met, and only after the collection of all previous outstanding accounts receivable balances. Consequently, significant timing differences may occur from the time a bill is issued, the time the services are provided and the time that cash is received and revenue is recognized.

5. Customer rebates and incentives not subject to deferral consist of amounts paid or accrued under marketing, promotion and rebate incentive programs with certain customers. Rebates and incentives paid or accrued under these programs are not accompanied by any up-front charges billed to customers. Therefore, these charges are accounted for as reductions of revenue as incurred.

6. Other revenues consist primarily of revenue recognized from amortization of prior period SAB 101 deferrals (refer to Note 7 below for a discussion of SAB 101), FUSF and dial-up charges billed to our customers and other revenues not subject to SAB 101 deferral because they do not relate to an on-going customer relationship or performance of future services.

7. In the fourth quarter of 2000, retroactive to January 1, 2000, the Company adopted an accounting policy to account for up-front fees associated with service activation and the related incremental direct costs in accordance with SAB 101. The Company recognizes up-front fees associated with service activation, net of any amounts concurrently paid or accrued under certain marketing, promotion and rebate incentive programs, over the expected term of the customer relationship, which is presently estimated to be 24 months, using the straight-line method. The Company also treats the incremental direct costs of service activation (which consist principally of customer premises equipment, service activation fees paid to other telecommunications companies and sales commissions) as deferred charges in amounts that are no greater than the up-front fees that are deferred, and such deferred incremental direct costs are amortized to expense using the straight-line method over 24 months.

Financials

Financial Contents

Selected Financial Data

(DOLLARS IN THOUSANDS, EXCEPT SHARE AND PER SHARE AMOUNTS)

	For the Year Ended December 31,				
	2003	2002	2001	2000	1999
Consolidated Statement of Operations Data:					
Revenues, net	$ 388,851	$ 383,496	$ 332,596	$ 158,736	$ 66,488
Depreciation and amortization	73,884	127,088	150,839	178,425	37,692
Provision for restructuring expenses	1,235	—	14,364	4,988	—
Provision for long-lived asset impairment	—	—	11,988	589,388	—
Loss from operations	(102,199)	(180,992)	(536,880)	(1,354,192)	(171,601)
Interest expense	(5,526)	(5,581)	(92,782)	(109,863)	(44,472)
Reorganization expenses, net	—	—	(62,620)	—	—
Gain on extinguishment of debt	—	—	1,033,727	—	—
Income (loss) before cumulative effect of change in accounting principle	(99,931)	(184,828)	344,758	(1,433,887)	(195,397)
Cumulative effect of change in accounting principle	—	—	—	(9,249)	—
NET INCOME (LOSS)	$ (99,931)	$ (184,828)	$ 344,758	$ (1,443,136)	$ (195,397)
Basic and diluted per share amounts:					
Net income (loss) before cumulative effect of change in accounting principle	$ (0.44)	$ (0.84)	$ 1.94	$ (9.41)	$ (1.83)
Cumulative effect of accounting change	—	—	—	(0.06)	—
NET INCOME (LOSS)	$ (0.44)	$ (0.84)	$ 1.94	$ (9.47)	$ (1.83)
Weighted average common shares used in computing basic and diluted per share amounts	224,949,891	219,743,662	177,347,193	152,358,589	107,647,812
Pro forma amounts assuming the accounting change is applied retroactively:					
Net income (loss)	$ (99,931)	$ (184,828)	$ 344,758	$ (1,433,887)	$ (204,646)
Net income (loss) attributable to common Stockholders	$ (99,931)	$ (184,828)	$ 344,758	$ (1,433,887)	$ (205,792)
Basic and diluted net income (loss) per common share	$ (0.44)	$ (0.84)	$ 1.94	$ (9.41)	$ (1.91)

	As of December 31,				
	2003	2002	2001	2000	1999
Consolidated Balance Sheet Data:					
Cash, cash equivalents and short-term investments	$ 114,345	$ 202,492	$ 283,863	$ 869,834	$ 767,357
Net property and equipment	$ 94,279	$ 108,737	$ 215,804	$ 338,409	$ 186,059
Total assets	$ 334,711	$ 442,161	$ 675,168	$ 1,511,485	$ 1,147,606
Long-term obligations, including current portion	$ 50,000	$ 50,165	$ 50,011	$ 1,374,673	$ 375,050
Total stockholders' equity (deficit)	$ (5,553)	$ 82,299	$ 259,829	$ (182,663)	$ 690,291

	As of and for the Year Ended December 31,				
	2003	2002	2001	2000	1999
Other Operating and Financial Data:					
Homes and businesses passed (approximately)	46,000,000	46,000,000	40,000,000	40,000,000	29,000,000
Lines in service	517,000	381,000	351,000	274,000	57,000
Capital expenditures for property and equipment	$ 44,142	$ 22,782	$ 15,732	$ 319,234	$ 174,054

Management Discussion and Analysis of Financial Condition and Results of Operations

The following discussion of our financial condition and results of operations should be read in conjunction with the consolidated financial statements and the related notes thereto included elsewhere in this Annual Report. This discussion contains forward-looking statements, the accuracy of which involves risks and uncertainties. Our actual results could differ materially from those anticipated in the forward-looking statements for many reasons including, but not limited to, those discussed in "Part I. Item 1. Business-Risk Factors" in our Annual Report on Form 10-K. We disclaim any obligation to update information contained in any forward-looking statement. See – Forward Looking Statements."

(ALL DOLLAR AMOUNTS ARE PRESENTED IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)

Overview

BACKGROUND

We are a leading provider of high-speed Internet connectivity and related communications services, which we sell to businesses and consumers indirectly through Internet service providers, or ISPs, telecommunications carriers and other resellers. We also sell our services directly to business and consumer end-users through our field sales force, telephone sales, referral agents and our Web site.

We managed the Company in 2003 in two strategic business units. Covad Strategic Partnerships, or CSP, focused on delivering services to enterprise, corporate, small business, small office/home office, or SoHo, and consumer customers primarily through wholesale relationships with large ISPs, telecommunications carriers and other large resellers. Covad Broadband Solutions, or CBS, focused on small business and SoHo markets by selling services directly to end-users as well as through independent authorized sales agents, small ISPs and resellers.

Beginning in January 2004, we realigned our business and no longer maintain CSP and CBS as separate business units. We believe this realignment will lead to more efficient product development, sales and marketing because we will no longer have two separate groups providing these functions. In connection with this realignment, David McMorrow, previously our Senior Vice President, Corporate Development, was appointed Executive Vice President, Sales; Andy Lockwood, previously our Executive Vice President and General Manager for CSP, was appointed Executive Vice President, Market Development, and Patrick Bennett, previously our Executive Vice President and General Manager for CBS, was appointed Executive Vice President and will oversee our product development and management, including our deployment of Voice over Internet Protocol.

Since our inception, we have generated significant net and operating losses and we continue to experience negative operating cash flow. We currently have a plan in place that we believe will ultimately allow us to achieve positive cash flows from our operating activities in mid-2004. Our cash reserves are limited and our plan is based on assumptions that we believe are reasonable, but some of which are out of our control. If actual events differ from our assumptions, we may need to raise additional capital on terms that are less favorable than we desire.

TRIENNIAL REVIEW

The FCC's decision in the Triennial Review is described in detail in the company's Annual Report on Form 10-K in Item 1, Business – Recent Developments. As a result of this ruling, in October of 2004 the traditional telephone companies will no longer be required by law to provide us with line-shared telephone lines under Section 251 of the 1996 Telecommunications Act, although existing customers as of October 2, 2003 are grandfathered at current rates, terms and conditions. Consequently, our future ability to offer stand-alone Internet access over a telephone line that is being used by a traditional telephone company to provide voice service, which is the primary service that we and our resellers have historically used to provide services to consumers, will depend on whether we are able to enter into new agreements with the traditional telephone companies to share access to the high frequency portion of their telephone lines on terms that are acceptable to us, or whether we are able to obtain favorable regulatory rulings.

Pursuant to the Triennial Review, companies that compete with the traditional telephone companies will continue to have the ability to access the local telephone networks to provide bundled voice and data services, so long as these arrangements are deemed appropriate by the state public utility commissions, subject to federal guidelines. This situation affords us the opportunity to continue to partner with voice providers, such as AT&T, to provide our data services in line-splitting relationships.

Investors should review the above-referenced discussion of the Triennial Review carefully to understand other potentially significant effects that this ruling will have on our ability to continue to engage in our business as we have in the past, as the FCC's ruling creates a number of other uncertainties, challenges and opportunities for us. The final effect of many of these components of the FCC's ruling will be subject to the reactions of the various participants in the telecommunications industry, and many of these components are, or likely will be, the subject of litigation that could influence their ultimate impact. As such, it is very difficult for us to predict with a high level of certainty the final effects of the Triennial Review.

Our Opportunities and Challenges

Given the highly competitive, dynamic and heavily regulated nature of our business environment, we face a complex array of factors that create challenges and opportunities for us. Key matters upon which we are focused at this time include the following:

ACHIEVE CASH FLOW SUFFICIENCY Since we exited our voluntary bankruptcy proceedings at the end of 2001, we have been able to decrease the amount of cash flow used in our operations, and concluded 2003 with working capital of approximately $46.3 million. We have a critical strategic goal of achieving cash flow sufficiency in mid-2004, and our ability to continue to pursue our business plan is dependent on our doing so. We have reduced our expenses over the past two years and continue to manage expenses closely, so our ability to attain our cash flow goal will largely depend on the rate at which we can grow our revenues.

MANAGE THROUGH A TRANSITION IN THE DELIVERY OF BROADBAND INTERNET ACCESS SERVICES TO CONSUMERS The delivery of stand-alone broadband Internet access services by our ISP customers is facing intense competition, particularly from the incumbent telephone carriers, who are aggressively pricing their consumer DSL services and placing pricing pressure on us, but also from cable providers, like Comcast, Adelphia and Cox Communications, and wireless service providers. We believe these market conditions have reduced the number of orders for our services and are also causing a higher-than-historical level of churn among our ultimate end-users, and we expect this situation to continue. One of our wholesale customers, AOL, has indicated it will stop taking orders for our services and is moving to a "bring your own access" model where it will refer customers to access providers like us. Anticipating these conditions, we have entered into line-splitting arrangements with voice providers, particularly AT&T, which are bundling our data services with their voice services. Our success in 2004 and beyond will be significantly dependent on whether we can achieve growth in the sales of our services under these line-splitting relationships that more than offsets the decline in sales of our stand-alone consumer-grade data services.

OBTAIN ACCEPTABLE LINE-SHARING TERMS FROM THE INCUMBENT TELEPHONE COMPANIES While we expect that the revenues we generate from line-sharing with the incumbent telephone companies will constitute a smaller portion of our business in future periods, we think this market will continue to be important to us. Our ability to remain viable in this market will depend on whether we are able to reach agreements for new customers with the telephone companies or obtain favorable regulatory rulings that will allow us to share phone lines on reasonable terms.

EXPAND AND DIVERSIFY OUR SOURCES OF REVENUE We are taking steps to improve our prospects for revenue growth. First, we have announced our plan to expand our network by adding 200 central office locations, which will allow us offer our services to more end-users. Second, we will continue our efforts to diversify our revenue sources by adding new resellers like Broadwing, a wholly-owned subsidiary of Corvis Corporation, and Global Crossing, that primarily resell our higher-priced business-grade services.

NEW MARKET OPPORTUNITIES We recently announced our plan to offer Voice over Internet Protocol, or VoIP, services by the end of 2004. We believe that VoIP services have the potential to be a significant contributor to our revenue growth in 2005 and beyond. Therefore, we are in the process of developing this capability, and our success in providing this new service will depend on our ability to offer a service that operates as a replacement for the voice services provided by other phone companies.

Restructuring and Reorganization Activities

On August 15, 2001, the Petition Date, we filed a voluntary petition under Chapter 11 of the United States Bankruptcy Code to implement the agreements we entered into with the majority holders of our then-outstanding debt securities, which we refer to as the Noteholders, and to restructure various financial obligations. The Petition was filed with the United States Bankruptcy Court for the District of Delaware. Our operating subsidiaries did not commence bankruptcy proceedings and continued to operate in the ordinary course of business. On December 13, 2001, the Bankruptcy Court entered an order confirming our First Amended Plan of Reorganization and, on December 20, 2001, the Effective Date, this Plan was consummated and we emerged from bankruptcy. However, the Bankruptcy Court still maintains jurisdiction over certain administrative matters related to the implementation of this Plan, including certain unresolved claims. Under the Plan, we extinguished approximately $1,394,020 in aggregate face amount of outstanding debt securities, in exchange for a combination of approximately $271,708 in cash and 35,292,800 of our common shares, or 15% of the reorganized company. We also recorded a gain on the extinguishment of debt in the amount of $1,033,727 in the fourth quarter of 2001.

As part of our Chapter 11 proceeding, we signed a loan agreement and restructured our resale and marketing agreement with SBC Communications, or SBC. The agreements included four financial elements: a one-time $75,000 prepayment, collateralized by substantially all of our domestic assets, that SBC can use toward the purchase of our services during the next 10 years; a $50,000 four-year loan, collateralized by substantially all of our domestic assets; a payment to us of a $10,000 restructuring fee in exchange for eliminating SBC's revenue commitments under the original resale and marketing agreement; and the elimination of a $15,000 cooperative marketing fee owed by us to SBC under the previous resale and marketing agreement. We received these funds on December 20, 2001. Under these agreements, upon a change of control, we are required to repay any outstanding principal and interest on the loan and any unused portion of the prepayment. In addition, SBC may accelerate any unpaid portion of the prepayment and the loan in the event that we default.

On June 25, 2001, our former subsidiary, BlueStar Communications Group, Inc., or BlueStar, made an irrevocable assignment for the benefit of its creditors, or ABC, of all its assets to an independent trustee, or Assignee, in the state of Tennessee. Immediately thereafter, the Assignee began an orderly liquidation of BlueStar that was initially expected to be completed in the fourth quarter of 2002. However, the Assignee has informed us that it is still in the process of resolving some matters among BlueStar creditors and the process may extend into the second half of 2004. An ABC under Tennessee law is a non-judicial alternative to a plan of liquidation under Chapter 7 of the United States Bankruptcy Code. As a result of the ABC, BlueStar's former assets are no longer controlled by us or BlueStar and cannot be used by either BlueStar's or our board of directors to satisfy the liabilities of BlueStar. Consequently, the liquidation of BlueStar's assets and the discharging of its liabilities are currently under the sole control of the Assignee. Therefore, due to this loss of control, we deconsolidated BlueStar effective June 25, 2001, which resulted in the recognition of a deferred gain in the amount of approximately $55,200 in our consolidated balance sheet as of December 31, 2001. Such deferred gain represented the difference between the carrying values of BlueStar's assets, aggregating approximately $7,900, and liabilities, aggregating approximately $63,100, as of June 25, 2001. During 2003 and 2002, we reduced the deferred gain by $9 and $1,228, respectively, because certain BlueStar assets were inadvertently not deconsolidated on June 25, 2001. Therefore, the deconsolidation of BlueStar resulted in a deferred gain balance of $53,963 and $53,972 in our consolidated balance sheets as of December 31, 2003 and 2002, respectively. We will recognize such deferred gain as an element of other income in our consolidated statements of operations when the liquidation of BlueStar is complete and its liabilities have been discharged.

Critical Accounting Policies and Estimates

Our discussion and analysis of 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. For additional information regarding our critical accounting policies, please see Note 1 to our Consolidated Financial Statements. The application of these policies requires us to make estimates that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosures of contingent assets and liabilities. We base our accounting estimates on historical experience and other factors that we believe to be reasonable under the circumstances. However, actual results may vary from these estimates under different assumptions or conditions. We have discussed the development and selection of critical accounting policies and estimates with our audit committee. The following is a summary of our critical accounting policies and estimates we make in preparing our consolidated financial statements:

- We recognize revenues when persuasive evidence of an arrangement between the customer and us exists, service has been provided to the customer, the price to the customer is fixed or determinable and collectibility of the sales price is reasonably assured. We recognize up-front fees associated with service activation over the expected term of the customer relationship, which is presently estimated to be 24 months, using the straight-line method. Similarly, we treat the incremental direct costs of service activation, which consist principally of customer premises equipment, service activation fees paid to other telecommunications companies and sales commissions, as deferred charges in amounts no greater than the up-front fees that are deferred, and such incremental direct costs are amortized to expense using the straight-line method over 24 months.
- We have concentrations of credit risk with several customers, some of which were experiencing financial difficulties as of December 31, 2003 and 2002 and were not current in their payments for our services as of those dates. We classify this group of customers as financially distressed for revenue recognition purposes. Accordingly, we recognize revenues from these customers in the period in which cash is collected, but only after the collection of all previous outstanding accounts receivable balances. We record payments received from financially distressed customers during a defined period prior to their filing of petitions for bankruptcy protection in the consolidated balance sheet caption unearned revenues if our ability to retain these payments is not reasonably assured. We perform ongoing credit evaluations of our customers' financial condition and maintain an allowance for estimated credit losses. In addition, we have billing disputes with some of our customers. These disputes arise in the ordinary course of business in the telecommunications industry and their impact on our accounts receivable and revenues can be reasonably estimated based on historical experience. In addition, certain customer revenues are subject to refund if the end-user terminates service within thirty days of service activation. Accordingly, we maintain allowances, through charges to revenues, based on our estimate of the ultimate resolution of these disputes and future service cancellations, and our reported revenue in any period could be different than what is reported if we employed different assumptions in estimating the outcomes of these items. See "Results of Operations – Revenues, net" for a further discussion of the impact of these billing matters on our reported revenue.
- We state our inventories at the lower of cost or market. In assessing the ultimate recoverability of inventories, we are required to make estimates regarding future customer demand.
- We implemented significant reorganization and restructuring plans in 2001 and 2000. We also consummated a plan of reorganization under Chapter 11 of the United States Bankruptcy Code on December 20, 2001. As of December 31, 2003, we had certain unresolved claims relating to our Chapter 11 bankruptcy proceedings that remain in dispute. Therefore, it is reasonably possible that such disputed bankruptcy claims could ultimately be settled for amounts that differ from the aggregate liability for such claims reflected in our consolidated balance sheet as of December 31, 2003.

- We record property and equipment and intangible assets at cost, subject to adjustments for impairment. We depreciate or amortize property and equipment and intangible assets using the straight-line method over their estimated useful lives, certain of which were significantly revised in 2001. In assessing the recoverability of our property and equipment and intangible assets, we must make assumptions regarding estimated future cash flows and other factors to determine the fair value of the respective assets. If these estimates and assumptions change in the future, we may be required to record additional impairment charges relating to our property and equipment and intangible assets.

- We are a party to a variety of legal proceedings, as either plaintiff or defendant, and are engaged in other disputes that arise in the ordinary course of business. We are required to assess the likelihood of any adverse judgments or outcomes to these matters, as well as potential ranges of probable losses for certain of these matters. The determination of the liabilities to be recognized, if any, for loss contingencies is made after careful analysis of each individual situation based on the facts and circumstances. However, it is reasonably possible that the liabilities reflected in our consolidated balance sheets for loss contingencies and business disputes could change in the near term due to new facts and circumstances, the effects of which could be material to our consolidated financial position and results of operations.

- We are currently analyzing the applicability of certain transaction-based taxes to sales of our products and services and purchases of telecommunications circuits from various carriers. This analysis includes discussions with authorities of jurisdictions in which we do business and various transaction-based tax experts to determine the extent of our transaction-based tax liabilities. We believe that these discussions will be concluded without a material adverse effect on our consolidated financial position and results of operations. In addition, we are currently analyzing the probable applicability of employment-related taxes for certain stock-based compensation provided to employees in prior periods. We believe that the analysis of the probable applicability of these taxes will be concluded without a material adverse effect to our consolidated financial position and results of operations. However, it is reasonably possible that our estimates of our transaction-based and employment-related tax liabilities could change in the near term, the effects of which could be material to our consolidated financial position and results of operations.

- We account for income taxes using the liability method, under which deferred tax assets and liabilities are determined based on differences between the financial reporting and tax bases of our assets and liabilities. We record a valuation allowance on our deferred tax assets to arrive at an amount that is more likely than not to be realized. In the future, should we determine that we are able to realize all or part of our deferred tax assets, which presently are fully reserved, an adjustment to our deferred tax assets would increase income in the period in which the determination was made.

- We account for stock-based awards to employees using the intrinsic value method, and non-employees using the fair value method. Under the intrinsic value method, when the exercise price of our employee stock options equals or exceeds the market price of the underlying stock on the date of grant, we do not record compensation expense in our consolidated statement of operations. We use the intrinsic value method in accounting for employee stock options because the alternative fair value accounting requires us to use option valuation models that were not developed for use in valuing employee stock options. Rather, such option valuation models were developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. Because our employee stock options have characteristics significantly different from those of traded options and because changes in the subjective input assumptions can materially affect the fair value estimates of these valuation models, we believe such existing models do not necessarily provide a reliable single measure of the fair value of our employee stock options.

Recent Accounting Pronouncements

On May 15, 2003, the Financial Accounting Standards Board, or FASB, issued Statement of Financial Accounting Standards, or SFAS, No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity." SFAS No. 150 establishes standards for classifying and measuring as liabilities certain financial instruments that embody obligations of the issuer and have characteristics of both liabilities and equity, such as mandatorily redeemable equity instruments. SFAS No. 150 must be applied immediately to instruments entered into or modified after May 31, 2003 and to all other instruments that exist as of the beginning of the first interim financial reporting period beginning after June 15, 2003, except for mandatorily redeemable instruments of non-public companies, to which the provisions of SFAS No. 150 must be applied in fiscal periods beginning after December 15, 2003. The application of SFAS No. 150 to pre-existing instruments should be recognized as the cumulative effect of a change in accounting principle. The adoption of SFAS No. 150 had no effect on our consolidated financial statements.

In January 2003, the FASB issued Interpretation, or FIN, No. 46, "Consolidation of Variable Interest Entities," an interpretation of Accounting Research Bulleting No. 51, "Consolidated Financial Statements." FIN 46 applies to any business enterprise that has a controlling interest, contractual relationship or other business relationship with a variable interest entity, or VIE, and establishes guidance for the consolidation of VIEs that function to support the activities of the primary beneficiary. FIN 46 was effective immediately for enterprises with VIEs created after January 31, 2003, and it will be effective March 31, 2004 for enterprises with VIEs created before February 1, 2003. We do not expect the adoption of FIN 46 to have a significant effect on our consolidated financial statements.

On January 1, 2003, we adopted SFAS No. 146, "Accounting for Costs Associated with an Exit or Disposal Activity." SFAS No. 146 revises the accounting for exit and disposal activities under the FASB's Emerging Issues Task Force, or EITF, Issue No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring)," by extending the period in which expenses related to restructuring activities are reported. A commitment to a plan to exit an activity or dispose of long-lived assets is no longer sufficient to record a one-time charge for most restructuring activities. Instead, companies record exit or disposal costs when they are incurred and can be measured at fair value. In addition, the resultant liabilities are subsequently adjusted for changes in estimated cash flows. SFAS No. 146 was effective prospectively for exit or disposal activities initiated after December 31, 2002. Companies may not restate previously issued financial statements for the effect of the provisions of SFAS No. 146, and liabilities that a company previously recorded under EITF Issue No. 94-3 are grandfathered. The adoption of SFAS No. 146 had no effect on our consolidated financial statements.

On January 1, 2003, we adopted SFAS No. 145, "Rescission of FASB Statements No. 4, 44, and 64, Amendment of SFAS No. 13, and Technical Corrections." SFAS No. 145 rescinds SFAS No. 4, "Reporting Gains and Losses from Extinguishment of Debt," which required all gains and losses from extinguishment of debt to be aggregated and, if material, classified as an extraordinary item, net of related income tax effect. SFAS No. 145, which is effective in periods beginning after May 15, 2002, requires that gains or losses from extinguishment of debt be classified as extraordinary items only if they meet the criteria of APB Opinion No. 30. Upon adoption of SFAS No. 145 in 2003, we reclassified the gain on extinguishment of debt that we recognized in 2001, which was previously classified as an extraordinary item, as an element of other income (expense) in our 2001 consolidated statement of operations.

On January 1, 2003, we adopted SFAS No. 143, "Accounting for Asset Retirement Obligations." SFAS No. 143 requires that the fair value of a liability for an asset retirement obligation be recognized in the period in which it is incurred if a reasonable estimate of fair value can be made. The associated asset retirement costs are capitalized as part of the carrying amount of the long-lived asset. The adoption of SFAS No. 143 had no effect on our consolidated financial statements.

In December 2002, the FASB issued SFAS No. 148, "Accounting for Stock-Based Compensation – Transition and Disclosure." SFAS No. 148 amends SFAS No. 123, "Accounting for Stock-Based Compensation," to provide alternative methods of transition for an entity that voluntarily changes to the fair value method of accounting for stock-based employee compensation. In addition, SFAS No. 148 amends the disclosure provisions of SFAS No. 123 to require prominent disclosure of the effects of an entity's accounting policy with respect to stock-based employee compensation on reported results of operations, including per share amounts, in annual and interim financial statements. The disclosure provisions of SFAS No. 148 were effective immediately upon issuance in 2002. As of December 31, 2003, we have no immediate plans to adopt the fair value method of accounting for stock-based employee compensation.

In November 2002, the EITF reached a final consensus on Issue No. 00-21, "Accounting for Revenue Arrangements with Multiple Deliverables," which is effective for revenue arrangements entered into in fiscal periods beginning after June 15, 2003. Under EITF Issue No.00-21, revenue arrangements with multiple deliverables are required to be divided into separate units of accounting under certain circumstances. We adopted EITF Issue No. 00-21 on July 1, 2003, and such adoption did not have a material effect on our consolidated financial statements.

In November 2002, the FASB issued FIN No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others." FIN No. 45 requires certain guarantees to be recorded at fair value, which is different from current practice, which is generally to record a liability only when a loss is probable and reasonably estimable. FIN No. 45 also requires a guarantor to make significant new disclosures, even when the likelihood of making any payments under the guarantee is remote. The disclosure provisions of FIN No. 45 were effective immediately upon issuance in 2002. We adopted the recognition and measurement provisions of FIN No. 45 on a prospective basis with respect to guarantees issued or modified after December 31, 2002. The adoption of the recognition and measurement provisions of FIN No. 45 had no effect on our consolidated financial statements. However, some of our contracts with our customers have provisions that would require us to indemnify them in the event that our services infringe upon a third party's intellectual property rights.

Reclassifications and Adjustments

Certain balances in the Company's 2002 and 2001 consolidated financial statements have been reclassified to conform to the presentation in 2003.

During the year ended December 31, 2003, a matter was identified related to prior financial reporting periods that necessitated the recording of additional expense. Such matter was related to the modification of stock options granted to certain employees in prior years. These modifications occurred upon the separation of such employees from our Company, principally during 2000. Accordingly, for the year ended December 31, 2003, we recorded additional stock-based compensation expense in the amount of $1,236 ($0.01 per share). Such amount is reflected in our sales, marketing, general and administrative expenses for the year ended December 31, 2003. We do not believe this amount is material to the periods in which it should have been recorded, nor do we believe it is material to our consolidated operating results for the year ended December 31, 2003. This adjustment is principally related to 2000, the impact of which would have been to increase sales, marketing, general and administrative expenses and net loss by $1,236 or $0.01 per share for such year. As explained below, certain other adjustments were recorded during

2002 that related to prior periods. $1,139 of such amounts pertained to 2000, the effect of which would have been to decrease the Company's 2000 net loss by $0.01 per share. The aggregate effect of the adjustments recorded during the years ended December 31, 2003 and 2002 to the previously reported results of operations for the year ended December 31, 2000 would be to increase net loss by $97, or $0.00 per share, for such year if these adjustments had been recorded in 2000.

As part of the continuing evaluation of our network assets during the year ended December 31, 2002, certain matters were identified related to prior financial reporting periods that necessitated the recording of adjustments to certain expenses. Such matters were related principally to changes in our network configuration, which necessitated reductions of the remaining estimated useful lives of certain network equipment, the capitalization of certain network and product costs that should have been charged to operating expenses when they were incurred and various restructuring activities that resulted in the abandonment of certain network equipment and leasehold improvements. Accordingly, for the year ended December 31, 2002, we recorded additional depreciation expense of $6,989, network and product costs of $2,635, loss on the disposition of property and equipment of $635 and interest expense of $51. In addition, as part of our financial statement close process for the year ended December 31, 2002, we discovered that amortization expense related to non-cash deferred stock-based compensation was overstated in prior periods by $3,213. Therefore, for the year ended December 31, 2002, we recorded reductions of network and product costs of $320 and sales, marketing, general and administrative expense of $2,893. Furthermore, as part of the review of our December 31, 2002 tax accruals, we determined that we had overstated our transaction-based tax and other tax accruals in prior periods by $4,804, which we adjusted during the three months ended December 31, 2002 through a reduction of network and product costs. The adjustment was primarily driven by various complex rules surrounding our estimated liability to the Federal Universal Service Fund, or FUSF. We do not believe any of the aforementioned amounts are material to the periods in which they should have been recorded, nor do we believe the prospective correction of such amounts during the year ended December 31, 2002 is material to our consolidated operating results for such year. The prospective correction of the aforementioned amounts relating to prior periods increased our 2002 consolidated net loss by $2,294, or $0.01 per share, and decreased our 2001 net loss by $3,433 or $0.02 per share.

Results of Operations

REVENUES, NET

The primary component of our net revenues is earned monthly broadband subscription billings for DSL products. We also earn revenues from monthly billings for high-capacity circuits sold to our wholesale customers and to a lesser degree for dial-up services. Because we do not recognize revenue from sales to financially distressed customers until we receive payment and until our ability to keep the payment is reasonably assured, our reported revenues in each of the last three years have been impacted by whether we receive, and the timing of receipt of, payments from these customers. Our revenues also include billings for installation services and equipment, which are recognized as revenue over the expected life of the relationship with the end-user, and FUSF charges billed to our customers. Customer incentives and rebates that we offer to attract and retain customers are recorded as reductions to revenue.

Our net revenues in 2003 increased by $5,355, or 1.4%, over 2002 and $56,255, or 16.9%, over 2001. This growth in 2003 was due to the addition of approximately 136,000 DSL end-users to our network, which led to an increase in broadband subscription billings. We expect our revenues and broadband subscription billings to continue to grow as we execute our current sales and marketing programs. In addition, we plan to introduce new sales and marketing programs and create new services for our customers to lead to higher revenues and broadband subscription billings. The increase in our revenues and broadband subscription billings in 2003 was offset by several factors. Our high-capacity circuit revenues and billings in 2003 decreased, primarily driven by customer network configuration changes and consolidation in our customer transport circuits. We do not expect a significant increase or decrease in high-capacity circuit billings in 2004. In addition, our dial-up revenues and billings continued to decrease in 2003, primarily driven by the decrease in demand for this service. We expect that demand for this service will continue to decrease in 2004. Furthermore, revenue recognized from our financially distressed customers decreased during 2003. The amount of revenue recognized in 2002 from payments received from financially distressed customers was higher than the corresponding amount in 2003 because we received several large payments from financially distressed customers for billings that were not initially included in revenue. As a result of the reduction in billings issued to financially distressed customers in 2002 and 2003, we received fewer payments from financially distressed customers in 2003. Due to the reduction in broadband subscription billings to distressed customers, we currently do not expect that a significant amount of revenue in 2004 will come from these customers. In 2003, we also increased our customer rebates and incentives, which resulted in reductions to our revenues. We expect customer rebates and incentives to continue to be an element of our sales and marketing programs due to competitive market conditions. Revenue from installation services and equipment billings, which we recognize over the expected life of the end user, decreased in 2003, primarily driven by lower net selling prices, some of which is attributable to lower prices from our vendors and competitive pricing in the marketplace. We expect prices for these services and equipment to continue to decline in the future. FUSF charges billed to our customers, which we recognize as revenue, decreased in 2003, primarily driven by changes in the applicability of FUSF to some of our wholesale customers.

We regularly have billing disputes with our customers. These disputes arise in the ordinary course of business in the telecommunications industry and we believe their impact on our accounts receivable and revenues can be reasonably estimated based on historical experience. In addition, certain revenues are subject to refund if the end-user terminates service within thirty days of service activation. Accordingly, we maintain allowances, through charges to revenues, based on our estimate of the ultimate resolution of these disputes and future service cancellations. These charges to revenues were $2,886, $2,322 and $11,178 during the years ended December 31, 2003, 2002 and 2001, respectively. During the years ended December 31, 2003 and 2002, respectively, we recovered $1,282 and $2,145 of accounts receivable balances previously written-off against such allowance. There were no similar recoveries of accounts receivable balances for the year ended December 31, 2001.

Segment Revenues and Significant Customers

Our segment net revenues were as follows:

	Year ended December 31,		
	2003	2002	2001
CSP	$ 236,928	$ 231,721	$ 162,054
Percent of total net revenues	60.9%	60.4%	48.7%
CBS	$ 151,923	$ 151,775	$ 170,542
Percent of total net revenues	39.1%	39.6%	51.3%

We had over 300 wholesale customers as of December 31, 2003 compared to approximately 150 as of December 31, 2002 and 2001. The increase in 2003 from 2002 resulted primarily from the addition of smaller resellers to our CBS segment. For the years ended December 31, 2003, 2002 and 2001, our 30 largest wholesale customers in each such year collectively comprised 93.3%, 93.3% and 88.5% of our total wholesale net revenues, respectively, and 71.6%, 79.5% and 76.0% of our total net revenues, respectively. As of December 31, 2003 and 2002, receivables from these customers collectively comprised 70.3% and 75.3%, respectively, of our gross accounts receivable balance.

For the year ended December 31, 2003, EarthLink, Inc. and AT&T, two wholesale customers in our CSP business segment, accounted for 21.5% and 12.5%, respectively, of our total net revenues. For the year ended December 31, 2002, these customers accounted for 20.0% and 10.4%, respectively, of our total net revenues. For the year ended December 31, 2001, these customers accounted for 17.5% and 6.4%, respectively, of our total net revenues. As of December 31, 2003, receivables from these customers comprised 20.9% and 17.1%, respectively, of our gross accounts receivable balance. As of December 31, 2002, receivables from these customers comprised 25.9% and 11.7%, respectively, of our gross accounts receivable balance. No other individual customer accounted for more than 10% of our total revenues in 2003, 2002 and 2001.

Beginning in January 2004 we realigned our business and no longer maintain CSP and CBS as separate business units. We believe this realignment will lead to more efficient product development, sales and marketing because we will no longer have two separate groups providing these functions. We expect most of our revenue growth in 2004 to come from our wholesale customers because we expect increased sales of business-grade services by these resellers and increased sales through line-splitting agreements with wholesale customers like AT&T.

Wholesaler Financial Difficulties

Some of our resellers are experiencing financial difficulties. During the years ended December 31, 2003, 2002 and 2001, certain of these customers either were not current in their payments for our services or were essentially current in their payments but, subsequent to the end of the reporting period, their financial condition deteriorated significantly and some of them filed for bankruptcy protection. Based on this information, we determined that the collectibility of revenues from these customers was not reasonably assured or our ability to retain some or all of the payments received from some of these customers that filed for bankruptcy protection was not reasonably assured. Accordingly, we have classified this group of customers as "financially distressed" for revenue recognition purposes. Although MCI, formerly known as WorldCom, Inc., filed for bankruptcy protection during the year ended December 31, 2002, we have not classified it as a financially distressed customer based on MCI's specific facts and circumstances in relation to the revenue recognition criteria described in Note 2 to our consolidated financial statements. Therefore, we continued to recognize revenues from MCI on an accrual basis during 2003 and 2002.

A number of our customers are currently in bankruptcy proceedings. Revenues from these customers accounted for approximately 1.3%, 5.6% and 7.1% of our total net revenues for the years ended December 31, 2003, 2002 and 2001, respectively. As described above, although MCI filed for bankruptcy protection on July 21, 2002, we continued to recognize revenues from MCI on an accrual basis during 2003 and 2002 based on the revenue recognition criteria described in Note 2 to our consolidated financial statements. Consequently, the disclosures in the following paragraph related to financially distressed customers exclude amounts pertaining to MCI because we have not presently classified it as a financially distressed customer for revenue recognition purposes.

During the years ended December 31, 2003, 2002 and 2001, we issued billings to our financially distressed customers aggregating $5,139, $42,881 and $74,928, respectively, that were not recognized as revenues or accounts receivable in our consolidated financial statements. However, we recognized net revenues from certain of these customers when cash was collected aggregating $4,367, $47,609 and $29,003 during the years ended December 31, 2003, 2002 and 2001, respectively. Revenues recognized during the year ended December 31, 2003 and 2002, respectively, include payments totaling $827 and $4,427, respectively, from certain bankrupt customers that we received prior to January 1, 2002 and recorded as unearned revenues in our consolidated balance sheet as of December 31, 2001 because our ability to retain these payments was not reasonably assured as of that date. However, as a result of subsequent developments in the bankruptcy proceedings of such customers, we determined that our ability to retain these payments was reasonably assured prior to December 31, 2003. Consequently, we recognized these payments as revenues during 2003 and 2002. No such payments were recognized as revenues during the year ended December 31, 2001. We had contractual receivables from our financially distressed customers totaling $1,093 and $6,031, respectively, as of December 31, 2003 and 2002 that are not reflected in our consolidated financial statements.

We have identified certain of our customers, including MCI, who were essentially current in their payments for our services prior to December 31, 2003, or have subsequently paid all or significant portions of the respective amounts that we recorded as accounts receivable as of December 31, 2003, that we believe may have a high risk of becoming financially distressed. Revenues from these customers accounted for approximately 11.6%, 34.6% and 14.2% of our total net revenues for the years ended December 31, 2003, 2002 and 2001, respectively. As of December 31, 2003, receivables from these customers comprised 14.7% of our gross accounts receivable balance. If these customers are unable to demonstrate their ability to pay for our services in a timely manner in periods ending subsequent to December 31, 2003, revenue from such customers will only be recognized when cash is collected, as described above.

Operating Expenses

Operating expenses include network and product costs, sales, marketing, general and administrative expenses, provision for and recoveries of bad debts, depreciation and amortization expenses, restructuring expenses, provisions for impairment of long-lived assets and litigation-related expenses.

Our total operating expenses were as follows:

	Year ended December 31,		
	2003	2002	2001
Amount	$ 491,050	$ 564,488	$ 869,476
Percent of net revenue	126.3%	147.2%	261.4%

Network and Product Costs

Network and product costs consist primarily of the costs of provisioning and maintaining telecommunications circuits and central office space, equipment sold to our customers, and labor related expenses and other non-labor items to operate and maintain our network and related system infrastructure.

Our network and product costs were as follows:

	Year ended December 31,		
	2003	2002	2001
Amount	$ 283,401	$ 298,336	$ 461,875
Percent of net revenue	72.9%	77.8%	138.9%

Our network and product costs during the year ended December 31, 2003 were lower because we managed our network capacity more efficiently and obtained lower prices for the copper loops we purchase from the traditional telephone companies. These reductions in network and product costs were partially offset by the additional network and product costs associated with the addition of subscribers to our network. In addition, during the year ended December 31, 2003, we changed our estimates of certain liabilities for transaction-based taxes and property taxes based on settlements reached with various states and local jurisdictions on our transaction-based taxes and additional compilation of data on the valuation of our taxable property and equipment. These changes in accounting estimate decreased our network and product costs by $8,439 during the year ended December 31, 2003. Also during 2003, we changed our estimates of certain liabilities for collocation and network services as a result of the resolution of various billing disputes with our vendors and on our receipt of an invoice in December 2003 from a vendor for certain services provided by such vendor primarily in 2000 and 2001, which we are currently disputing. These changes in accounting estimate increased our network and product costs by $3,414 during the year ended 2003. Network and product costs for the year ended December 31, 2003 include $6,018 of migration expenses from the Qwest customer list acquisition and $2,135 for the probable applicability of employment-related taxes related to certain stock-based compensation provided to employees in prior periods. Network and product costs for the year ended December 31, 2002 include a credit of $5,550 from the settlement of certain disputed network service obligations during the year and customer acquisition costs of $3,674 associated with the acquisition of InternetConnect assets. Included in network and product costs for the year ended December 31, 2001 is a credit of $5,570 from the settlement of certain disputed collocation claims costs of approximately $34,768 from our BlueStar subsidiary, which we deconsolidated effective June 25, 2001.

We expect network and product costs to increase in future periods as we add subscribers and services like line-splitting to our network. To offset these increased costs, we plan to continue cost-saving programs, like outsourcing portions of our customer support to India and improving the technology we use to deliver our services. We expect that network and product costs as a percentage of revenue will decline as we transition more of our customer lines to line-splitting arrangements rather than line-sharing arrangements because we generally do not pay a fee to our partners for access to the high-frequency portion of the phone line used to provide our services in our line-splitting arrangements.

As discussed in the "Overview – Triennial Review," there is uncertainty concerning our ability to purchase line-shared services from the traditional telephone companies as a result of the FCC's Triennial Review decision. As a result of those legal and regulatory proceedings, it is possible that the traditional telephone companies could substantially increase the cost or reduce the availability of line-shared services, which would substantially increase our overall network cost structure and might cause us to discontinue our consumer grade services for new and existing customers.

Sales, Marketing, General and Administrative Expenses

Sales, marketing, general and administrative expenses consist primarily of salaries and related expenses and our promotional and advertising expenses.

Our sales, marketing, general and administrative expenses were as follows:

	Year ended December 31,		
	2003	2002	2001
Amount	$ 132,431	$ 150,373	$ 199,908
Percent of net revenue	34.1%	39.2%	60.1%

We reduced our sales, marketing, general and administrative workforce in all periods, which contributed to a reduction in our expenses. In addition, for the year ended December 31, 2003, we reduced our advertising expense by $19,433. The decrease in sales, marketing, general and administrative expenses for the year ended December 31, 2003 was partially offset by charges of $1,236 for additional stock-based compensation and $3,796 for the potential applicability of employment-related taxes related to certain stock-based compensation provided to employees in prior periods.

The decrease in sales, marketing, general and administrative expenses for the year ended December 31, 2002 is also partially attributable to the deconsolidation of our BlueStar subsidiary, which was effective June 25, 2001. We incurred no sales, marketing, general and administrative expenses related to BlueStar for the year ended December 31, 2002 as compared to $11,510 for the year ended December 31, 2001. Sales, marketing, general and administrative expenses for the year ended December 31, 2002 include a reduction of amortization expense related to non-cash deferred stock-based compensation in the amount of $3,074. For the year ended December 31, 2002, the decrease in sales, marketing, general and administrative expenses was offset by an increase of approximately $10,616 in advertising expenses attributable to our radio, television and other various media marketing and advertising programs related to our "Popularizing Broadband" campaign, which we launched on September of 2002.

We expect sales, marketing, general and administrative expense levels to remain relatively unchanged. We plan to incur additional advertising expenses to support sales of business-grade services and our anticipated deployment of VoIP services in the second half of 2004. We plan that these increased advertising expenses will be offset by other cost-saving measures.

Depreciation and Amortization

Depreciation and amortization of property and equipment was $56,559, $112,438 and $137,920 for the years ended December 31, 2003, 2002 and 2001, respectively. The decrease in 2003 and 2002 was due principally to asset retirements and certain assets becoming fully depreciated during 2002 and 2003. As a result of increased capital expenditures in 2003 to support additional end-users, and anticipated expenditures in 2004 to add capabilities to our network and expand coverage to an additional 200 central office locations, we expect depreciation and amortization to increase.

Amortization of intangible assets was $17,325, $14,650 and $12,919 for the years ended December 31, 2003, 2002 and 2001, respectively. The increase in amortization of intangible assets in 2003 and 2002 resulted from the resumption of our network build for selected markets during 2003 and 2002, which increased collocation fee expenditures and related amortization expenses. We expect amortization of intangible assets to continue to increase as a result of adding 200 central offices to our network in 2004.

Following the completion of our long-lived asset impairment analysis as of December 31, 2000, as discussed below, we also re-evaluated the remaining estimated useful lives of our long-lived assets, including intangibles. As a result, effective January 1, 2001, we reduced the remaining estimated useful lives of all long-lived assets, excluding buildings and leasehold improvements, that previously had estimated useful lives in excess of five years so that the residual balances and any subsequent additions are now depreciated or amortized over five years. This change in accounting estimate decreased our net income by $14,006, or $0.08 per share, in 2001.

We do not allocate depreciation and amortization expense to our business segments.

Provision for Restructuring Expenses

During the year ended December 31, 2003, we reduced our workforce by approximately 113 employees, which represented approximately 10.3% of our workforce. The reductions covered employees in the areas of sales and marketing, operations and corporate functions. In connection with the reductions, we recorded restructuring expenses, consisting primarily of employee severance benefits, of $1,235 during the year ended December 31, 2003. While we do not currently plan to make any additional material reductions in force, business conditions may require additional reductions in future periods.

We recorded restructuring expenses aggregating $14,364 during the year ended December 31, 2001. These expenses consist principally of collocation and building lease termination costs that met the requirements for accrual in 2001. Of these expenses, $2,140 related to the BlueStar shutdown. We did not record any restructuring expenses during 2002. We continuously evaluate and consider whether additional restructuring is necessary, consequently, additional charges to operations related to any further restructuring activities may be incurred in future periods.

Provision for Long-lived Asset Impairment

During the year ended December 31, 2001, we recorded a charge in the amount of $11,988 for the impairment of certain long-lived assets. In the fourth quarter of 2001, we made a decision to sell our Manassas, Virginia facility, including land, a building and certain furniture and fixtures. In March 2002, we entered into a non-binding agreement with a third party to sell this property for less than its book value. The sale of our Manassas facility resulted in a write-down of this property in the amount of $9,999. We also recorded a write-down of goodwill in the amount of $1,989 during 2001 associated with our BlueStar subsidiary.

Litigation-related Expenses

We recorded a credit to litigation-related expenses of $11,628 for the year ended December 31, 2002. The credit represents the non-cash valuation adjustment for the change in value of the 6,495,844 shares of common stock that will ultimately be distributed pursuant to the Memorandum of Understanding described in Note 10 to our consolidated financial statements. We recorded litigation-related expenses of $31,160 for the year ended December 31, 2001, including a cash payment of $5,359 and a non-cash charge of $25,801 for the value of 9,328,334 shares of common stock that either were issued in 2001 or will ultimately be issued, as described above. We did not recognize similar charges or credits for the year ended December 31, 2003.

Other Income (Expense)

NET INTEREST EXPENSE Our net interest expense was $3,421, $459 and $68,189 for the years ended December 31, 2003, 2002 and 2001, respectively. Net interest expense during the years ended December 31, 2003 and 2002 consisted principally of interest expense on our long-term note payable to SBC, which is further described below, less interest income earned on our cash, cash equivalents and short-term investments balances. Net interest expense during the year ended December 31, 2001 consisted primarily of interest expense on notes that were extinguished upon our emergence from our voluntary bankruptcy proceeding and capital lease obligations, less interest income earned on our cash, cash equivalents and short-term investments balances on hand during the years. For the year ended December 31, 2001, our contractual interest obligation on our notes was $142,356. During the year ended December 31, 2001, we completed a reorganization under Chapter 11 of the United States Bankruptcy Code. Under our Plan, we were able to extinguish approximately $1,394,020 in aggregate face amount of outstanding notes, including accrued interest, in exchange for a combination of approximately $271,708 in cash and 35,292,800 common shares, or 15% of the reorganized company. As a result of the extinguishment, we did not recognize contractual interest expense of $49,574 for the year ended December 31, 2001 on these notes.

As described above, upon our emergence from Chapter 11 bankruptcy on December 20, 2001 (see Note 3 to our consolidated financial statements – Reorganization Under Bankruptcy Protection – for additional information), we entered into a series of new agreements with SBC (see Note 11 to our consolidated financial statements – Stockholders' Equity (Deficit) – for additional information). One such agreement, the Credit Agreement, involves a term note that is collateralized by substantially all of our domestic assets. This note bears interest at 11%, which is payable quarterly beginning in December 2003. The entire unpaid principal balance is payable in December 2005. We have the right to prepay the principal amount of the note, in whole or in part, at any time without penalty.

Our current net interest expense is limited to accrued interest on our 11% note payable to SBC offset by interest earned on cash balances. We may, however, seek additional debt financing if it is available on terms that we believe are favorable. If we seek additional debt financing our interest expense may increase.

REORGANIZATION ITEMS During the year ended December 31, 2001, we recognized expenses directly associated with our Chapter 11 bankruptcy proceeding in the amount of $62,620.

These reorganization expenses consisted of non-cash adjustments to unamortized debt issuance costs and discounts and professional fees for legal and financial advisory services.

INVESTMENT LOSSES We recorded losses and write-downs on investments for the year ended December 31, 2003 in the amount of $1,026. This included impairment write-downs of equity investments of $747 and our equity in the losses of unconsolidated affiliates of $279. We recorded losses and write-downs on investments for the year ended December 31, 2002 in the amount of $1,847. This included a net realized loss on short-term investments of $17, an impairment write-down of an equity investment of $388, our equity in the losses of unconsolidated affiliates of $806 and a net realized loss on the sale of certain investments in unconsolidated affiliates of $636. We recorded losses and write-downs on investments for the year ended December 31, 2001 in the amount of $19,062. This included impairment write-downs of equity investments of $10,069, our equity in the losses of unconsolidated affiliates of $13,769, the recognition of other than temporary losses on short-term investments of $1,311, a net realized gain on short-term investments of $5,909 and a net realized gain on the sale of an investment in an unconsolidated affiliate of $178.

MISCELLANEOUS INCOME AND EXPENSES We recorded miscellaneous income for the year ended December 31, 2003 in the amount of $6,715. Included in this amount are $5,606 of royalty payments received from a license agreement on our OSS software, $5,000 of which was received as a result of an amendment to the license agreement that resulted in the acceleration of a payment that was originally scheduled to be received in 2005. The remaining balance included in miscellaneous income is primarily comprised of trade purchase discounts. We recorded miscellaneous expenses for the years ended December 31, 2002 and 2001 in the amount of $1,530 and $2,218, respectively. These amounts are primarily comprised of losses on the disposition of certain of our fixed assets.

GAIN ON EXTINGUISHMENT OF DEBT We recorded a gain on extinguishment of debt in the amount of $1,033,727 for the year ended December 31, 2001. See Note 3 to our consolidated financial statements – Reorganization Under Bankruptcy Proceedings – for additional information.

Income Taxes

We made no provision for income taxes in any period presented in the accompanying consolidated financial statements because we incurred operating losses in each of these periods. In addition, we made no provision for income taxes on the gain resulting from the extinguishment of debt in 2001 due to the relevant tax regulations governing the treatment of debt extinguishment income in Chapter 11 bankruptcy proceedings. As of December 31, 2003, we had net operating loss carryforwards for federal tax purposes of approximately $761,000, which will begin to expire in 2022, if not utilized. As a result of the Company emerging from bankruptcy, the federal operating loss carryforwards have been reduced by approximately $995,000 in 2001. We also had aggregate net operating loss carryforwards for state income tax purposes of approximately $1,221,000, of which $14,856 will expire in 2004, $122,832 will expire in 2005, and $1,083,312 will expire through 2022, if not utilized. In addition, we had capital loss carryforwards for federal and state income tax purposes of approximately $42,000, which will begin to expire in 2006.

The utilization of the Company's net operating loss may be subject to substantial annual limitation due to the "change in ownership" provisions of the Internal Revenue Code of 1986, as amended, and similar state provisions. The annual limitation may result in the expiration of net operating losses and tax credits before utilization.

Realization of our deferred tax assets relating to net operating loss carryforwards and other temporary differences is dependent upon future earnings, the timing and amount of which are uncertain. Accordingly, our net deferred tax assets have been fully offset by a valuation allowance. The valuation allowance increased (decreased) by $39,071, $129,529 and $(145,941) during the years ended December 31, 2003, 2002 and 2001, respectively.

Quarterly Financial Information (Unaudited)

The Company's 2003 and 2002 unaudited condensed consolidated quarterly financial information is as follows:

	Three months ended			
	March 31	June 30	September 30	December 31
2003:				
Revenues, net	$ 90,860	$ 92,445	$ 100,507	$ 105,039
Network and product costs	$ 68,877	$ 68,632	$ 74,052	$ 71,840
Sales, marketing, general and administrative	$ 36,895	$ 31,791	$ 32,510	$ 31,235
Loss from operations	$ (34,330)	$ (26,194)	$ (23,876)	$ (17,799)
Net loss	$ (34,722)	$ (27,287)	$ (25,143)	$ (12,779)
Basic and diluted net loss per share	$ (0.16)	$ (0.12)	$ (0.11)	$ (0.06)

	Three months ended			
	March 31	June 30	September 30	December 31
2002:				
Revenues, net	$ 101,666	$ 97,733	$ 96,206	$ 87,891
Network and product costs	$ 90,194	$ 76,262	$ 69,546	$ 62,334
Sales, marketing, general and administrative	$ 37,204	$ 33,833	$ 41,173	$ 38,163
Loss from operations	$ (56,374)	$ (39,524)	$ (51,864)	$ (33,230)
Net loss	$ (56,839)	$ (40,793)	$ (51,707)	$ (35,489)
Basic and diluted net loss per share	$ (0.26)	$ (0.19)	$ (0.23)	$ (0.16)

During the year ended December 31, 2003, a matter was identified related to prior financial reporting periods that necessitated the recording of additional expense. Such matter was related to the modification of stock options granted to certain employees in prior years. These modifications occurred upon the separation of such employees from our Company, principally during 2000. Accordingly, for the year ended December 31, 2003, we recorded additional stock-based compensation expense in the amount of $1,236 ($0.01 per share). Such amount is reflected in our sales, marketing, general and administrative expenses for the year ended December 31, 2003. We do not believe this amount is material to the periods in which it should have been recorded, nor do we believe it is material to our consolidated operating results for the year ended December 31, 2003. This adjustment is principally related to 2000, the impact of which would have been to increase sales, marketing, general and administrative expenses and net loss by $1,236 ($0.01 per share) for such year. As explained below, certain other adjustments were recorded during 2002 that related to prior periods. $1,139 of such amounts pertained to 2000, the effect of which would have been to decrease our 2000 net loss by $0.01 per share. The aggregate effect of the adjustments recorded during the years ended December 31, 2003 and 2002 to the previously reported results of operations for the year ended December 31, 2000 would be to increase net loss by $97, or $0.00 per share, for such year if these adjustments had been recorded in 2000.

As part of the continuing evaluation of our network assets during the third and fourth quarters of 2002, certain matters were identified related to prior financial reporting periods that necessitated the recording of adjustments to certain expenses. Such matters were related principally to (i) changes in our network configuration, which necessitated reductions of the remaining estimated useful lives of certain network equipment, (ii) the capitalization of certain network and product costs that should have been charged to operating expenses when they were incurred and (iii) various restructuring activities that resulted in the abandonment of certain network equipment and leasehold improvements. Accordingly, for the three months ended September 30, 2002, we recorded additional (i) depreciation expense of $9,584 and (ii) network and product costs of $1,215. During the three months ended December 31, 2002, we reduced depreciation expense by $1,306 and recorded additional (i) network and product costs of $1,930, (ii) loss on the disposition of property and equipment of $863 and (iii) interest expense of $75 as a result of this continuing evaluation. In addition, as part of our financial statement close process for the fourth quarter of 2002, we discovered that we had overstated our non-cash amortization expense relating to deferred stock-based compensation in prior periods by $3,745. Therefore, we recorded reductions of (i) network and product costs of $671 and (ii) sales, marketing, general and administrative expense of $3,074 during the three months ended December 31, 2002. Furthermore, as part of the review of our December 31, 2002 tax accruals, we determined that we had overstated our transaction-based tax and other tax accruals in prior periods by $5,291, which we adjusted during the three months ended December 31, 2002 through a reduction of network and product costs of $5,122 and a reduction of sales, marketing, general and administrative expenses of $169. The adjustment was primarily driven by various complex rules surrounding our estimated liability to the Federal Universal Service Fund. We do not believe any of the aforementioned amounts are material to the periods in which they should have been recorded, nor do we believe the prospective correction of such amounts during the year ended December 31, 2002 is material to our consolidated operating results for such year. The impact on prior financial reporting periods in 2003 and 2002 would have been as follows if the amounts described above had been recorded in the proper financial reporting periods:

	Three Months Ended March 31	June 30	September 30	December 31	Year Ended December 31
2003:					
Net loss, as reported	$ (34,722)	$ (27,287)	$ (25,143)	$ (12,779)	$ (99,931)
Effect of prospectively correcting certain differences relating to prior periods, which is included in net loss, as reported	—	1,236	—	—	1,236
Net loss, net of effect of prospectively correcting certain differences relating to prior periods	$ (34,722)	$ (26,051)	$ (25,143)	$ (12,779)	$ (98,695)
Net loss per share, as reported	$ (0.16)	$ (0.12)	$ (0.11)	$ (0.06)	$ (0.45)
Effect of prospectively correcting certain differences relating to prior periods, which is included in net loss per share, as reported	—	0.01	—	—	0.01
Net loss per share, net of effect of prospectively correcting certain differences relating to prior periods	$ (0.16)	$ (0.11)	$ (0.11)	$ (0.06)	$ (0.44)

	Three Months Ended March 31	June 30	September 30	December 31	Year Ended December 31
2002:					
Net loss, as reported	$ (56,839)	$ (40,793)	$ (51,707)	$ (35,489)	$ (184,828)
Effect of prospectively correcting certain differences relating to prior periods, which is included in net loss, as reported	—	—	10,799	(7,474)	3,325
Effect of unadjusted differences	(1,186)	(1,231)	1,386	—	(1,031)
Net loss, had unadjusted differences been recorded, net of effect of prospectively correcting certain differences relating to prior periods	$ (58,025)	$ (42,024)	$ (39,522)	$ (42,963)	$ (182,534)
Net loss per share, as reported	$ (0.26)	$ (0.19)	$ (0.23)	$ (0.16)	$ (0.84)
Effect of prospectively correcting certain differences relating to prior periods, which is included in net loss per share, as reported	—	—	0.04	(0.03)	0.01
Effect of unadjusted differences	(0.01)	(0.01)	0.01	—	(0.01)
Net loss per share, had unadjusted differences been recorded, net of effect of prospectively correcting certain differences relating to prior periods	$ (0.27)	$ (0.20)	$ (0.18)	$ (0.19)	$ (0.84)

Related Party Transactions

Our former Vice-chairman and former interim Chief Executive Officer, Frank Marshall, who was also a member of our Board of Directors from October 1997 to December 2002, was a minority stockholder and former member of the board of directors of one of our former ISP customers, InternetConnect, which filed for bankruptcy protection in 2001. On January 3, 2002, we purchased substantially all of the assets of InternetConnect in an auction supervised by the United States Bankruptcy Court for the Central District of California for $5,470 in cash, and we may be required to pay additional cash of up to $1,880 for the assets of InternetConnect, depending upon the outcome of a previous post-petition bankruptcy claim filed by us against InternetConnect. That claim is still unresolved. We did not assume any liabilities or obligations of InternetConnect or hire any of InternetConnect's employees.

We acquired an equity interest in a supplier during 1999 and disposed of this interest in 2001. Purchases from this supplier totaled $8,346, $5,774 and $13,928 for the years ended December 31, 2003, 2002 and 2001, respectively. We also purchased certain products from a company in which Mr. Marshall serves as a director. Purchases from this vendor totaled $269, $258 and $140 during the years ended December 31, 2003, 2002 and 2001, respectively.

A member of our Board of Directors, Richard Jalkut, is the President and CEO of TelePacific, one of our resellers. We recognized revenues from TelePacific of $611, $1,311 and $1,822 for the years ended December 31, 2003, 2002 and 2001, respectively.

L. Dale Crandall, one of our Directors, is also a director of BEA Systems, one of our vendors. We paid $2,232, $121 and $214 to BEA Systems during the years ended December 31, 2003, 2002 and 2001, respectively.

We believe the terms of these transactions are comparable to transactions that would likely be negotiated with clearly independent parties.

Liquidity and Capital Resources

Our operations have required substantial capital investment for the procurement, design and construction of our central office collocation facilities, the design, creation, implementation and maintenance of our internal support system infrastructure, the purchase of telecommunications equipment and the design, development and maintenance of our networks. Capital expenditures were $59,031 for the year ended December 31, 2003. This included $3,750 of expenditures in connection with our acquisition of a customer list from Qwest.

We expect to incur $7,833 in capital expenditures for the purchase of additional equipment for the 200 central offices we plan to add to our network in 2004. Even with these expenditures, we do not anticipate a significant change in our capital expenditures for 2004. However, if we do not add end-users to our network at the rate that we anticipate capital expenditures will be lower in comparison to 2003. If we add more end-users than we anticipate, our capital expenditures related to the new end-users will increase in comparison with 2004.

From our inception through December 31, 2003, we have financed our operations primarily through private placements of $220,600 of equity securities, $1,282,000 in net proceeds raised from the issuance of notes, including our agreement with SBC for a $50,000 note payable, a $75,000 collateralized deposit from SBC and $719,000 in net proceeds raised from public equity offerings. As of December 31, 2003, we had an accumulated deficit of $1,629,267, and unrestricted cash, cash equivalents, and short-term investments of $114,345. In addition, we had a stockholders' deficit as of December 31, 2003 of $5,553 and current liabilities of $114,317.

Net cash used in our operating activities was $45,553 for the year ended December 31, 2003, in comparison with $76,042 in net cash used in our operating activities for the year ended December 31, 2002. The net cash used in our operating activities during 2003 was primarily due to the net loss of $99,931, a decrease in collateralized customer deposits of $7,933, and a decrease in unearned revenues of $12,089, offset by depreciation and amortization charges of $73,884, a decrease in deferred costs of service activation of $8,800, an increase in accounts payable of $2,067, and miscellaneous income from the recovery of certain internal-use licensed software costs of $5,606.

Net cash provided by our investing activities was $8,508 for the year ended December 31, 2003. The net cash provided by our investing activities during this period was primarily due to purchases of short-term investments of $131,903 and capital expenditures of $59,031, offset by maturities of short-term investments of $191,894 and the recovery of internal-use software costs of $7,345.

Net cash provided by our financing activities was $8,005 for the year ended December 31, 2003. The net cash provided by our financing activities during this period resulted from purchases of our common stock by our employees under our stock purchase plan and stock option plan totaling $8,170, offset by principal payments under capital lease obligations of $165.

As of December 31, 2003, we had $65,376 in unrestricted cash and cash equivalents and $48,969 in unrestricted short-term investments. We expect to experience negative cash flow from operating and investing activities into 2004 until we add enough end-users to our network to cover the fixed cost of maintaining our network and pay for our sales, marketing, general and administrative expenses. Our future cash requirements for developing, deploying and enhancing our network and operating our business, as well as our revenues, will depend on a number of factors including:

- the effect of the FCC's Triennial Review order, our continuing ability to access line-shared telephone wires and other traditional telephone company facilities at reasonable prices;
- the deployment of local voice services by providers other than the traditional telephone companies and our ability to bundle our data services with the voice services of these alternative providers;
- the rate at which wholesalers and end-users purchase and pay for our services and the pricing of such services;
- the financial condition of our customers;
- the level of marketing required to acquire and retain customers and to continue to maintain a competitive position in the marketplace;
- the rate at which we invest in engineering, development and intellectual property with respect to existing and future technology;
- the operational costs that we incur to install, maintain and repair end-user lines and our network as a whole;
- pending and any future litigation;
- network development schedules and associated costs; and
- the number of regions entered, the timing of entry and services offered.

In addition, we may wish to selectively pursue possible acquisitions of, or investments in businesses, technologies or products complementary to ours in order to expand our geographic presence, broaden our product and service offerings and achieve operating efficiencies. We may not have sufficient liquidity, or we may be unable to obtain additional financing on favorable terms or at all, in order to finance such an acquisition or investment.

Our contractual debt, lease and purchase obligations as of December 31, 2003 for the next five years, and thereafter, were as follows:

	2004	2005-2006	2007-2008	Thereafter	Total
Note payable to SBC	$ —	$ 50,000	$ —	$ —	$ 50,000
Office leases	4,696	6,087	3,355	269	14,407
Other operating leases	303	209	—	—	512
Purchase obligations	20,665	4,475	—	—	25,140
	$ 25,664	$ 60,771	$ 3,355	$ 269	$ 90,059

We lease certain vehicles, equipment and office facilities under various noncancelable operating leases that expire at various dates through 2009. The facility leases generally require us to pay operating costs, including property taxes, insurance and maintenance, and contain scheduled rent increases and certain other rent escalation clauses. Rent expense is reflected in our consolidated financial statements on a straight-line basis over the terms of the respective leases.

In 2002, we entered into a three-year, non-exclusive agreement with MCI, for the right to provide certain network services to us. We have a monthly minimum usage requirement which began in June 2002. The agreement expires in May 2005 and has a minimum remaining aggregate purchase obligation of $11,390 as of December 31, 2003. Similarly, in 2002 and we entered into a three-year, non-exclusive agreement with AT&T for the right to provide certain data services to us. We have an annual minimum usage requirement which began in January 2002. The agreement expires in December 2004 and we have a minimum remaining aggregate purchase obligation of approximately $11,500 as of December 31, 2003. In addition, in 2002, we entered into a four-year, non-exclusive agreement with AT&T for the right to provide long-distance services to us. We have an annual minimum usage requirement which began in April 2002. The agreement expires in March 2006 and has a minimum remaining aggregate usage commitment of approximately $2,250 as of December 31, 2003.

We have in the past described our expectation of attaining cash flow sufficiency in mid-2004. Nonetheless, adverse business, legal, regulatory or legislative developments, such as the inability to continue line-sharing, may require us to raise additional financing, raise our prices or substantially decrease our cost structure. We also recognize that we may not be able to raise additional capital. If we are unable to acquire additional capital on favorable terms if needed, or are required to raise it on terms that are less satisfactory than we desire, our financial condition will be adversely affected.

Our 2004 business plan includes certain discretionary spending that is based on several assumptions, including growth of our subscriber base with a reasonable per subscriber profit margin and improvements in productivity. If necessarily, we will curtail this discretionary spending so that we can continue as a going concern at least through December 31, 2004 using only our unrestricted cash, cash equivalent and short term investment balances in existence as of December 31, 2003.

Forward-Looking Statements

We include certain estimates, projections, and other forward-looking statements in our reports, in presentations to analysts and others, and in other publicly available material. Future performance cannot be ensured. Actual results may differ materially from those in forward-looking statements. The statements contained in this Annual Report that are not historical facts are "forward-looking statements" *(as such term is defined in Section 27A of the Securities Act and Section 21E of the Exchange Act)*, which can be identified by the use of forward-looking terminology such as "estimates," "projects," "anticipates," "expects," "intends," "believes," or the negative thereof or other variations thereon or comparable terminology, or by discussions of strategy that involve risks and uncertainties. Examples of such forward-looking statements include but are not limited to:

- the impact of the FCC's decision in the Triennial Review and our ability to obtain access to line-sharing at rates that allow us to sell consumer-grade services to new customers;
- expectations regarding the continuing deployment of local voice services by providers other than the traditional telephone companies and our ability to bundle our data services with the voice services of these alternative providers;
- expectations regarding our ability to become cash-flow positive;
- expectations regarding the extent to which customers purchase our services;
- expectations regarding our relationships with our strategic partners and other potential third parties;
- expectations as to pricing for our services in the future;
- expectations regarding our margins on our service offerings;
- the possibility that we will increase our revenues;
- plans to make strategic investments and acquisitions and the effect of such investments and acquisitions;
- estimates and expectations of future operating results, including expectations regarding when we anticipate operating on a cash flow positive basis, the adequacy of our cash reserves, our monthly cash burn rate and the number of installed lines;
- plans to develop and commercialize value-added services, like Voice over Internet Protocol;
- our anticipated capital expenditures;
- plans to enter into business arrangements with broadband-related service providers;
- the effect of regulatory changes;
- the effect of litigation currently pending; and
- other statements contained in this Annual Report regarding matters that are not historical facts.

These statements are only estimates or predictions and cannot be relied upon. We can give you no assurance that future results will be achieved. Actual events or results may differ materially as a result of risks facing us or actual results differing from the assumptions underlying such statements. Such risks and assumptions that could cause actual results to vary materially from the future results indicated, expressed or implied in such forward-looking statements include our ability to:

- adapt our business plan in response to further developments resulting from the FCC's Triennial Review order;
- collect receivables from customers;
- retain end-users that are served by customers facing financial difficulties;
- successfully market our services to customers;
- generate customer demand for our services;
- successfully defend our company against litigation;
- successfully reduce our operating costs and overhead while continuing to provide good customer service;
- successfully continue to increase the number of business-grade lines;
- achieve favorable pricing for our services;
- respond to increasing competition;
- manage growth of our operations; and
- access regions and negotiate suitable interconnection agreements with the traditional telephone companies in the areas where we provide service, all in a timely manner, at reasonable costs and on satisfactory terms that provide us with access to line-sharing and remote terminals.

All written and oral forward-looking statements made in connection with this Annual Report which are attributable to us or persons acting on our behalf are expressly qualified in their entirety by the "Part I, Item 1. Business – Risk Factors" and other cautionary statements included in our Annual Report on Form 10-K. We disclaim any obligation to update information contained in any forward-looking statement.

Quantitative and Qualitative Disclosures About Market Risk

Our exposure to financial market risk, including changes in interest and marketable equity security prices, relates primarily to our investment portfolio and outstanding debt obligations. We typically do not attempt to reduce or eliminate our market exposure on our investment securities because a substantial majority of our investments are in fixed-rate, short-term securities. We do not have any derivative instruments. The fair value of our investment portfolio or related income would not be significantly impacted by either a 100 basis point increase or decrease in interest rates due mainly to the fixed-rate, short-term nature of the substantial majority of our investment portfolio. In addition, all of our outstanding indebtedness as of December 31, 2003 is fixed-rate debt.

Report of Ernst & Young LLP, Independent Auditors

The Board of Directors and Stockholders
Covad Communications Group, Inc.

We have audited the accompanying consolidated balance sheets of Covad Communications Group, Inc. as of December 31, 2003 and 2002, and the related consolidated statements of operations, stockholders' equity (deficit), and cash flows for each of the three years in the period ended December 31, 2003. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Covad Communications Group, Inc. at December 31, 2003 and 2002, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2003, in conformity with accounting principles generally accepted in the United States.

Ernst + Young LLP

Walnut Creek, California
February 12, 2004

Consolidated Balance Sheets

(AMOUNTS IN THOUSANDS, EXCEPT SHARE AND PER SHARE AMOUNTS)

	December 31, 2003	December 31, 2002
Assets		
Current assets:		
Cash and cash equivalents	$ 65,376	$ 94,416
Short-term investments	48,969	108,076
Restricted cash and cash equivalents	2,892	2,576
Accounts receivable, net of allowances of $4,951 at December 31, 2003 ($5,388 at December 31, 2002)	28,528	21,746
Unbilled revenues	5,127	3,921
Other receivables	637	1,385
Inventories	5,335	5,096
Prepaid expenses and other current assets	3,761	5,524
Total current assets	160,625	242,740
Property and equipment, net	94,279	108,737
Collocation fees and other intangible assets, net of accumulated amortization of $49,698 at December 31, 2003 ($32,372 at December 31, 2002)	40,848	43,284
Investments in unconsolidated affiliates	—	1,026
Deferred costs of service activation	31,486	40,286
Deferred customer incentives	4,431	3,540
Other long-term assets	3,042	2,548
TOTAL ASSETS	$ 334,711	$ 442,161
Liabilities and stockholders' equity (deficit)		
Current Liabilities:		
Accounts payable	12,982	10,915
Accrued compensation	21,661	12,774
Current portion of capital lease obligations	—	165
Accrued collocation and network service fees	18,714	16,537
Accrued transaction-based taxes	35,268	45,426
Accrued interest	5,683	5,683
Accrued market development funds and customer incentives	7,024	6,422
Unresolved claims related to bankruptcy proceedings	7,378	7,381
Other accrued liabilities	5,607	8,581
Total current liabilities	114,317	113,884
Long-term debt	50,000	50,000
Collateralized customer deposit	60,258	68,191
Deferred gain resulting from deconsolidation of subsidiary	53,963	53,972
Unearned revenues	61,726	73,815
TOTAL LIABILITIES	340,264	359,862
Commitments and contingencies		
Stockholders' Equity (Deficit):		
Preferred stock, $0.001 par value; 5,000,000 shares authorized; no shares issued and outstanding at December 31, 2003 and 2002	—	—
Common stock, $0.001 par value; 590,000,000 shares authorized; 230,163,012 shares issued and outstanding at December 31, 2003 (223,182,511 shares issued and outstanding at December 31, 2002)	230	223
Common stock – Class B, $0.001 par value; 10,000,000 shares authorized; no shares issued and outstanding at December 31, 2003 and 2002	—	—
Additional paid-in capital	1,624,489	1,612,319
Deferred stock-based compensation	(52)	(160)
Accumulated other comprehensive loss	(953)	(747)
Accumulated deficit	(1,629,267)	(1,529,336)
Total stockholders' equity (deficit)	(5,553)	82,299
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)	$ 334,711	$ 442,161

See accompanying notes.

Consolidated Statements of Operations

(AMOUNTS IN THOUSANDS, EXCEPT SHARE AND PER SHARE AMOUNTS)

	Year ended December 31,		
	2003	2002	2001
Revenues, net	$ 388,851	$ 383,496	$ 332,596
Operating expenses:			
Network and product costs	283,401	298,336	461,875
Sales, marketing, general and administrative	132,431	150,373	199,908
Provision for bad debts (bad debt recoveries)	99	319	(658)
Depreciation and amortization of property and equipment	56,559	112,438	137,920
Amortization of intangible assets	17,325	14,650	12,919
Provision for restructuring expenses	1,235	—	14,364
Provision for long-lived asset impairment	—	—	11,988
Litigation-related expenses, net	—	(11,628)	31,160
TOTAL OPERATING EXPENSES	491,050	564,488	869,476
Loss from operations	(102,199)	(180,992)	(536,880)
Other income (expense):			
Interest income	2,105	5,122	24,593
Realized gain (loss) on short-term investments	—	(17)	5,909
Other than temporary losses on short-term investments	—	—	(1,311)
Provision for impairment of investments in unconsolidated affiliates	(747)	(388)	(10,069)
Equity in losses of unconsolidated affiliates	(279)	(806)	(13,769)
Gain (loss) on disposal of investments in unconsolidated affiliates	—	(636)	178
Interest expense (contractual interest expense was $142,356 during the year ended December 31, 2001)	(5,526)	(5,581)	(92,782)
Miscellaneous income (expense), net	6,715	(1,530)	(2,218)
Reorganization expenses, net	—	—	(62,620)
Gain on extinguishment of debt	—	—	1,033,727
Other income (expense), net	2,268	(3,836)	881,638
NET INCOME (LOSS)	$ (99,931)	$ (184,828)	$ 344,758
Basic and diluted per share amounts:			
NET INCOME (LOSS)	$ (0.44)	$ (0.84)	$ 1.94
Weighted average common shares used in computing basic and diluted per share amounts	224,949,891	219,743,662	177,347,193

See accompanying notes.

Consolidated Statements of Stockholders' Equity (deficit)

(AMOUNTS IN THOUSANDS, EXCEPT SHARE AND PER SHARE AMOUNTS)

	Preferred Stock		Common Stock	
	Shares	Amount	Shares	Amount
Balances at December 31, 2000	—	$ —	171,937,452	$ 172
Issuance of common stock	—	—	1,010,000	1
Issuance of common stock upon exercise of options	—	—	4,100,979	4
Repurchase of common stock	—	—	(67,500)	—
Issuance of common stock upon emergence from Chapter 11 bankruptcy	—	—	37,292,800	37
Deconsolidation of subsidiary	—	—	—	—
Stock-based compensation	—	—	—	—
Issuance of common stock for business acquisition	—	—	2,268,481	2
Reversal of deferred stock-based compensation	—	—	—	—
Amortization of deferred stock-based compensation	—	—	—	—
Unrealized losses on available-for-sale securities	—	—	—	—
Foreign currency translation	—	—	—	—
Net income	—	—	—	—
Balances at December 31, 2001	—	—	216,542,212	216
Issuance of common stock	—	—	5,417,251	6
Issuance of common stock upon exercise of options	—	—	1,005,937	1
Issuance of common stock following emergence from Chapter 11 bankruptcy	—	—	217,111	—
Issuance of warrants	—	—	—	—
Stock-based compensation	—	—	—	—
Deferred stock-based compensation	—	—	—	—
Amortization (reversal) of deferred stock-based compensation	—	—	—	—
Unrealized losses on available-for-sale securities	—	—	—	—
Foreign currency translation	—	—	—	—
Net loss	—	—	—	—
Balances at December 31, 2002	—	—	223,182,511	223
Issuance of common stock	—	—	1,996,222	2
Issuance of common stock upon exercise of options	—	—	4,984,279	5
Issuance of warrants	—	—	—	—
Stock-based compensation	—	—	—	—
Amortization (reversal) of deferred stock-based compensation	—	—	—	—
Unrealized losses on available-for-sale securities	—	—	—	—
Net loss	—	—	—	—
BALANCES AT DECEMBER 31, 2003	—	$ —	230,163,012	$ 230

See accompanying notes.

	Additional Paid-In Capital	Deferred Stock-Based Compensation	Notes Receivable From Stockholders	Accumulated Other Comprehensive Income (Loss)	Accumulated Deficit	Total Stockholders' Equity (Deficit)
	$ 1,509,365	**$ (3,067)**	**$ (423)**	**$ 556**	**$ (1,689,266)**	**$ (182,663)**
	579	—	—	—	—	580
	2,109	—	—	—	—	2,113
	(172)	—	—	—	—	(172)
	93,568	—	—	—	—	93,605
	—	—	423	—	—	423
	439	—	—	—	—	439
	2,062	—	—	—	—	2,064
	(1,213)	1,213	—	—	—	—
	—	1,597	—	—	—	1,597
	—	—	—	(2,327)	—	(2,327)
	—	—	—	(588)	—	(588)
	—	—	—	—	344,758	344,758
	1,606,737	**(257)**	**—**	**(2,359)**	**(1,344,508)**	**259,829**
	4,303	—	—	—	—	4,309
	398	—	—	—	—	399
	261	—	—	—	—	261
	3,790	—	—	—	—	3,790
	285	—	—	—	—	285
	290	(290)	—	—	—	—
	(3,745)	387	—	—	—	(3,358)
	—	—	—	270	—	270
	—	—	—	1,342	—	1,342
	—	—	—	—	(184,828)	(184,828)
	1,612,319	**(160)**	**—**	**(747)**	**(1,529,336)**	**82,299**
	1,721	—	—	—	—	1,723
	6,453	—	—	—	—	6,458
	2,640	—	—	—	—	2,640
	1,356	—	—	—	—	1,356
	—	108	—	—	—	108
	—	—	—	(206)	—	(206)
	—	—	—	—	(99,931)	(99,931)
	$ 1,624,489	$ (52)	$ —	$ (953)	$ (1,629,267)	$ (5,553)

Consolidated Statements of Cash Flows

(AMOUNTS IN THOUSANDS)

	Year ended December 31, 2003	2002	2001
Operating Activities:			
Net income (loss)	$ (99,931)	$ (184,828)	$ 344,758
Adjustments to reconcile net income (loss) to net cash used in operating activities:			
Provision for bad debts (bad debt recoveries)	99	319	(658)
Depreciation and amortization	73,884	127,088	150,839
Loss on disposition of property and equipment	112	1,712	2,679
Non-cash reorganization expenses	—	—	42,856
Non-cash litigation-related expenses	—	(11,628)	25,801
Provision for long-lived asset impairment	—	—	11,988
Amortization (reversal) of deferred stock-based compensation, net	108	(3,358)	1,597
Other stock-based compensation	1,367	305	439
Other non-cash charges	1,749	803	—
Accretion of interest on investments	(1,090)	(209)	(7,136)
Accretion of debt discount and amortization of deferred debt issuance costs	—	—	20,845
Other than temporary losses on short-term investments	—	—	1,311
Provision for impairment of investments in unconsolidated affiliates	747	388	10,069
Equity in losses of unconsolidated affiliates	279	806	13,769
Miscellaneous income from internal-use software license royalties	(5,606)	—	—
(Gain) loss on disposal of investment in unconsolidated affiliates	—	636	(178)
Gain on extinguishment of debt	—	—	(1,033,727)
Net changes in operating assets and liabilities:			
Restricted cash and cash equivalents	(316)	6,627	(9,103)
Accounts receivable	(6,881)	1,180	532
Unbilled revenues	(1,206)	1,043	2,282
Inventories	(239)	2,153	6,748
Prepaid expenses and other assets	1,995	4,159	3,163
Deferred costs of service activation	8,800	17,676	(5,131)
Accounts payable	2,067	(4,927)	(53,652)
Unresolved claims related to bankruptcy proceedings	(3)	(2,930)	22,200
Collateralized customer deposit	(7,933)	(6,809)	—
Accrued restructuring expenses	—	—	2,024
Other current liabilities	(1,466)	(1,366)	(22,291)
Unearned revenues	(12,089)	(24,882)	12,777
Net cash used in operating activities	(45,553)	(76,042)	(455,199)

See accompanying notes.

	Year ended December 31,					
		2003		2002		2001
Investing Activities:						
Cash relinquished as a result of deconsolidating a subsidiary		—		—		(1,599)
Purchase of short-term investments		(131,903)		(237,088)		(638,096)
Maturities of short-term investments		191,894		165,526		547,477
Sale of short-term investments		—		40,017		329,458
Redemption of restricted investments		—		—		26,875
Purchase of restricted investments in connection with bankruptcy proceedings		—		—		(257,202)
Redemption of restricted investments in connection with bankruptcy proceedings		—		—		270,698
Purchase of property and equipment		(44,142)		(22,782)		(15,732)
Proceeds from sale of property and equipment		181		13,451		1,280
Recovery of internal-use software costs		7,345		814		2,000
Payment of collocation fees and purchase of other intangible assets		(14,889)		(3,782)		(7,940)
Proceeds from sale of investments in unconsolidated affiliates		—		3,360		1,225
Decrease (increase) in other long-term assets		22		371		(206)
Net cash provided by (used in) investing activities		8,508		(40,113)		258,238
Financing Activities:						
Proceeds from collateralized customer deposit		—		—		75,000
Proceeds from issuance of long-term debt		—		—		50,000
Principal payments of long-term debt in connection with bankruptcy proceedings		—		—		(271,708)
Other principal payments of long-term debt		—		—		(8,393)
Principal payments under capital lease obligations		(165)		(328)		(1,089)
Proceeds from common stock issuance, net of repurchase		8,170		3,089		2,521
Net cash provided by (used in) financing activities		8,005		2,761		(153,669)
Net decrease in cash and cash equivalents		(29,040)		(113,394)		(350,630)
Cash and cash equivalents at beginning of year		94,416		207,810		558,440
Cash and cash equivalents at end of year	$	65,376	$	94,416	$	207,810
Supplemental Disclosures of Cash Flow Information:						
Cash paid during the year for interest	$	5,510	$	80	$	68,051
Supplemental Schedule of Non-Cash Investing and Financing Activities:						
Equipment purchased through capital leases	$	—	$	482	$	—

See accompanying notes.

1. Nature of Operations and Summary of Significant Accounting Policies

Organization, Business and Basis of Presentation

ORGANIZATION AND BUSINESS Covad Communications Group, Inc. ("Covad") is a provider of high-speed connectivity services. These services include a range of high-speed, high-capacity Internet and network access services utilizing digital subscriber line ("DSL") technology and related value-added services. Covad's high-speed connectivity services are sold to businesses and consumers directly and indirectly through Internet service providers ("ISPs"), enterprises, telecommunications carriers and other customers. These services are sold directly to business and consumer end-users through Covad's field sales force, telephone sales, third party referrals and Covad's Web site. ISPs purchase Covad's services in order to provide high-speed Internet access to their business and consumer end-users. Enterprise customers purchase services directly or indirectly from Covad to provide their employees with high-speed remote access to the enterprise's local area network. Other telecommunications carriers purchase Covad's services for resale to their ISP affiliates, Internet users and enterprise customers.

BASIS OF PRESENTATION The consolidated financial statements include the accounts of Covad and its wholly owned subsidiaries (collectively, the "Company"), except for the accounts of BlueStar Communications Group, Inc. and its wholly owned subsidiaries (collectively, "BlueStar"), which have been excluded from the Company's consolidated financial statements effective June 25, 2001 (Note 4). All significant intercompany accounts and transactions have been eliminated in consolidation.

The Company's 2004 business plan includes certain discretionary spending that is based on several assumptions, including growth of the Company's subscriber base with a reasonable per subscriber profit margin and improvements in productivity. If necessary, the Company will curtail this discretionary spending so that it can continue as a going concern at least through December 31, 2004 using only the Company's unrestricted cash, cash equivalent and short-term investment balances in existence as of December 31, 2003. Additionally, on August 21, 2003, the Federal Communications Commission ("FCC") issued its order in the Triennial Review of its rules for network unbundling obligations of Incumbent Local Exchange Carriers ("ILECs"). Among other things, that order will phase out the FCC rule requiring line-sharing over a three-year period. The ultimate impact of the Triennial Review order on the Company's business, which currently relies to a large extent on line-sharing to serve the Company's consumer end-users, will depend on the Company's ability to negotiate fair and reasonable prices substantially lower than the whole loop cost that will ultimately be permitted under the FCC's rules. The Company does not believe the FCC's revised unbundling rules will have a material adverse effect on the Company's ability to continue as a going concern at least through December 31, 2004, but the Company's operating results and financial condition may be adversely affected over time if the new rules result in substantially higher prices for access to the ILECs' telephone lines.

During the year ended December 31, 2003, a matter was identified related to prior financial reporting periods that necessitated the recording of additional expense. Such matter was related to the modification of stock options granted to certain employees in prior years. These modifications occurred upon the separation of such employees from the Company, principally during 2000. Accordingly, for the year ended December 31, 2003, the Company recorded additional stock-based compensation expense in the amount of $1,236 ($0.01 per share). Such amount is reflected in the Company's sales, marketing, general and administrative expenses for the year ended December 31, 2003. The Company does not believe this amount is material to the periods in which it should have been recorded, nor does it believe it is material to its consolidated operating results for the year ended December 31, 2003. This adjustment is principally related to 2000, the impact of which would have been to increase sales, marketing, general and administrative expenses and net loss by $1,236 ($0.01 per share) for such year. As explained below, certain other adjustments were recorded during 2002 that related to prior periods. $1,139 of such amounts pertained to 2000, the effect of which would have been to decrease the Company's 2000 net loss by $0.01 per share. The aggregate effect of the adjustments recorded during the year ended December 31, 2003 and 2002 to the previously reported results of operations for the year ended December 31, 2000 would be to increase net loss by $97, or $0.00 per share, for such year if these adjustments had been recorded in 2000.

As part of the Company's continuing evaluation of its network assets during the year ended December 31, 2002, certain matters were identified related to prior financial reporting periods that necessitated the recording of adjustments to certain expenses. Such matters were related principally to (i) changes in the Company's network configuration, which necessitated reductions of the remaining estimated useful lives of certain network equipment, (ii) the capitalization of certain network and product costs that should have been charged to operating expenses when they were incurred and (iii) various restructuring activities that resulted in the abandonment of certain network equipment and leasehold improvements. Accordingly, for the year ended December 31, 2002, the Company recorded additional (i) depreciation expense of $6,989 ($1,306 of which was recorded during the fourth quarter of 2002), (ii) network and product costs of $2,635 ($1,930 of which was recorded during the fourth quarter of 2002), (iii) loss on the disposition of property and equipment of $635 (all of which was recorded during the fourth quarter of 2002), and (iv) interest expense of $51 (all of which was recorded during the fourth quarter of 2002). In addition, as part of the Company's financial statement close process for the year ended December 31, 2002, the Company discovered that it had overstated its amortization expense relating to non-cash deferred stock-based compensation in prior periods by $3,213. Therefore, for the year ended December 31, 2002, the Company recorded reductions of (i) network and products costs of $320 (all of which was recorded during the fourth quarter of 2002) and (ii) sales, marketing, general and administrative expense of $2,893 (all of which was recorded during the fourth quarter of 2002). Furthermore, as part of the Company's review of its December 31, 2002 tax accruals, it determined that it had overstated its transaction-based tax and other tax accruals in prior periods by $4,804, which the Company adjusted during the year ended December 31, 2002 (all of which was recorded during the fourth quarter of 2002). The adjustment was primarily driven by various complex rules surrounding the Company's estimated liability to the Federal Universal Service Fund ("FUSF"). The Company does not believe any of the aforementioned amounts are material to the periods in which they should have been recorded, nor does it believe the prospective correction of such amounts during the year ended December 31, 2002 is material to its consolidated operating results for such year (the prospective correction of the aforementioned amounts relating to prior periods increased the Company's 2002 consolidated net loss by $2,294, or $0.01 per share, and decreased the Company's 2001 net loss by $3,433 or $0.02 per share).

Summary of Significant Accounting Policies

USE OF ESTIMATES The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires the Company to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results may differ materially from those estimates. The Company's critical accounting estimates include (i) revenue recognition and the establishment of accounts receivable allowances (Notes 1 and 2), (ii) inventory valuation (Note 1), (iii) reorganization and restructuring liabilities (Notes 3 and 4), (iv) useful life assignments and impairment evaluations associated with property and equipment and intangible assets (Notes 1 and 5), (v) anticipated outcomes of legal proceedings and other disputes (Notes 3, 4 and 10), (vi) transaction-based tax and employment-related tax liabilities (Note 10) and (vii) valuation allowances associated with deferred tax assets (Note 12).

CASH EQUIVALENTS AND SHORT-TERM INVESTMENTS The Company considers all highly liquid investments with a maturity of three months or less from the date of original issuance to be cash equivalents. As of December 31, 2003 and 2002, cash equivalents consisted principally of money market mutual funds. All of the Company's investments are classified as available-for-sale and stated at their fair market values, which are determined based on quoted market prices. The Company's short-term investments had original maturities greater than three months, but less than one year, from the balance sheet dates. The Company determines the appropriate classification of investments at the time of purchase and reevaluates such designation at the end of each period. Unrealized gains and losses on available-for-sale securities are included as a separate component of stockholders' equity. Realized gains and losses on available-for-sale securities are determined based on the specific identification of the cost of securities sold.

Short-term investments consisted of the following:

	December 31, 2003			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Government agency securities	$ 38,961	$ 7	$ —	$ 38,968
Certificates of deposit	10,000	1	—	10,001
Total available-for-sale securities	$ 48,961	$ 8	$ —	$ 48,969

	December 31, 2002			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Government agency securities	$ 107,867	$ 209	$ —	$ 108,076
Total available-for-sale securities	$ 107,867	$ 209	$ —	$ 108,076

As of December 31, 2003, the contractual maturities of all available-for-sale securities are between January 2004 and September 2004.

Realized gains and losses resulting from the sale of available-for-sale securities were as follows:

	Year ended December 31,		
	2003	2002	2001
Gains	$ —	$ —	$ 6,373
Losses	—	(17)	(464)
	$ —	$ (17)	$ 5,909

RESTRICTED CASH AND CASH EQUIVALENTS As of December 31, 2003 and 2002, the Company held $2,892 and $2,576, respectively, in money market mutual funds, which (i) collateralize irrevocable letters of credit pertaining to certain operating lease commitments (Note 7) or (ii) are restricted for the payment of unresolved bankruptcy claims (Note 2).

OTHER INVESTMENTS Other investments consist primarily of strategic investments in privately held entities. These investments in privately held companies are accounted for under either the cost or equity methods of accounting, depending on the Company's ability to significantly influence these entities.

The Company performs periodic reviews of its investments for impairment. Impairment write-downs create a new carrying value for the investment and the Company does not record subsequent increases in fair value in excess of the new carrying value for these types of privately held investments accounted for under the cost or equity methods. The Company recorded write-downs of $747, $388 and $10,069 during the years ended December 31, 2003, 2002 and 2001, respectively, related to impairments of its privately held investments.

CONCENTRATIONS OF CREDIT RISK, SIGNIFICANT CUSTOMERS, KEY SUPPLIERS AND RELATED PARTIES Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of cash and cash equivalents, short-term investments and restricted cash and cash equivalents. The Company's cash and investment policies limit cash equivalents, short-term investments and restricted cash and cash equivalents to short-term, investment grade instruments. Cash and cash equivalents, short-term investments and restricted cash and cash equivalents are held primarily with various domestic and Canadian financial institutions with high credit standings. The Company has not experienced any significant losses on its cash, cash equivalents or restricted cash and cash equivalents. However, during the year ended December 31, 2001, the Company recognized other than temporary losses on certain available-for-sale securities aggregating $1,311. No similar losses were recognized during the years ended December 31, 2003 and 2002.

The Company conducts business primarily with ISPs, enterprise customers and telecommunications carrier customers in the United States. As more fully described in Note 2, the Company has concentrations of credit risk with a small number of customers, and certain of the Company's customers were experiencing financial difficulties as of December 31, 2003, 2002 and 2001 and were not current in their payments for the Company's services at those dates. The Company performs ongoing credit evaluations of its customers' financial condition and generally does not require collateral. An allowance is maintained for estimated credit losses. During the years ended December 31, 2003, 2002 and 2001, the Company wrote-off certain accounts receivable balances aggregating $385, $2,652 and $10,371, respectively, against the allowance for credit losses. During the years ended December 31, 2003, 2002 and 2001, the Company recovered $374, $684 and $2,037, respectively, of accounts receivable balances previously written-off against such allowance.

The Company is dependent on a limited number of suppliers for certain equipment used to provide its services. The Company has generally been able to obtain an adequate supply of such equipment. However, an extended interruption in the supply of equipment currently obtained from its suppliers could adversely affect the Company's business and results of operations.

The Company's former vice-chairman and former interim chief executive officer, Frank Marshall, who was also a member of the Company's board of directors from October 1997 to December 2002, was a minority stockholder and former member of the board of directors of one of the Company's former ISP customers, InternetConnect, which filed for bankruptcy protection in 2001 (Note 6).

The Company acquired an equity interest in a supplier during 1999 and disposed of this interest in 2001. Purchases from this supplier totaled $8,346, $5,774 and $13,928 for the years ended December 31, 2003, 2002 and 2001, respectively. The Company also purchased certain products from a company in which Mr. Marshall serves as a director. Purchases from this vendor totaled $269, $258 and $140 during the years ended December 31, 2003, 2002 and 2001, respectively.

A member of the Company's Board of Directors, Richard Jalkut, is the President and CEO of TelePacific, one of the Company's resellers. The Company recognized revenues from TelePacific of $611, $1,311 and $1,822 for the years ended December 31, 2003, 2002 and 2001, respectively. Another member of the Company's Board of Directors, L. Dale Crandall, is also a director of BEA Systems, one of the Company's vendors. The Company paid $2,232, $121 and $214 to BEA Systems during the years ended December 31, 2003, 2002 and 2001, respectively.

The Company believes the terms of these transactions are comparable to transactions that would likely be negotiated with clearly independent parties.

INVENTORIES Inventories, consisting primarily of customer premises equipment, are stated at the lower of cost, determined using the "first-in, first-out" method, or market.

PROPERTY AND EQUIPMENT Property and equipment are recorded at cost, subject to adjustments for impairment, and depreciated or amortized using the straight-line method over the following estimated useful lives:

Leasehold improvements	5 years or the term of the lease, whichever is less
Computer equipment	2 to 5 years
Computer software	3 to 5 years
Furniture and fixtures	2 to 5 years
Network and communications equipment	2 to 5 years

The Company incurs significant costs associated with internal-use software, which consists principally of the Company's operational support systems ("OSS") software and Web site. The Company charges the costs of research to expense as they are incurred, including pre-development efforts related to determining technological or product alternatives, and costs incurred for training and maintenance. Software and Web site development costs, which include direct costs such as labor and contractors, are capitalized when they can be segregated from other non-capitalizable labor activities and when it is probable that the project will be completed and the software or Web site will be used as intended. Costs incurred for upgrades and enhancements to the Company's software or Web site are capitalized when it is probable that such efforts will result in additional and significant functionality. Capitalized software and Web site costs are amortized to expense over the estimated useful life of the software or Web site. Amortization of internal-use software costs was $3,336, $6,030 and $9,433 during the years ended December 31, 2003, 2002 and 2001, respectively. The Company accounts for incidental sales of licenses to its OSS software on a cost recovery basis (Note 6).

The Company leased certain equipment under capital lease agreements. Assets and liabilities under capital leases are recorded at the lesser of the present value of the aggregate future minimum lease payments, including estimated bargain purchase options, or the fair value of the assets under lease. Assets under capital leases are amortized over the lesser of the lease term or useful life of the assets. Amortization of assets under capital leases is included in depreciation and amortization expense.

COLLOCATION FEES AND OTHER INTANGIBLE ASSETS Collocation fees represent nonrecurring fees paid to other telecommunications carriers for the right to use central office space to house equipment owned or leased by the Company. Such nonrecurring fees are capitalized as intangible assets and amortized over five years using the straight-line method. The Company's collocation agreements also require periodic recurring payments, which are charged to expense as incurred. All such collocation agreements are cancelable by the Company at any time.

Other intangible assets consist of a customer list acquired from a third party (Note 6). Such customer list is being amortized over twenty-four months using the straight-line method.

As of December 31, 2003, the Company's estimated annual amortization expenses associated with collocation fees and other intangible assets for the next five years were as follows:

2004	$	17,236
2005	$	14,769
2006	$	5,067
2007	$	2,332
2008	$	1,444

CHANGE IN ACCOUNTING ESTIMATE In addition to the changes in accounting estimate described above under "Basis of Presentation," effective January 1, 2001, the Company reduced the remaining estimated useful lives of all long-lived assets, excluding a building and leasehold improvements, that previously had estimated useful lives in excess of five years such that the residual balances and any subsequent additions are now depreciated or amortized over five years using the straight-line method. This change in accounting estimate decreased the company's net income by $14,006 ($0.08 per share) for the year ended December 31, 2001.

IMPAIRMENT OF LONG-LIVED ASSETS The Company periodically evaluates potential impairments of its long-lived assets, including intangibles. When the Company determines that the carrying value of long-lived assets may not be recoverable based upon the existence of one or more indicators of impairment, the Company evaluates the projected undiscounted cash flows related to the assets. If these cash flows are less than the carrying value of the assets, the Company measures the impairment using discounted cash flows or other methods of determining fair value.

Long-lived assets to be disposed of are carried at the lower of cost or fair value less estimated costs of disposal.

STOCK-BASED COMPENSATION The Company accounts for stock-based awards to (i) employees (including non-employee directors) using the intrinsic value method and (ii) non-employees using the fair value method.

Under the intrinsic value method, when the exercise price of the Company's employee stock options equals the market price of the underlying stock on the date of grant, no compensation expense is recognized. The following table illustrates the pro forma effect on net income (loss) and earnings (loss) per share for the years ended December 31, 2003, 2002 and 2001 had the Company applied the fair value method to account for stock-based awards to employees:

	2003	2002	2001
Net income (loss), as reported	$ (99,931)	$ (184,828)	$ 344,758
Stock-based employee compensation expense (reversal) included in the determination of net income (loss), as reported	1,344	(3,112)	1,849
Stock-based employee compensation expense that would have been included in the determination of net income (loss) if the fair value method had been applied to all awards	(12,791)	(28,471)	(66,751)
Pro forma net income (loss)	$ (111,378)	$ (216,411)	$ 279,856
Basic and diluted net income (loss) per common share:			
As reported	$ (0.44)	$ (0.84)	$ 1.94
Pro forma	$ (0.50)	$ (0.98)	$ 1.58

The weighted-average grant date fair value of stock-based awards to employees was $1.13, $0.83 and $1.38 per share during the years ended December 31, 2003, 2002 and 2001, respectively. Such weighted-average grant date fair values were estimated using the Black-Scholes option valuation model and the assumptions listed in Note 13 under the caption "Pro Forma Stock-Based Compensation Information."

ADVERTISING COSTS The Company charges the costs of advertising to expense as incurred. Advertising expense for the years ended December 31, 2003, 2002 and 2001 was $7,650, $27,083 and $16,467, respectively.

The Company makes market development funds ("MDF") available to certain customers for the reimbursement of co-branded advertising expenses and other purposes. To the extent that MDF is used by the Company's customers for co-branded advertising, and (i) the customers provide the Company with third-party evidence of such co-branded advertising as required by Company policy and (ii) the Company can reasonably estimate the fair value of its portion of the advertising, such amounts are charged to advertising expense as incurred. Other amounts payable to customers relating to rebates, customer incentives and nonqualified MDF activities are recorded as reductions of revenues as incurred.

INCOME TAXES The Company uses the liability method to account for income taxes. Under this method, deferred tax assets and liabilities are determined based on differences between financial reporting and tax bases of assets and liabilities. Deferred tax assets and liabilities are measured using enacted tax rates and laws that will be in effect when the differences are expected to reverse. Valuation allowances are established when necessary to reduce deferred tax assets to the amount expected to be realized.

FAIR VALUES OF FINANCIAL INSTRUMENTS The following methods and assumptions were used to estimate the fair values of the Company's financial instruments:

CASH, CASH EQUIVALENTS, SHORT-TERM INVESTMENTS AND RESTRICTED CASH AND CASH EQUIVALENTS The carrying amounts of these assets approximate their respective fair values, which were determined based on quoted market prices.

BORROWINGS The fair values of borrowings, including long-term debt and capital lease obligations, are estimated based on quoted market prices, where available, or by discounting the future cash flows using estimated borrowing rates at which similar types of borrowing arrangements with the same remaining maturities could be obtained by the Company. The aggregate fair value of the Company's long-term debt was $58,646 as of December 31, 2003, as compared to the aggregate carrying amount of $50,000 as of such date. The aggregate fair value of the Company's long-term debt and capital lease obligations was $59,140 as of December 31, 2002, as compared to the aggregate carrying amount of $50,165 as of such date.

FOREIGN CURRENCY The functional currency of the Company's unconsolidated affiliates is the local currency. The investments in these unconsolidated affiliates are translated into U.S. dollars at year-end exchange rates, and the Company's equity in the income or losses of these affiliates is translated at average exchange rates prevailing during the year. Translation adjustments are included in "Accumulated other comprehensive loss," a separate component of stockholders' equity (deficit).

PER SHARE AMOUNTS Basic per share amounts are computed by using the weighted average number of shares of the Company's common stock, less the weighted average number of common shares subject to repurchase, outstanding during the period.

Diluted per share amounts are determined in the same manner as basic per share amounts, except that the number of weighted average common shares used in the computations includes dilutive common shares subject to repurchase and is increased assuming the (i) exercise of dilutive stock options and warrants using the treasury stock method and (ii) conversion of dilutive convertible debt instruments. However, diluted net income (loss) per share is the same as basic net income (loss) per share in the periods presented in the accompanying consolidated statements of operations because loss from operations is the "control number" in determining whether potential common shares are included in the calculation. Consequently, the impact of (i) including common shares subject to repurchase, (ii) the assumed exercise of outstanding stock options and warrants and (iii) the assumed conversion of convertible debt instruments was not dilutive to loss from operations.

The following table presents the calculation of weighted average common shares used in the computations of basic and diluted per share amounts presented in the accompanying consolidated statements of operations:

	Year ended December 31,		
	2003	2002	2001
Weighted average shares of common stock outstanding	224,949,891	219,750,287	177,489,090
Less weighted average shares of common stock subject to repurchase	—	6,625	141,897
Weighted average common shares used in computing basic per share amounts	224,949,891	219,743,662	177,347,193

COMPREHENSIVE INCOME (LOSS) Significant components of the Company's comprehensive income (loss) are as follows:

	Cumulative	Year ended December 31,		
	Amounts	2003	2002	2001
Net income (loss)	$ (1,629,267)	$ (99,931)	$ (184,828)	$ 344,758
Unrealized gains (losses) on available-for-sale securities	9	(206)	270	(2,327)
Foreign currency translation adjustment	(962)	—	1,342	(588)
Comprehensive income (loss)	$ (1,630,220)	$ (100,137)	$ (183,216)	$ 341,843

RECENT ACCOUNTING PRONOUNCEMENTS On May 15, 2003, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity." SFAS No. 150 establishes standards for classifying and measuring as liabilities certain financial instruments that embody obligations of the issuer and have characteristics of both liabilities and equity, such as mandatorily redeemable equity instruments. SFAS No. 150 must be applied immediately to instruments entered into or modified after May 31, 2003 and to all other instruments that exist as of the beginning of the first interim financial reporting period beginning after June 15, 2003, except for mandatorily redeemable instruments of non-public companies, to which the provisions of SFAS No. 150 must be applied in fiscal periods beginning after December 15, 2003. The application of SFAS No. 150 to pre-existing instruments should be recognized as the cumulative effect of a change in accounting principle. The adoption of SFAS No. 150 had no effect on the Company's consolidated financial statements.

In January 2003, the FASB issued Interpretation ("FIN") No. 46, "Consolidation of Variable Interest Entities," an interpretation of Accounting Research Bulleting No. 51, "Consolidated Financial Statements." FIN 46 applies to any business enterprise that has a controlling interest, contractual relationship or other business relationship with a variable interest entity ("VIE") and establishes guidance for the consolidation of VIEs that function to support the activities of the primary beneficiary. FIN 46 was effective March 31, 2004 for enterprises with VIEs created after January 31, 2003, and will be effective March 31, 2004 for enterprises with VIEs created before February 1, 2003. The Company does not expect the adoption of FIN 46 will have an effect on its consolidated financial statements.

In December 2002, the FASB issued SFAS No. 148, "Accounting for Stock-Based Compensation—Transition and Disclosure." SFAS No. 148 amends SFAS No. 123, "Accounting for Stock-Based Compensation," to provide alternative methods of transition for an entity that voluntarily changes to the fair value method of accounting for stock-based employee compensation. In addition, SFAS No. 148 amends the disclosure provisions of SFAS No. 123 to require prominent disclosure of the effects of an entity's accounting policy with respect to stock-based employee compensation on reported operating results, including per share amounts, in annual and interim financial statements. The disclosure provisions of SFAS No. 148 were effective immediately upon issuance in 2002. As of December 31, 2003, the Company has no immediate plans to adopt the fair value method of accounting for stock-based employee compensation.

In November 2002, the FASB's Emerging Issues Task Force ("EITF") reached a final consensus on Issue No. 00-21, "Accounting for Revenue Arrangements with Multiple Deliverables," which is effective for revenue arrangements entered into in fiscal periods beginning after June 15, 2003. Under EITF Issue No. 00-21, revenue arrangements with multiple deliverables are required to be divided into separate units of accounting under certain circumstances. The Company adopted EITF Issue No. 00-21 on July 1, 2003, and such adoption did not have a material effect on its consolidated financial statements.

In November 2002, the FASB issued FIN No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others." FIN No. 45 requires certain guarantees to be recorded at fair value, which is different from current practice, which is generally to record a liability only when a loss is probable and reasonably estimable. FIN No. 45 also requires a guarantor to make significant new disclosures, even when the likelihood of making any payments under the guarantee is remote. The disclosure provisions of FIN No. 45 were effective immediately in 2002. The Company adopted the recognition and measurement provisions of FIN No. 45 on a prospective basis with respect to guarantees issued or modified after December 31, 2002. The adoption of the recognition and measurement provisions of FIN No. 45 had no effect on the Company's consolidated financial statements. However, some of the Company's contracts with customers have provisions that would require the Company to indemnify them in the event that the Company's services infringe upon a third party's intellectual property rights (Note 10).

On January 1, 2003, the Company adopted SFAS No. 146, "Accounting for Costs Associated with an Exit or Disposal Activity." SFAS No. 146 revised the accounting for exit and disposal activities under EITF Issue No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring)," by extending the period in which expenses related to restructuring activities are reported. A commitment to a plan to exit an activity or dispose of long-lived assets is no longer sufficient to record a one-time charge for most restructuring activities. Instead, companies record exit or disposal costs when they are incurred and can be measured at fair value. In addition, the resultant liabilities are subsequently adjusted for changes in estimated cash flows. SFAS No. 146 is effective prospectively for exit or disposal activities initiated after December 31, 2002. Companies may not restate previously issued financial statements for the effect of the provisions of SFAS No. 146, and liabilities that a company previously recorded under EITF Issue No. 94-3 are grandfathered. The adoption of SFAS No. 146 had no effect on the Company's consolidated financial statements.

On January 1, 2003, the Company adopted SFAS No. 145, "Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections." SFAS No. 145 rescinds SFAS No. 4, "Reporting Gains and Losses from Extinguishment of Debt," which required all gains and losses from extinguishment of debt to be aggregated and, if material, classified as an extraordinary item, net of related income tax effect. SFAS No. 145 requires that gains or losses from extinguishment of debt be classified as extraordinary items only if they meet the criteria of APB Opinion No. 30. Upon adoption of SFAS No. 145 in 2003, the Company reclassified the gain on extinguishment of debt that it recognized in 2001, which was previously classified as an extraordinary item, as an element of other income (expense) in the accompanying 2001 consolidated statement of operations.

On January 1, 2003, the Company adopted SFAS No. 143, "Accounting for Asset Retirement Obligations." SFAS No. 143 requires that the fair value of a liability for an asset retirement obligation be recognized in the period in which it is incurred if a reasonable estimate of fair value can be made. The associated asset retirement costs are capitalized as part of the carrying amount of the long-lived asset. The adoption of SFAS No. 143 had no effect on the Company's consolidated financial statements.

RECLASSIFICATIONS Certain balances in the Company's 2002 and 2001 consolidated financial statements have been reclassified to conform to the presentation in 2003.

2. Revenue Recognition

Revenues from recurring service are recognized when (i) persuasive evidence of an arrangement between the Company and the customer exists, (ii) service has been provided to the customer, (iii) the price to the customer is fixed or determinable and (iv) collectibility of the sales prices is reasonably assured. Revenues earned for which the customer has not been billed are recorded as "Unbilled revenues" in the consolidated balance sheets. Amounts billed in advance of providing service are deferred and recorded as an element of the consolidated balance sheets caption "Unearned revenues." Included in revenues are FUSF charges billed to customers aggregating $4,993, $8,233 and $13,277 for the years ended December 31, 2003, 2002 and 2001, respectively.

The Company recognizes up-front fees associated with service activation over the expected term of the customer relationship, which is presently estimated to be 24 months, using the straight-line method. The Company treats the incremental direct costs of service activation (which consist principally of customer premises equipment, service activation fees paid to other telecommunications companies and sales commissions) as deferred charges in amounts that are no greater than the up-front fees that are deferred, and such deferred incremental direct costs are amortized to expense using the straight-line method over 24 months.

The Company had over 300 wholesale customers as of December 31, 2003. However, for the years ended December 31, 2003, 2002 and 2001, the Company's 30 largest wholesale customers in each such year collectively comprised 93.3%, 93.3% and 88.5% of the Company's total wholesale net revenues, respectively, and 71.6%, 79.5% and 76.0% of the Company's total net revenues, respectively. As of December 31, 2003 and 2002, receivables from these customers collectively comprised 70.3% and 75.3%, respectively, of the Company's gross accounts receivable balance.

For the year ended December 31, 2003, EarthLink, Inc. and AT&T, two of the Company's wholesale customers that are included in the Company's Covad Strategic Partnerships ("CSP") business segment (Note 14), accounted for 21.5% and 12.5%, respectively, of the Company's total net revenues. For the years ended December 31, 2002 and 2001, EarthLink, Inc. accounted for 20.0% and 17.5%, respectively, of the Company's total net revenues. As of December 31, 2003 and 2002, receivables from these customers comprised 20.9% and 17.1%, and 25.9% and 11.7%, respectively, of the Company's gross accounts receivable balance. No other individual customer accounted for more than 10% of the Company's total net revenues in 2003, 2002 and 2001.

Some of the Company's ISP and telecommunications carrier customers are experiencing financial difficulties. During the years ended December 31, 2003, 2002 and 2001, certain of these customers either (i) were not current in their payments for the Company's services or (ii) were essentially current in their payments but, subsequent to the end of the reporting period, the financial condition of such customers deteriorated significantly and certain of them have filed for bankruptcy protection. Based on this information, the Company determined that the collectibility of revenues from these customers was not reasonably assured or its ability to retain some or all of the payments received from certain of these customers that have filed for bankruptcy protection was not reasonably assured. Accordingly, the Company classified this group of customers as "financially distressed" for revenue recognition purposes. Revenues from financially distressed customers that have not filed for bankruptcy protection are recognized when cash for those services is collected, assuming all other criteria for revenue recognition have been met, but only after the collection of all previous outstanding accounts receivable balances. Payments received from financially distressed customers during a defined period prior to their filing of petitions for bankruptcy protection are recorded in the consolidated balance sheet caption "Unearned revenues" if the Company's ability to retain these payments is not reasonably assured.

A number of the Company's customers are currently in bankruptcy proceedings. Revenues from these customers accounted for approximately 1.3%, 5.6% and 7.1% of the Company's total net revenues for the years ended December 31, 2003, 2002 and 2001, respectively. Although MCI filed for bankruptcy protection on July 21, 2002, the Company continued to recognize revenues from MCI on an accrual basis during 2002 and 2003 based on its specific facts and circumstances in relation to the revenue recognition criteria described above. Consequently, the disclosures in the following paragraph related to financially distressed customers exclude amounts pertaining to MCI because the Company has not presently classified it as a financially distressed customer for revenue recognition purposes. The Company continues to attempt to migrate end-users from some of its financially distressed customers to the extent it is legally and operationally feasible.

During the years ended December 31, 2003, 2002 and 2001, the Company issued billings to its financially distressed customers aggregating $5,139, $42,881 and $74,928, respectively, that were not recognized as revenues or accounts receivable in the accompanying consolidated financial statements at the time of such billings. However, in accordance with the revenue recognition policy described above, the Company recognized revenues from certain of these customers when cash was collected aggregating $4,367, $47,609 and $29,003 during the years ended December 31, 2003, 2002 and 2001, respectively, some of which relates to services provided in prior periods. In addition, revenues and the provision for bad debts (bad debt recoveries) recognized during the year ended December 31, 2003 and 2002 include cash collected totaling $827 and $4,427, respectively, from certain bankrupt customers that the Company received prior to the periods in which they were ultimately recognized. The Company recorded these payments as unearned revenues in the accompanying consolidated balance sheet as of those dates because its ability to retain the payments was not reasonably assured at such dates. However, as a result of subsequent developments in the bankruptcy proceedings of such customers, the Company determined that its ability to retain these payments was reasonably assured prior to December 31, 2003. Consequently, the Company recognized these payments as revenues and bad debt recoveries, respectively, during 2003 and 2002. No such payments were recognized as revenues or bad debt recoveries during the year ended December 31, 2001. The Company had contractual receivables from its financially distressed customers totaling $1,093 and $6,031 as of December 31, 2003 and 2002, respectively, that are not reflected in the accompanying consolidated balance sheet as of such date.

The Company has obtained information indicating that some of its customers, including MCI, who (i) were essentially current in their payments for the Company's services prior to December 31, 2003, or (ii) have subsequently paid all or significant portions of the respective amounts recorded as accounts receivable as of December 31, 2003, may become financially distressed. Revenues from these customers accounted for approximately 11.6%, 34.6% and 14.2% of the Company's total net revenues for the years ended December 31, 2003, 2002 and 2001, respectively. As of December 31, 2003 and 2002, receivables from these customers comprised 14.7% and 31.8% of the Company's gross accounts receivable balance, respectively. If these customers are unable to demonstrate their ability to pay for the Company's services in a timely manner in periods ending subsequent to December 31, 2003, the Company, based on its revenue recognition policy described above, will recognize revenue when cash is collected.

The Company has obtained persuasive evidence indicating that the financial condition of one of its customers, which was designated as financially distressed in 2000, improved significantly during the year ended December 31, 2002, principally as a result of a capital infusion during this period. Consequently, the Company concluded that collection of its billings to this customer was now reasonably assured. Therefore, the Company resumed the recognition of revenues from this customer on an accrual basis during 2002, which resulted in the recognition of revenues in the amount of approximately $1,542 that relate to services rendered in periods ended prior to January 1, 2002. Similarly, the Company resumed the recognition of revenue on an accrual basis for another wholesale customer during 2002. The Company did not, however, recognize additional revenue from services rendered in prior periods because this customer was current in its payments. No similar amounts were recognized during the other periods reported in the accompanying consolidated financial statements.

The Company has billing disputes with some of its customers. These disputes arise in the ordinary course of business in the telecommunications industry and their impact on the Company's accounts receivable and revenues can be reasonably estimated based on historical experience. In addition, certain revenues are subject to refund if the end-user terminates service within thirty days of service activation. Accordingly, the Company maintains allowances, through charges to revenues, based on the Company's estimates of (i) the ultimate resolution of the disputes (ii) future service cancellations. These charges to revenues amounted to $2,886, $2,322 and $11,178 during the years ended December 31, 2003, 2002 and 2001, respectively. During the years ended December 31, 2003, 2002 and 2001, the Company wrote-off certain accounts receivable balances aggregating $1,557, $3,748 and $6,701, respectively, against the allowance for customer disputes and service cancellations. During the years ended December 31, 2003 and 2002, the Company recovered $1,282 and $2,145, respectively, of accounts receivable balances previously written-off against such allowance. There were no similar recoveries of accounts receivable balances for the year ended December 31, 2001.

During the year ended December 31, 2001, the Company recognized $11,661 in revenue that was included in the cumulative effect adjustment as of January 1, 2000, which resulted from the Company's adoption of Securities and Exchange Commission Staff Accounting Bulletin No. 101, "Revenue Recognition in Financial Statements" (no similar revenues were recognized during the years ended December 31, 2003 and 2002). The effect of that revenue during 2001 was to increase net income by $3,067.

3. Reorganization Under Bankruptcy Proceedings

On August 15, 2001 (the "Petition Date"), Covad, excluding its operating subsidiaries, filed a voluntary petition (the "Petition") under Chapter 11 of the United States Bankruptcy Code (the "Bankruptcy Code") for the purpose of confirming its pre-negotiated First Amended Plan of Reorganization, as modified, on November 26, 2001 (the "Plan") with the majority holders (the "Noteholders") of its senior notes. The Petition was filed with the United States Bankruptcy Court for the District of Delaware (the "Bankruptcy Court") and was assigned Case No. 01-10167 (JJF). On December 13, 2001, the Bankruptcy Court entered an order confirming the Plan and, on December 20, 2001 (the "Effective Date"), the Plan was consummated and Covad emerged from bankruptcy. However, the Bankruptcy Court still maintains jurisdiction over certain administrative matters related to the implementation of the Plan, including the unresolved claims described below.

On the Effective Date, the Company made the following distributions of cash and shares of its common stock to certain claimants:

		Common Stock		
Claimant	Cash	Shares	Aggregate Fair Market Value	Total Consideration
Noteholders	$ 271,708	35,292,800	$ 88,585	$ 360,293
Plaintiffs in litigation (Note 10)	5,793	2,000,000	5,020	10,813
Other claimants	1,900	—	—	1,900
	$ 279,401	37,292,800	$ 93,605	$ 373,006

The aforementioned distributions of cash and shares of the Company's common stock resulted in the extinguishment of certain liabilities of Covad as of the Effective Date and the recognition of a gain on extinguishment of debt and certain litigation-related and other general and administrative expenses in the accompanying consolidated statement of operations for the year ended December 31, 2001, as follows:

Extinguishment of senior notes:	
Senior notes	$ 1,351,488
Accrued interest	42,532
	1,394,020
Less consideration distributed to the Noteholders	360,293
GAIN ON EXTINGUISHMENT OF DEBT	$ 1,033,727
Settlement of litigation (Note 10):	
Consideration distributed to the plaintiffs	$ 10,813
Less amounts accrued prior to the Effective Date	6,820
ADDITIONAL LITIGATION-RELATED EXPENSES RECOGNIZED	$ 3,993
Other:	
Consideration distributed to the claimants	$ 1,900
Less amounts accrued prior to the Effective Date	—
ADDITIONAL GENERAL AND ADMINISTRATIVE EXPENSES RECOGNIZED	$ 1,900

There were unresolved claims related to Covad's Chapter 11 bankruptcy proceedings aggregating $8,341 and $8,344 as of December 31, 2003 and 2002, respectively. As of December 31, 2003 and 2002, the Company recorded these unresolved claims in its consolidated balance sheets based on the amount of such claims allowed by the Bankruptcy Court (adjusted for changes in the value of the Company's common stock after December 20, 2001), unless the Company has persuasive evidence indicating that a claim is duplicative with another allowed claim that was settled previously or is otherwise in error. In these cases, the unresolved claim does not meet the criteria for recognition in the Company's consolidated financial statements. However, it is reasonably possible that the Company's unresolved Chapter 11 bankruptcy claims could ultimately be settled for amounts that differ from the aggregate liability for "Unresolved claims related to bankruptcy proceedings" reflected in the accompanying consolidated balance sheets as of December 31, 2003 and 2002.

As of December 31, 2003 and 2002, the Company had (i) placed $309 and $501, respectively, of cash in a reserve fund (this balance is classified as "Restricted Cash and Cash Equivalents" in the accompanying consolidated balance sheets) and (ii) reserved 7,078,733 and 7,078,733 shares, respectively, of common stock pending the resolution of the aforementioned disputed claims.

The holders of the Company's common stock issued prior to the Effective Date of the Plan retained their existing equity interests, but were diluted through the issuance of common stock to the claimants described above. As of the Effective Date, and after the issuance of 37,292,800 shares of the Company's common stock pursuant to the Plan as described above, there were 216,445,276 shares of the Company's common stock issued and outstanding. The holders of the Company's common stock immediately before the Effective Date of the Plan held more than 50% of the Company's voting shares (including shares reserved for future issuance under the Plan) immediately after the Effective Date of the Plan. Therefore, under AICPA Statement of Position ("SOP") 90-7, "Financial Reporting by Entities in Reorganization Under the Bankruptcy Code," the Company did not qualify for fresh-start reporting.

In accordance with SOP 90-7, expenses resulting from the restructuring are reported separately as reorganization items. For the year ended December 31, 2001, the Company recognized expenses directly associated with Covad's Chapter 11 bankruptcy proceedings in the amount of $63,229 (none for the years ended December 31, 2003 and 2002). These reorganization expenses consisted of (i) non-cash adjustments to unamortized debt issuance costs and discounts and (ii) professional fees for legal and financial advisory services. For the year ended December 31, 2001, the Company recognized interest income in the amount of $609 on accumulated cash that Covad did not disburse as a result of its Chapter 11 bankruptcy proceedings (none for the years ended December 31, 2003 and 2002). Such interest income has been offset against the aforementioned reorganization expenses in the Company's 2001 consolidated statement of operations.

Operating cash receipts and payments made by Covad resulting from the Plan were as follows for the period from August 15, 2001 through December 20, 2001:

Cash receipts:		
Interest received	$	2,650
TOTAL CASH RECEIPTS	$	2,650
Cash disbursements:		
Interest paid	$	1,509
Professional fees paid		16,003
Claims paid		277,892
TOTAL CASH DISBURSEMENTS	$	295,404

4. Other Restructuring Activities

BlueStar, which was acquired by the Company on September 22, 2000 in a transaction accounted for as a purchase (Note 6), provided broadband communications and Internet services to small and medium-sized businesses in smaller cities using a direct sales model. Continued losses at BlueStar, with no near term possibility of improvement, caused the Company's board of directors to decide, on June 22, 2001, to cease the Company's funding of BlueStar's operations. Subsequently, on June 25, 2001, BlueStar terminated all of its 365 employees. However, 59 of BlueStar's former employees were temporarily retained by the Company for varying periods through July 31, 2001 to assist with the migration of certain BlueStar end-user lines to the Company's network, as described below. In addition, the Company hired 69 of BlueStar's former employees subsequent to June 25, 2001.

On June 24, 2001, the Company and BlueStar entered into a Purchase Agreement ("PA") under which the Company purchased the right to offer service to BlueStar's customers, subject to BlueStar's right to seek higher offers. The Company paid approximately $2,000 in 2001 (none in 2003 and 2002) under the PA and had no additional liabilities under the PA as of December 31, 2003 and 2002. To facilitate this migration, the Company and BlueStar entered into a Migration Agreement on July 12, 2001 that required the Company to pay certain amounts contemplated in the PA directly to certain former employees of BlueStar and certain BlueStar vendors, including the Assignee, as defined below. The Company made payments aggregating $5,100 in connection with BlueStar's cessation of operations during the year ended December 31, 2001 (none in 2003 and 2002). Of this amount, $1,300 represents employee severance benefits, $2,000 represents customer acquisition costs under the PA and $1,800 represents legal and other professional fees. Such (i) severance benefits and professional fees and (ii) customer acquisition costs have been charged to restructuring expenses and network and product costs, respectively, in the Company's consolidated statement of operations for the year ended December 31, 2001.

On June 25, 2001, BlueStar made an irrevocable assignment for the benefit of creditors ("ABC") of all its assets to an independent trustee (the "Assignee") in the State of Tennessee. Immediately thereafter, the Assignee began an orderly liquidation of BlueStar that was initially expected to be completed in the fourth quarter of 2002. However, the Assignee has informed the Company that it is still in the process of resolving some matters among BlueStar's creditors and that the process may extend into the second half of 2004. An ABC under Tennessee law is a non-judicial alternative to a plan of liquidation under Chapter 7 of the Bankruptcy Code. As a result of the ABC, BlueStar's former assets are no longer controlled by BlueStar or the Company and cannot be used by either BlueStar's or the Company's boards of directors to satisfy the liabilities of BlueStar. Consequently, the liquidation of BlueStar's assets and the settlement of its liabilities are currently under the sole control of the Assignee and the control of BlueStar's assets no longer rests with the Company. Therefore, the Company deconsolidated BlueStar effective June 25, 2001, which resulted in the recognition of a deferred gain in the amount of $55,200 in the Company's consolidated balance sheet as of December 31, 2001. Such deferred gain represented the difference between the carrying values of BlueStar's assets (aggregating $7,900) and liabilities (aggregating $63,100) as of June 25, 2001. During 2003 and 2002, the deferred gain was reduced by $9 and $1,228, respectively, because certain BlueStar assets were inadvertently not deconsolidated on June 25, 2001. Therefore, the deconsolidation of BlueStar, resulted in a deferred gain balance of $53,963 and $53,972 in the Company's consolidated balance sheets as of December 31, 2003 and 2002, respectively. The Company will recognize such deferred gain as an element of other income (expense) when the liquidation of BlueStar is complete and its liabilities have been discharged.

The following unaudited pro forma financial information presents the consolidated results of operations of the Company as if the deconsolidation of BlueStar had occurred on January 1, 2001 and does not purport to be indicative of the results of operations that would have occurred had the deconsolidation occurred on January 1, 2001, or the results that may occur in the future:

Year ending December 31, 2001		
Revenues	$	320,619
Loss before gain on extinguishment of debt and cumulative effect of accounting charge	$	(646,647)
NET INCOME (LOSS)	$	387,080
Basic and diluted net income (loss) per share	$	2.18

During the fourth quarter of 2000, the Company announced a comprehensive restructuring plan that involved the following steps:

- raising revenue by reducing rebates and other incentives that the Company provides to customers and reducing new line addition plans for 2001 to improve margins and reduce subscriber payback times;
- closing approximately 200 under-performing or not fully built-out central offices and reducing the size of the Company's network to approximately 1,700 central offices;
- reducing the Company's workforce by 638 employees, which represented approximately 21% of the Company's workforce;
- closing a facility in Alpharetta, Georgia and consolidating offices in Manassas, Virginia, Santa Clara, California and Denver, Colorado;
- continued downsizing of the Company's international operations and discontinuing plans to fund additional international expansion while continuing to manage existing investments;
- enhancing productivity in the Company's operations to increase customer satisfaction while reducing costs;
- restructuring the Company's direct sales and marketing channel; and
- evaluating and implementing other cost reduction strategies, including salary freezes and reductions in travel, facilities and advertising expenses.

In connection with this restructuring plan, the Company recorded a charge to operations of $4,988 in the fourth quarter of 2000 relating to employee severance benefits that met the requirements for accrual as of December 31, 2000. During the year ended December 31, 2001, the total workforce was reduced by 638 employees and the Company paid $3,849 in severance benefits, which were charged against the restructuring liability recorded as of December 31, 2000.

The Company recorded additional restructuring expenses aggregating $14,364 during the year ended December 31, 2001, of which $2,140 related to the BlueStar shutdown. These expenses consist principally of collocation and building lease termination costs that met the requirements for accrual in 2001. During the year ended December 31, 2001, the Company paid collocation and building lease termination costs of $12,355, which were charged against the restructuring liabilities recorded during 2001. During the year ended December 31, 2001, the restructuring liability was also reduced by $131 based on revised estimates of the Company's restructuring expenses. No restructuring expenses were recorded during the year ended December 31, 2002.

During the year ended December 31, 2003, the Company reduced its workforce by approximately 113 employees, which represented approximately 10.2% of the Company's workforce. The reductions covered employees in the areas of sales and marketing, operations and corporate functions. In connection with the reductions in force, the Company recorded a charge to operations for the year ended December 31, 2003 of $1,235 relating to employee severance benefits, all of which was paid during the year ended December 31, 2003. The expenses associated with these reductions in force were $103 related to the Company's CSP business segment (Note 14), and $349 related to the Company's Covad Broadband Solutions ("or CBS") business segment (Note 14). The remaining $783 in expenses associated with these reductions in force were related to the Company's Corporate Operations (Note 14).

Management continues to consider whether additional restructuring is necessary, and the Company may incur additional charges to operations related to any further restructuring activities in future periods.

5. Property and Equipment

Property and equipment consisted of the following:

	December 31, 2003	December 31, 2002
Leasehold improvements	$ 10,339	$ 9,276
Computer equipment	48,801	47,206
Computer software	33,912	30,486
Furniture and fixtures	17,515	17,785
Networks and communication equipment	362,910	334,001
	473,477	438,754
Less accumulated depreciation and amortization	379,198	330,017
Property and equipment, net	$ 94,279	$ 108,737

During the fourth quarter of 2001, the Company determined that (i) certain of its communication equipment was obsolete based on its discontinued use in the Company's network and (ii) it would sell (subject to the approval of the Company's Board of Directors) its land, building and certain furniture and fixtures located in Manassas, Virginia. In March 2002, the Company entered into a non-binding letter of intent with a third party to sell the aforementioned Manassas, Virginia property for $14,000. Accordingly, the Company recognized a write-down of this property and equipment in the amount of $9,999 during the fourth quarter of 2001. In April 2002, the Company received the necessary approval from its Board of Directors to proceed with the sale of this property (at which time the Company suspended depreciation of the building and related improvements when such assets had an aggregate carrying value of $13,201). In June 2002, the Company completed the sale of this property and recognized a gain of $133, which represents the net proceeds of $13,334 less the aggregate carrying value of the property, as described above, in the accompanying consolidated statement of operations for the year ended December 31, 2002. The Company recorded no impairment write-downs of long-lived assets during 2003 and 2002.

6. Business Acquisition, Asset Acquisitions and Equity Investments

Acquisition of BlueStar

On September 22, 2000, the Company acquired BlueStar by issuing approximately 6,100,000 shares of common stock (including 800,000 shares to be held in escrow for a one year period pending the Company's verification of certain representations and warranties made to it by BlueStar at the date of the acquisition) in exchange for all of the outstanding preferred and common shares of BlueStar. Two of the Company's stockholders and members of its Board of Directors when the acquisition occurred were also stockholders of BlueStar, and one was a member of the board of directors of BlueStar.

This transaction was accounted for as a purchase. Accordingly, the Company's consolidated financial statements include the results of operations of BlueStar for periods ending after the date of acquisition. However, as described in Note 3, the Company deconsolidated BlueStar effective June 25, 2001.

Up to 5,000,000 additional common shares of the Company's common stock were to be issued if BlueStar achieved certain specified levels of revenues and earnings before interest, taxes, depreciation and amortization in 2001. However, during April, 2001, the Company reached an agreement with the BlueStar stockholders' representative to resolve this matter, as well as the matters that caused 800,000 of the Company's common shares to be held in escrow as of December 31, 2000, by providing the BlueStar stockholders with 2,532,850 (which include 264,369 options and warrants which are held by the Company in the event such options and warrants are exercised after the distribution date) of the 5,000,000 shares, in exchange for a release of all claims against the Company. The 800,000 common shares held in escrow were ultimately returned to the Company under this agreement. BlueStar's former stockholders received the additional shares of the Company's common stock during 2001. Consequently, the Company recorded additional goodwill of $1,989 in 2001. However, the Company determined that such goodwill was impaired based on BlueStar's continued operating losses, as described in Note 3. Therefore, such goodwill balance was written-off through a charge to the provision for long-lived asset impairment during the year ended December 31, 2001.

Acquisition of InternetConnect Assets

On January 3, 2002, the Company purchased substantially all of the assets of InternetConnect, a related party (Note 1), in an auction supervised by the United States Bankruptcy Court for the Central District of California. The purchase price for these assets was $5,470 in cash, $235 of which had been deposited with InternetConnect's agent prior to January 1, 2002. Under the terms of the asset purchase agreement, the Company may be required to pay additional cash of up to $1,880, depending upon the outcome of a previous post-petition bankruptcy claim filed against InternetConnect by the Company, which is still pending before the court. The Company did not assume any liabilities or obligations of InternetConnect or hire any of InternetConnect's employees. In addition, the Company does not believe the assets acquired from InternetConnect constitute a self-sustaining, integrated set of activities and assets that would constitute a business.

The tangible assets of InternetConnect purchased by the Company consisted of accounts receivable, refundable deposits and property and equipment. The Company also purchased the right, but not the obligation, to assume InternetConnect's customer contracts. However, the Company did not exercise this right. Instead, the Company solicited the approximately 9,250 DSL, T-1, virtual private network ("VPN") and dial-up customers of InternetConnect, and approximately 6,200 of such customers executed new contracts with the Company or its resellers subsequent to January 3, 2002.

The Company has allocated the aforementioned purchase price based on the estimated fair values of the elements of this transaction as of January 3, 2002, as follows:

Accounts receivable	$	1,386
Refundable deposits		349
Property and equipment		61
Customer acquisition costs		3,674
	$	5,470

The customer acquisition costs of $3,674 described above were charged to network and product costs for the year ended December 31, 2002 based on the Company's accounting policy for costs of this nature that are not accompanied by up-front fees (Note 2).

Acquisition of Qwest Customer List

On June 5, 2003, the Company purchased a customer list from Qwest Communications Corporation and Qwest Interprise America, Inc. (collectively, "Qwest") pertaining to approximately 23,000 DSL subscribers who were not located in the states where Qwest provides local telephone services (substantially all of whom were not, indirectly, end-user customers of the Company as of June 5, 2003 under the then-existing wholesale DSL services agreement with Qwest). In exchange for the customer list, the Company paid $3,750 in cash and released Qwest from its obligations under the wholesale DSL services agreement. In addition, the Company agreed to pay Qwest an additional amount of up to $1,250 if certain numbers of these customers migrate to the Company's network within a defined period, which has now elapsed. The additional level of successful migrations was not achieved and, consequently, the Company was not required to pay such additional amount to Qwest. The Company did not assume any liabilities or obligations of Qwest or hire any of Qwest's employees. In addition, the Company does not believe the customer list acquired from Qwest constitutes a self-sustaining, integrated set of activities and assets that would constitute a business. Approximately 13,000 of these customers were migrated to the Company's network as of December 31, 2003.

The Company recorded the $3,750 cash payment to Qwest for the customer list as an intangible asset, and such intangible asset is being amortized on a straight-line basis to operations over a twenty-four month period, which is the Company's estimate of the aggregate expected term of its customer relationships.

Unconsolidated Investments in Affiliates

The following table lists the Company's unconsolidated investments in affiliates as of December 31, 2003 and 2002:

Entity Name	Date of Investment(s)	Ownership Percentage 2003	Ownership Percentage 2002	Method of Accounting	Investment Carrying Value 2003	Investment Carrying Value 2002
DishnetDSL Limited	February 2000	—%	—%	Equity	$ —	$ —
ACCA Networks Co., Ltd.	August 2000	10%	10%	Equity	—	—
Certive Corporation	November 1999; May 2000	5%	5%	Equity	—	1,026
Sequoia Capital X	May-November 2000	—%	—%	Equity	—	—
Loop Holdings Europe ApS	September 2000	—%	—%	Equity	—	—
					$ —	$ 1,026

DishnetDSL Limited

In February 2000, the Company acquired a 6% American Depository Receipt ("ADR") equity interest in DishnetDSL Limited ("Dishnet"), a privately held, Indian telecommunications company, in exchange for cash payments totaling approximately $23,000, which the Company believed was representative of the fair value of such investment based on significant concurrent investments in Dishnet made by new, non-strategic investors. The difference between the cost of the Company's equity investment in Dishnet and its proportional share of Dishnet's net assets ($11,963 as of December 31, 2001) was being amortized using the straight-line method over a period of five years. Concurrent with its purchase of the Dishnet ADRs, the Company also acquired, without further consideration, (i) contingent warrants for the purchase of up to 3,700,000 Dishnet ADRs at a price that is presently indeterminate and (ii) a put option (the "Put Option") from a Dishnet shareholder and another entity that entitles the Company to require these entities to purchase the Dishnet ADRs owned by the Company at their original purchase price for a specified period beginning in February 2002. Because of the contingent nature of the Dishnet warrants and uncertainties concerning the financial capacity of the makers of the Put Option, the Company ascribed no separate value to these elements of the transaction. As a result of this strategic investment, one employee of the Company became a member of the board of directors of Dishnet. (The Company's chairman holds options to purchase shares of Dishnet and is a member of the board of directors of Dishnet).

In February 2002, the Company's board of directors approved an offer involving (i) the sale of the Company's 6% ADR interest in Dishnet for $3,000 in cash, (ii) settlement of a claim alleging breach of contract by the Company relating to the OSS license described below and (iii) relinquishment of the Put Option by the Company. Consequently, during 2001, the Company wrote-down the carrying value of its Dishnet equity investment to its estimated net realizable value through a charge to the provision for impairment of unconsolidated equity investments in the amount of $10,069. This transaction was completed in May 2002, which resulted in the recognition of an additional loss in the amount of $996. Such loss included a cumulative foreign currency translation loss in the amount of $1,342, which was included in (i) the carrying value of the Company's Dishnet equity investment and (ii) the Company's accumulated other comprehensive income (loss) balance as of the date of sale of such investment.

In February 2000, the Company also licensed its OSS software to Dishnet and another entity for $28,000, $24,000 of which was received in cash on such date. The Company also agreed to provide certain software support, customization and training services to Dishnet and another entity relating to the OSS license up to an aggregate cost of $2,500. Accordingly, the Company recorded $2,500 of the OSS license proceeds received from Dishnet as a liability in February 2000, all of which has been offset by expenses incurred in 2000 and 2001 by the Company to customize the OSS for Dishnet. The remaining proceeds of $21,500 have been offset against the Company's capitalized internal-use software costs.

ACCA Networks Co., Ltd.

In August 2000, the Company acquired a 42% preferred equity interest in ACCA Networks Co., Ltd. ("ACCA"), a privately held, Japanese telecommunications company, in exchange for cash payments aggregating approximately $11,700, which the Company believes is representative of the fair value of such investment based on significant concurrent investments in ACCA made by new non-strategic investors. The difference between the cost of the Company's equity investment in ACCA and its proportional share of ACCA's net assets had been fully amortized as of December 31, 2001. As of December 31, 2003, the Company's equity interest in ACCA was diluted to 10% due to ACCA's financings in 2002 and 2001. As a result of this strategic investment, one employee of the Company is a member of the board of directors of ACCA.

In addition, in August 2000, the Company also licensed its OSS software to ACCA for $9,000, of which $2,000 and $2,000 was received in cash during 2001 and 2000, respectively. The remainder of $5,000, which was scheduled to be received in 2005, was received in December 2003 in accordance with an amendment to the August 2000 OSS software license agreement. The Company recorded the $5,000 payment received in December 2003 as miscellaneous income, because the carrying value of the OSS software licensed to ACCA was fully recovered at that time. The Company may also receive certain on-going royalty payments from ACCA under terms of the amended OSS license agreement. Such payments amounted to $2,345 and $814 during the years ended December 31, 2003 and 2002 (none during the year ended December 31, 2001). As stated above, the OSS software licensed to ACCA had a net book value of zero at December 31, 2003. Consequently, any additional royalty payments will be recorded as miscellaneous income in future periods. The Company also agreed to provide certain software support, customization and training services to ACCA relating to the OSS license up to an aggregate cost of $2,000. Accordingly, the Company recorded $2,000 of the OSS license proceeds received from ACCA as a liability in August 2000, all of which has been offset by expenses incurred in 2000 and 2001 by the Company to customize the OSS software for ACCA.

Certive Corporation

As of December 31, 2003 and 2002, the Company held a 5% preferred equity interest in Certive Corporation ("Certive"), a privately held, development stage application service provider. The Company's chairman is also the chairman and a principal stockholder of Certive. During 2003, the Company determined that its investment in Certive may be impaired due to Certive's financial condition and market prospects. Accordingly, the Company wrote-off the remaining carrying value of its investment through a charge to operations of $747 in 2003.

Sequoia Capital X

As of December 31, 2000, the Company held a 2% limited partnership interest in Sequoia Capital X, a privately held venture capital partnership. The Company sold its investment in Sequoia Capital X during 2001 for $1,225 in cash, which resulted in the recognition of a gain in the amount of $178.

Loop Holdings Europe ApS

In September 2000, the Company acquired 100% of the capital stock of Loop Holdings Europe ApS ("Loop Holdings"), which owns 70% (a 43% voting interest) of the preferred stock of Loop Telecom, S.A. ("Loop Telecom"), a privately held, Spanish telecommunications company. Consideration for the Company's acquisition of the capital stock of Loop Holdings consisted of $15,000 in cash and non-recourse notes payable aggregating $35,000. In March 2001, the Company declined to make the first scheduled payment of $15,000 under the terms of the non-recourse notes payable. As a result, the Company's indirect preferred equity interest in Loop Telecom was diluted to 21% (a 21% voting interest) and its obligations under the non-recourse notes payable were released. Accordingly, in the Company's consolidated balance sheet as of December 31, 2000, the Company netted the non-recourse notes payable aggregating $35,000 against the equity investment balance and wrote-off its initial $15,000 investment balance in Loop Holdings through a charge to operations in 2000 due to uncertainties concerning the recoverability of such investment.

On February 5, 2002, the Company, via Loop Holdings, sold its equity interest in Loop Telecom to certain other shareholders of Loop Telecom for $360 in cash, which resulted in the recognition of a gain in the amount of $360.

7. Credit Arrangements

As of December 31, 2003 and 2002, the Company's long-term debt consisted of a $50,000 term note payable to SBC (Note 11), as described below.

Immediately prior to Covad's emergence from Chapter 11 bankruptcy on December 20, 2001 (Note 3), the Company's new agreements with SBC became effective (Note 11). One such agreement (the "Credit Agreement") involves a term note payable that is collateralized by substantially all of the Company's domestic assets. This note bears interest at 11%, which is payable quarterly beginning in December 2003. The entire unpaid principal balance is payable in December 2005. However, the Company has the right to prepay the principal amount of the note, in whole or in part, at any time without penalty. In addition, upon a "Change of Control" of the Company, as defined in the Credit Agreement, SBC has the option to require all amounts due under the terms of the Credit Agreement to be paid by the Company within 30 days of the Change of Control. The Credit Agreement contains various restrictive covenants, which, among other things, restrict the Company's ability to incur additional indebtedness or permit liens to be placed on its assets.

As of December 31, 2003, the Company had a $3,000 revolving line of credit with a bank that is available through April 2004. At the Company's option, borrowings under this credit facility bear interest at certain fixed or variable rates. As of December 31, 2003 and 2002, the Company had issued irrevocable letters of credit aggregating $2,583 and $2,075, respectively, under this line of credit in favor of lessors of equipment and facilities.

8. Capital Leases

The capitalized costs and accumulated amortization related to assets under capital leases were $165 and $165, respectively, as of December 31, 2003 (the corresponding amounts were $482 and $344, respectively, as of December 31, 2002). All of the Company's capital leases were retired at maturity in 2003.

9. Operating Leases and Purchase Obligations

Operating Leases

The Company leases vehicles, equipment and office space under various noncancelable operating leases. The facility leases generally require the Company to pay operating costs, including property taxes, insurance and maintenance, and contain scheduled rent increases and certain other rent escalation clauses. The Company recognizes rent expense on a straight-line basis over the terms of the respective leases. Future minimum lease payments by year under operating leases with noncancelable terms in excess of one year, along with future minimum payments to be received under noncancelable subleases, are as follows:

	Gross Lease Payments	Less Sublease Payments	Net Lease Payments
Year ending December 31,			
2004	$ 4,999	$ 544	$ 4,455
2005	3,482	—	3,482
2006	2,814	—	2,814
2007	1,926	—	1,926
2008	1,429	—	1,429
Thereafter	269	—	269
TOTAL	$ 14,919	$ 544	$ 14,375

Rent expense, which is net of sublease income of $533, $402 and $152 in 2003, 2002 and 2001, respectively, totaled $7,874, $8,710 and $15,421 for the years ended December 31, 2003, 2002 and 2001, respectively.

Purchase Obligations

In 2002, the Company entered into a three-year, non-exclusive agreement with MCI, for the right to provide certain network services to the Company. The Company has a monthly minimum usage requirement which began in June 2002. The agreement expires in May 2005 and the Company has a minimum remaining aggregate purchase obligation of approximately $11,390 as of December 31, 2003. Similarly, in 2002, the Company entered into a three-year, non-exclusive agreement with AT&T for the right to provide certain data services to the Company. The Company has an annual minimum usage requirement which began in January 2002. The agreement expires in December 2004 and the Company has a minimum remaining aggregate purchase obligation of approximately $11,500 as of December 31, 2003. In addition, in 2002, the Company entered into a four-year, non-exclusive agreement with AT&T for the right to provide long distance services to the Company. The Company has an annual minimum usage requirement which began in April 2002. The agreement expires in March 2006 and the Company has a minimum remaining aggregate usage commitment of approximately $2,250 as of December 31, 2003.

Aggregate payments by year for the Company's purchase obligations are as follows:

Year ending December 31,	
2004	$ 20,665
2005	4,475
TOTAL	$ 25,140

Network and product costs, recognized pursuant to the aforementioned purchase obligations totaled $1,292 for the year ended December 31, 2003. No similar amounts for these purchase obligations were recorded during 2002 and 2001.

10. Contingencies

Litigation

Purchasers of the Company's common stock and purchasers of the convertible senior notes the Company issued in September 2000 filed complaints against the Company and certain present and former officers of the Company in the United States District Court for the Northern District of California (the "District Court"). The complaints were consolidated and the lead plaintiff filed its amended consolidated complaint. The amended consolidated complaint alleges violations of federal securities laws on behalf of persons who purchased or otherwise acquired the Company's securities, including common stock and notes, during the period from April 19, 2000 to May 24, 2001. The relief sought includes monetary damages and equitable relief. In 2001, the Company and the officer and director defendants entered into a Memorandum of Understanding ("MOU") with counsel for the lead plaintiffs in this litigation that tentatively resolves the litigation, providing for the distribution of $16,500 in cash to be funded by the Company's insurance carriers and 6,495,844 shares of the Company's common stock. The plaintiffs voted in favor of the plan. Consequently, the Company recorded a liability of approximately $18,578 in its consolidated balance sheet as of December 31, 2001 through a charge to litigation-related expenses for the year then ended in connection with this anticipated settlement. As a result of changes in the fair market value of the Company's common stock, the Company decreased this liability to $6,950 as of December 31, 2002 through a credit to litigation-related expenses of $11,628 for the year ended December 31, 2002. The settlement provided for in the MOU was subject to the approval of the District Court and, on December 18, 2002, the District Court issued its final judgment and dismissal order. One class member subsequently filed an appeal pertaining to the final judgment, but his appeal only relates to the allocation of the settlement proceeds between the plaintiffs and their attorneys.

In April 1999, the Company filed a lawsuit against Bell Atlantic (now Verizon) and its affiliates in the United States District Court for the District of Columbia. The Company is pursuing antitrust and other claims in this lawsuit arising out of Verizon's conduct as a supplier of network facilities, including central office space, transmission facilities and telephone lines. In December 2000, the Company also filed a lawsuit against BellSouth Telecommunications and its subsidiaries in the United States District Court for the Northern District of Georgia. The Company is pursuing claims in this lawsuit that are similar to its claims against Verizon. Both courts dismissed some of the Company's claims based on the ruling of the United States Court of Appeals for the Seventh Circuit in Goldwasser v. Ameritech. The court in the Verizon case also dismissed the Company's remaining claims on other grounds. The Company voluntarily dismissed its remaining claims in the BellSouth case so it could pursue certain issues on appeal. The Company appealed these decisions to the United States Court of Appeals for the Eleventh Circuit and the United States Court of Appeals for the District of Columbia. On August 2, 2002, the Eleventh Circuit Court of Appeals reversed the lower court's decision in the BellSouth case and remanded the case for further proceedings. BellSouth appealed this decision to the United States Supreme Court. On January 20, 2004, the United States Supreme Court reversed a decision entitled Verizon Communications v. Law Offices of Curtis Trinko, which rejected the Goldwasser decision. The Eleventh Circuit also relied in part on the Trinko decision when it reversed the lower court's dismissal of our claims against BellSouth. The Supreme Court also vacated the Eleventh Circuit's decision in the Company's case against BellSouth and remanded the case to the Eleventh Circuit for review in light of the Trinko decision. The Company believes the Trinko decision does not impact its cases, but both BellSouth and Verizon claim that Trinko supports the dismissal of the Company's lawsuits. The Company cannot predict the outcome of these matters.

On June 11, 2001, Verizon Communications filed a lawsuit against the Company in the United States District Court for the Northern District of California. Verizon is a supplier of telephone lines that the Company uses to provide services to its customers. In its amended complaint, Verizon claims that the Company falsified trouble ticket reports with respect to the phone lines the Company ordered and seeks unspecified monetary damages (characterized as being in the "millions") and injunctive relief. The current complaint asserts causes of action for negligent and intentional misrepresentation and violations of California's unfair competition statute. On November 13, 2002, the District Court entered summary judgment in favor of the Company and dismissed Verizon's claims against the Company in their entirety. Verizon has appealed the dismissal of its lawsuit. The Company believes it has strong defenses to this lawsuit, but litigation is inherently unpredictable and there is no guarantee it will prevail.

Several stockholders filed complaints in the United States District Court for the Southern District of New York, on behalf of themselves and purported classes of stockholders, against the Company and several former and current officers and directors in addition to some of the underwriters who handled the Company's stock offerings. These lawsuits are so-called IPO allocation cases, challenging practices allegedly used by certain underwriters of public equity offerings during the late 1990s and 2000. On April 19, 2002, the plaintiffs amended their complaint and removed the Company as a defendant. Certain directors and officers are still named in the complaint. The plaintiffs claim that the Company and others failed to disclose the arrangements that some of these underwriters purportedly made with certain investors. The plaintiffs and the issuer defendants have reached a tentative agreement to settle the matter, and the Company believes the tentative settlement will not have a material adverse effect on its consolidated financial position or results of operations. That settlement, however, has not been finalized. If the settlement is not finalized, the Company believes it has strong defenses to these lawsuits and intends to contest them vigorously. However, litigation is inherently unpredictable and there is no guarantee that the Company will prevail.

In June 2002, Dhruv Khanna was relieved of his duties as the Company's General Counsel and Secretary. Shortly thereafter, Mr. Khanna alleged that, over a period of years, certain current and former directors and officers breached their fiduciary duties to the Company by engaging in or approving actions that constituted waste and self-dealing, that certain current and former directors and officers had provided false representations to the Company's auditors and that he had been relieved of his duties in retaliation for his being a purported whistleblower and because of racial or national origin discrimination. He had threatened to file a shareholder derivative action against those current and former directors and officers, as well as a wrongful termination lawsuit. Mr. Khanna was placed on paid leave while his allegations were being investigated.

The Company's Board of Directors appointed a special investigative committee, which initially consisted of Dale Crandall and Hellene Runtagh, to investigate the allegations made by Mr. Khanna. Richard Jalkut was appointed to this committee shortly after he joined the Company's Board of Directors. This committee retained an independent law firm to assist in its investigation. Based on this investigation, the committee concluded that Mr. Khanna's allegations were without merit and that it would not be in the best interests of the Company to commence litigation based on these allegations. The committee considered, among other things, that many of Mr. Khanna's allegations were not accurate, that certain allegations challenged business decisions lawfully made by management or the Board of Directors, that the transactions challenged by Mr. Khanna in which any director had an interest were approved by a majority of disinterested directors in accordance with Delaware law, that the challenged director and officer representations to the Company's auditors were true and accurate, and that Mr. Khanna was not relieved of his duties as a result of retaliation for alleged whistleblowing or racial or national origin discrimination. Mr. Khanna has disputed the committee's work and the outcome of its investigation.

After the committee's findings had been presented and analyzed, the Company concluded in January 2003 that it would not be appropriate to continue Mr. Khanna on paid leave status, and determined that there was no suitable role for him at the Company. Accordingly, he was terminated as an employee of the Company.

Based on the events mentioned above, in September 2003, Mr. Khanna filed a purported class action and a derivative action against the Company's current and former directors in the Court of Chancery of the State of Delaware in and for New Castle County. In this action Mr. Khanna seeks recovery on behalf of the Company from the individual defendants for their purported breach of fiduciary duty. Mr. Khanna also seeks to invalidate the Company's election of directors in 2002 and 2003 because he claims that the Company's proxy statements were misleading. While the Company believes Mr. Khanna's contentions referred to above are without merit, and the Company and its directors will vigorously defend against them, it is unable to predict the outcome of this lawsuit.

The Company is also a party to a variety of other pending or threatened legal proceedings as either plaintiff or defendant, or is engaged in business disputes that arise in the ordinary course of business. Failure to resolve these various legal disputes and controversies without excessive delay and cost and in a manner that is favorable to the Company could significantly harm its business. The Company does not believe the ultimate outcome of these matters will have a material impact on its consolidated financial position and results of operations. However, litigation is inherently unpredictable and there is no guarantee the Company will prevail or otherwise not be adversely affected.

The Company is subject to state public utility commission, FCC and other regulatory and court decisions as they relate to the interpretation and implementation of the 1996 Telecommunications Act, the interpretation of competitive telecommunications company interconnection agreements in general, and the Company's interconnection agreements in particular. In some cases the Company may be bound by or may otherwise be significantly impacted by the results of ongoing proceedings of these bodies or the legal outcomes of other contested interconnection agreements that are similar to the Company's agreements. The results of any of these proceedings could harm the Company's business.

Other Contingencies

As of December 31, 2003, the Company had disputes with a number of telecommunications companies concerning the balances owed to such telecommunications carriers for collocation fees and certain network services. The Company believes such disputes will be resolved without a material adverse effect on its consolidated financial position and results of operations. However, it is reasonably possible that the Company's estimates of its collocation fee and network service obligations, as reflected in the accompanying consolidated balance sheets, could change in the near term, and the effects could be material to the Company's consolidated financial position and results of operations. In this regard, on February 26, 2002, the Company executed a settlement agreement with Verizon involving certain disputed collocation fee and network service obligations. Under the terms of this settlement agreement, (i) the Company was relieved of an accrued collocation fee and network service obligation with a balance of $5,570, which was recorded as a reduction of network and product costs during the fourth quarter of 2001 and (ii) Verizon's ultimate damage award or settlement, if any, pursuant to the Company's antitrust lawsuit against Verizon will be reduced by approximately $6,600. Furthermore, in May 2002, the Company executed a settlement agreement with another telecommunications company involving certain disputed network service obligations. Under the terms of this settlement agreement, the Company was relieved of a network service obligation with a recorded balance of $6,018 through a combination of a $468 payment and a $5,550 credit that reduced network and product costs during the year ended December 31, 2002. During 2003, the Company changed its estimates of certain liabilities for collocation and network services as a result of (i) the resolution of various billing disputes with its vendors and (ii) the receipt of an invoice in December 2003 from a vendor for certain services provided by such vendor primarily in 2000 and 2001, which the Company is currently disputing. In addition, the Company is engaged in a variety of legal proceedings with multiple telephone companies. These negotiations, arbitrations and regulatory proceedings concern the traditional telephone companies' denial of physical central office space to the Company in certain central offices, the cost and delivery of transmission facilities and telephone lines and central office space, billing issues and other operational issues. An unfavorable outcome in any of these negotiations, arbitrations and regulatory proceedings could have a material adverse effect on the Company's consolidated financial position and results of operations if it is denied or charged higher rates for transmission lines or central office space.

The Company is analyzing the applicability of certain transaction-based taxes to (i) sales of its products and services and (ii) purchases of telecommunications circuits from various carriers. This analysis includes discussions with authorities of significant jurisdictions in which the Company does business and various transaction-based tax experts to determine the extent of the Company's respective transaction-based tax liabilities. It is the Company's opinion that such analysis will be concluded without a material adverse effect on its consolidated financial position and results of operations. However, it is reasonably possible that the Company's estimates of its transaction-based tax liabilities, as reflected in the accompanying condensed consolidated balance sheets, could change in the near term, and the effects could be material to the Company's consolidated financial position and results of operations. During the year ended December 31, 2003, the Company changed its estimates of certain accrued liabilities for transaction-based and property taxes based on settlement agreements reached with various states and local jurisdictions where the Company does business. These changes in accounting estimate reduced the Company's net loss by $8,439 ($0.04 per share). No such changes in estimate were recognized during the years ended December 31, 2002 and 2001.

The Company is analyzing the applicability of employment-related taxes for certain stock-based compensation provided to employees in prior periods. Due to the probable applicability of these taxes, the Company recorded an estimated liability through a charge to operations in the amount of $5,931 during the year ended December 31, 2003. It is the Company's opinion that such analysis will be concluded without a material adverse effect on its consolidated financial position and results of operations. However, it is reasonably possible that the Company's estimates of these tax liabilities, as reflected in the accompanying consolidated balance sheets as of December 31, 2003, could change in the near term, and the effects could be material to the Company's consolidated financial position and results of operations.

Guarantees

From time to time, the Company enters into certain types of contracts that contingently require it to indemnify various parties against claims from third parties. These contracts primarily relate to: (i) certain real estate leases, under which the Company may be required to indemnify property owners for environmental and other liabilities, and other claims arising from the Company's use of the applicable premises, (ii) certain agreements with the Company's officers, directors and employees, under which the Company may be required to indemnify such persons for liabilities arising out of their employment relationship, (iii) contracts under which the Company may be required to indemnify customers against third-party claims that a Company product infringes a patent, copyright or other intellectual property right and (iv) procurement or license agreements under which the Company may be required to indemnify licensors or vendors for certain claims that may be brought against them arising from the Company's acts or omissions with respect to the supplied products or technology.

Generally, a maximum obligation under these contracts is not explicitly stated. Because the obligated amounts associated with these types of agreements are not explicitly stated, the overall maximum amount of the obligation cannot be reasonably estimated. Historically, the Company has not been required to make payments under these obligations, and no liabilities have, therefore, been recorded for these obligations in the Company's consolidated balance sheets.

11. Stockholders' Equity (Deficit)

Strategic Investors

Effective December 20, 2001, immediately prior to Covad's emergence from Chapter 11 bankruptcy (Note 3), the Company entered into a series of agreements with SBC, including (i) a $50,000 Credit Agreement (Note 7), (ii) a 10-year resale agreement (the "Resale Agreement") under which SBC, its affiliates or special agents will resell the Company's DSL services (SBC made a $75,000 non interest-bearing prepayment, which is collateralized by substantially of the Company's domestic assets, to the Company on December 20, 2001 under the terms of the Resale Agreement) and (iii) a termination and mutual general release agreement (the "Termination Agreement") that resulted in the cancellation of various agreements entered into in September 2000, except for the stock purchase agreement and an interconnection and line-sharing agreement that remains in effect. The Company received a payment of $10,000 from SBC on December 20, 2001 under the terms of the Termination Agreement, which was deferred and is being recognized as revenue on a straight-line basis over the 10-year term of the Resale Agreement.

Common Stock

6,625 shares of the Company's common stock outstanding at December 31, 2002 (none in 2003) were subject to repurchase provisions, which generally lapse over a four-year period from the date of issuance.

Common stock reserved for future issuance as of December 31, 2003 was as follows:

Bankruptcy claims (Note 3)	7,078,733
Outstanding options (Note 13)	21,676,765
Options available for grant (Note 13)	14,895,194
Employee stock purchase plan (Note 13)	3,005,809
Outstanding warrants (Note 11)	6,511,574
TOTAL	53,168,075

Stockholder Protection Rights Plan

On February 15, 2000, the Company's Board of Directors adopted a Stockholder Protection Rights Plan under which stockholders received one right for each share of the Company's common stock or Class B common stock owned by them. The rights become exercisable, in most circumstances, upon the accumulation by a person or group of 15% or more of the Company's outstanding shares of common stock. Each right entitles the holder to purchase from the Company, as provided by the Stockholder Protection Rights Agreement, one one-thousandth of a share of participating preferred stock, par value $.001 per share, for $400 per share, subject to adjustment. As of December 31, 2003 and 2002, none of these rights were exercisable.

Warrants

On January 1, 2003, in conjunction with an amendment to an agreement with AT&T, the Company granted AT&T three warrants to purchase shares of the Company's common stock as follows: 1,000,000 shares for $0.94 per share; 1,000,000 shares for $3.00 per share; and 1,000,000 shares for $5.00 per share. Such warrants were immediately exercisable, fully vested and nonforfeitable at the date of grant. Accordingly, the measurement date for these warrants was the date of grant. The aggregate fair value of such warrants of $2,640 was recorded as a deferred customer incentive during the first quarter of 2003 and is being recognized as a reduction of revenues on a straight-line basis over the three-year term of the agreement because the Company believes that future revenues from AT&T will exceed the fair value of the warrants described above. This value was determined using the Black-Scholes option valuation model and the following assumptions: closing price of the Company's common stock on December 31, 2002 of $0.94 per share; expected life of seven years (which is also the contractual life of the warrants); dividend yield of zero; volatility of 1.52; and a risk-free interest rate of 3.36%. None of these warrants were exercised during 2003 or had expired as of December 31, 2003.

On September 4, 2002, in conjunction with the execution of a five-year agreement with America Online, Inc. ("AOL"), a wholesale customer, the Company granted AOL three warrants to purchase 1,500,000 shares of the Company's common stock for $1.06 per share, 1,000,000 shares of the Company's common stock for $3.00 per share and 1,000,000 shares of the Company's common stock for $5.00 per share. Such warrants were immediately exercisable, fully vested and nonforfeitable at the date of grant. Accordingly, the measurement date for these warrants was the date of grant. The aggregate fair value of such warrants of $3,790, which was determined using the Black-Scholes option valuation model and the following assumptions: closing price of the Company's common stock on September 4, 2002 of $1.14 per share; expected life of seven years (which is also the contractual life of the warrants); dividend yield of zero; volatility of 1.56; and a risk-free interest rate of 3.63%, was recorded as a deferred customer incentive and is being recognized as a reduction of revenues on a straight-line basis over the five-year term of the agreement. None of these warrants were exercised during 2003 or had expired as of December 31, 2003.

Other warrants for the purchase of 11,574 shares of the Company's common stock were outstanding as of December 31, 2003. Such warrants are exercisable at a purchase price of $0.01 per share and fully vested as of December 31, 2003. Unless exercised, all such warrants will expire on March 15, 2008. Warrants for the purchase of 225,000 shares of the Company's common stock expired in February 2003.

12. Income Taxes

The Company has made no provision for income taxes in any period presented in the accompanying consolidated financial statements because it incurred operating losses in each of these periods. In addition, the Company made no provision for income taxes on the extraordinary gain resulting from the extinguishment of debt in 2001 (Note 3) due to the relevant federal and state tax regulations governing the treatment of debt extinguishment income in Chapter 11 bankruptcy proceedings.

A reconciliation of income taxes computed at the federal statutory rate (35%) to income tax expense (benefit) recorded in the Company's consolidated statements of operations is as follows:

	Year ended December 31,		
	2003	2002	2001
Federal benefit at statutory rate	$ (34,976)	$ (64,690)	$ (241,139)
Nondeductible interest expense	—	—	878
Net operating losses with no current benefits	33,807	65,704	206,948
Deconsolidation of BlueStar	—	—	23,915
Other	1,169	(1,014)	9,398
INCOME TAX EXPENSE (BENEFIT)	$ —	$ —	$ —

Deferred income taxes reflect the net tax effect of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and amounts used for income tax purposes. Significant components of the Company's deferred tax assets and liabilities for federal and state income taxes are as follows:

	December 31,	
	2003	2002
Deferred tax assets:		
Net operating loss carryforwards	$ 327,574	$ 284,482
Capital loss carryforwards	16,919	10,803
Deferred and unearned revenue	37,921	45,600
Deconsolidation of BlueStar	21,585	21,589
Unconsolidated investments in affiliates	6,725	12,424
Depreciation and amortization	38,158	36,037
Other	12,231	11,107
Total deferred tax assets	461,113	422,042
Valuation allowance	(461,113)	(422,042)
Net deferred tax assets	—	—
Deferred tax liabilities	—	—
NET DEFERRED TAXES	$ —	$ —

Realization of the Company's deferred tax assets relating to net operating loss carryforwards and other temporary differences is dependent upon future earnings, the timing and amount of which are uncertain. Accordingly, the Company's net deferred tax assets have been fully offset by a valuation allowance. The valuation allowance increased (decreased) by $39,071, $129,529 and $(145,941) during 2003, 2002 and 2001, respectively.

As of December 31, 2003, the Company had net operating loss carryforwards for federal income tax purposes of $762,000, which will expire beginning in 2022, if not utilized. As a result of the Company emerging from the bankruptcy (Note 3), the Company's federal net operating loss carryforwards were reduced by approximately $995,000 in 2001. The Company also had aggregate net operating loss carryforwards for state income tax of approximately $1,221,000, of which $14,856 will expire in 2004, $122,832 will expire in 2005, and $1,083,312 will expire thereafter, if not utilized. In addition, the Company had capital loss carryforwards for both federal and state income tax purposes of approximately $42,000, which begin to expire in 2006, if not utilized.

The tax benefits associated with employee stock options provided cumulative deferred tax benefits of approximately $6,938 and $2,300 for the years ended December 31, 2003 and 2002, respectively. Such deferred tax benefits have been offset by a valuation allowance and will be credited to additional paid-in capital when realized.

The utilization of the Company's net operating loss may be subject to substantial annual limitation due to the "change in ownership" provisions of the Internal Revenue Code of 1986, as amended, and similar state provisions. The annual limitation may result in the expiration of net operating losses and tax credits before utilization.

13. Employee Benefit Plans

Defined Contribution Plan

The Company has a defined contribution retirement plan under Section 401(k) of the Internal Revenue Code that covers substantially all employees. Eligible employees may contribute amounts to the plan, via payroll withholding, subject to certain limitations. The Company does not match contributions by plan participants.

In connection with the Company's acquisition of Laser Link.net, Inc. ("Laser Link") on March 20, 2000 and BlueStar (Notes 4 and 6), the Company merged Laser Link's and BlueStar's defined contribution retirement plan under Section 401(k) of the Internal Revenue Code into the Company's defined contribution retirement plan.

1998 Employee Stock Purchase Plan

In January 1999, the Company adopted the 1998 Employee Stock Purchase Plan. Under this plan, eligible employees could purchase common stock at 85% of the lesser of the fair market value of the Company's common stock on the first day of the applicable twenty-four month offering period or the last day of the applicable six month purchase period. The 1998 Employee Stock Purchase Plan was terminated on April 28, 2003.

2003 Employee Stock Purchase Plan

In June 2003, following the termination of the 1998 Employee Stock Purchase Plan, the Company adopted the 2003 Employee Stock Purchase Plan. Under this plan, eligible employees may purchase common stock at 85% of: (i) the fair market value of the Company's common stock on the first day of the applicable twenty-four month offering period; or (ii) the fair market value on the last day of the applicable six-month purchase period.

Stock Option Plans

The 1997 Stock Plan (the "Plan") provides for the grant of stock purchase rights and options to purchase shares of common stock to employees and consultants from time to time as determined by the Company's Board of Directors. The options expire from two to eight years after the date of grant. As of December 31, 2003, the Company has reserved 14,895,194 shares of the Company's common stock under the Plan for sale and issuance at prices to be determined by the Company's Board of Directors.

In connection with the Company's acquisition of Laser Link, the Company assumed Laser Link's stock option plan. Laser Link's stock option plan provides for the grant of options to purchase shares of common stock to employees and consultants from time to time. The options expire up to ten years after the date of grant. The Company assumed the Laser Link stock option plan at the time it acquired Laser Link and it is no longer issuing options under the Laser Link stock option plan. A maximum of 1,434,957 shares of the Company's common stock will be available for issuance under the Laser Link Plan. The options granted under the Laser Link plan are included in the data set forth below.

In connection with the Company's acquisition of BlueStar, the Company assumed BlueStar's stock option plan. BlueStar's stock option plan provides for the grant of options to purchase shares of common stock to employees and consultants from time to time. The options expire up to ten years after the date of grant. The Company assumed the BlueStar stock option plan at the time it acquired BlueStar and it is no longer issuing options under the BlueStar stock option plan. A maximum of 1,251,182 shares of the Company's common stock will be available for issuance under the BlueStar stock option plan. The options granted under the BlueStar stock option plan are included in the data set forth below.

The following table summarizes stock option activity for the years ended December 31, 2003, 2002 and 2001:

	Number of Shares of Common Stock	Option Price Per Share
Balance as of December 31, 2000	27,734,375	$ 0.001 – $ 149.79
Granted	24,726,003	$ 0.350 – $ 39.00
Exercised	(4,100,977)	$ 0.001 – $ 2.56
Cancelled	(16,759,071)	$ 0.001 – $ 149.79
Balance as of December 31, 2001	31,600,330	$ 0.001 – $ 149.79
Granted	2,231,048	$ 0.940 – $ 2.30
Exercised	(1,005,937)	$ 0.001 – $ 2.56
Cancelled	(7,150,427)	$ 0.001 – $ 149.79
Balance as of December 31, 2002	25,675,014	$ 0.001 – $ 149.79
Granted	7,195,875	$ 0.570 – $ 5.53
Exercised	(4,984,279)	$ 0.001 – $ 5.44
Cancelled	(6,209,845)	$ 0.296 – $ 149.79
Balance as of December 31, 2003	**21,676,765**	**$ 0.001 – $ 149.79**

The following is a summary of the status of stock options outstanding at December 31, 2003:

	Options Outstanding			Options Exercisable	
Exercise Price Range	Number of Shares	Weighted-Average Life Remaining	Weighted-Average Exercise Price	Number of Shares	Weighted-Average Exercise Price
$ 0.001 – $ 0.48	594,439	4.06	$ 0.28	429,847	$ 0.23
$ 0.49 – $ 0.56	2,987,310	5.70	$ 0.55	1,269,337	$ 0.55
$ 0.57 – $ 0.72	451,965	6.21	$ 0.68	199,946	$ 0.69
$ 0.78 – $ 0.84	2,356,825	5.48	$ 0.84	1,415,761	$ 0.84
$ 0.86 – $ 1.17	948,540	6.53	$ 1.05	309,610	$ 1.05
$ 1.18 – $ 1.28	4,954,980	7.57	$ 1.28	1,428,203	$ 1.28
$ 1.29 – $ 2.56	2,081,123	5.60	$ 1.80	1,211,408	$ 1.86
$ 2.56 – $ 2.56	2,499,601	5.22	$ 2.56	2,031,856	$ 2.56
$ 2.59 – $ 27.75	2,357,460	5.05	$ 10.77	1,608,614	$ 12.73
$ 27.83 – $ 149.79	2,444,522	3.84	$ 43.62	2,384,705	$ 43.29
$ 0.001 – $ 149.79	21,676,765	5.76	$ 7.09	12,289,287	$ 11.02

In addition to the recognition and reversal of stock-based compensation described in Note 1 under "Basis of Presentation," during the years ended December 31, 2003 and 2002, the Company reversed approximately $136 and $1,213, respectively, of stock-based compensation recorded in prior years due to the termination of certain employees (none in 2003). During the year ended December 31, 2002, the Company recorded deferred stock-based compensation of approximately $426, as a result of employment status changes, stock option grants and restricted stock issuances with exercise or purchase prices that were less than the fair value of the Company's common stock at the date of grant or issuance (none in 2003 or 2001). These amounts are being amortized to operations over the respective vesting periods of the underlying options using a graded vesting method. Amortization (reversal) of deferred stock-based compensation for the years ended December 31, 2003, 2002 and 2001 was approximately $1,344, $(3,358) and $1,597, respectively. Included in the amortization of deferred stock-based compensation for the year ended December 31, 2001 is $302 relating to accelerated vesting provisions included in stock options granted to certain employees in previous years. These accelerated vesting provisions were triggered by the resignation of such employees during 2001. No similar amounts are included in the amortization of deferred stock-based compensation in 2003 and 2002.

During the years ended December 31, 2002 and 2001, the Company extended the exercise period of options granted to certain former employees for the purchase of 272,184 and 244,550 shares, respectively, of the Company's common stock. Consequently, for the years ended December 31, 2002 and 2001, the Company recognized stock-based compensation expense of $221 and $253, respectively, which represents the difference between the exercise price of these options and the fair value of the Company's common stock on the respective dates of the option award modifications. The Company did not modify any stock-based awards in 2003.

The Company grants options to consultants from time to time in exchange for services. In general, these options vest over the contractual period of the consulting arrangement. The Company granted options to consultants to purchase 347,000 shares of the Company's common stock in 2001. No options were granted to consultants in 2003 or 2002. The fair value of these options is being amortized to expenses over the vesting term of the options. The Company recorded expenses of $120, $64 and $186 for the fair value of these options in 2003, 2002 and 2001, respectively. As of December 31, 2003, 2002 and 2001 the fair value of the remaining unvested options granted to consultants was $22, $3 and $643, respectively. These charges are subject to adjustment based on the fair value of the Company's common stock on the date the options vest.

Pro Forma Stock-Based Compensation Information

Pro forma information regarding the results of operations and net income (loss) per share (Note 1) is determined as if the Company had accounted for its employee stock options using the fair value method. Under this method, the fair value of each option granted is estimated on the date of grant using the Black-Scholes option valuation model.

The Company uses the intrinsic value method in accounting for its employee stock options because, as discussed below, the alternative fair value accounting requires the use of option valuation models that were not developed for use in valuing employee stock options. Under the intrinsic value method, when the exercise price of the Company's employee stock options equals or exceeds the market price of the underlying stock on the date of grant, no compensation expense is recognized.

Option valuation models were developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions, including the expected life of the option. Because the Company's employee stock options have characteristics significantly different from those of traded options and because changes in the subjective input assumptions can materially affect the fair value estimates, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options.

For the years ended December 31, 2003, 2002 and 2001, the fair value of the Company's stock-based awards to employees was estimated using the following weighted average assumptions:

	Stock Options			Employee Stock Purchase Plan		
	2003	2002	2001	2003	2002	2001
Expected life of options in years	4.0	4.0	4.0	0.5	0.5	0.5
Volatility	131.70%	152.10%	169.20%	131.70%	152.10%	169.20%
Risk-free interest rate	2.10%	3.10%	4.09%	1.08%	1.72%	3.45%
Expected dividend yield	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%

14. Business Segments

The Company's business segments are strategic business units that are managed based upon differences in customers, services and marketing channels, even though the assets and cash flows from these operations are not independent of each other. CSP focuses on delivering services to enterprise, corporate, small business, small office/home office ("SoHo") and consumer customers primarily through wholesale relationships with large ISPs, telecommunications carriers and other large resellers. CBS focuses on small business and SoHo markets by selling services directly to end-users as well as through independent authorized sales agents, small ISPs and resellers. All other business operations and activities of the Company are aggregated and reported as Corporate Operations. These operations and activities are primarily comprised of general corporate functions to support the Company's revenue producing segments as well as costs and expenses for headquarters facilities and equipment, depreciation and amortization, network capacity and other non-recurring or unusual items not directly attributable or allocated to the segments, gains and losses on the Company's investments, and income and expenses from the Company's treasury and financing activities.

The accounting policies used in measuring segment assets and operating results are the same as those described in Notes 1 and 2. The Company evaluates the performance of, and allocates resources to, the segments based on segment net income or loss, which excludes certain operating expenses, including depreciation and amortization, and all other income and expense items, all of which are allocated to Corporate Operations. The Company does not allocate such operating expenses and other income and expense items to its business segments because it believes that these expenses and other income items are not directly controlled by the business segments.

Segment information, including a reconciliation to the respective balances in the Company's consolidated financial statements, as of December 31, 2003, 2002 and 2001, are as follows (the Company's 2002 and 2001 segment information have been restated to conform to the Company's organizational structure in 2003):

	CSP	CBS	Total Segments	Corporate Operations	Intercompany Eliminations	Consolidated Total
As of and for the year ended December 31, 2003:						
Domestic revenues from unaffiliated customers, net	$ 236,928	$ 151,923	$ 388,851	$ —	$ —	$ 388,851
Intersegment revenues	—	—	—	—	—	—
Total revenues, net	236,928	151,923	388,851	—	—	388,851
Operating expenses	186,093	106,885	292,978	122,953	—	415,931
Depreciation and amortization	—	—	—	56,559	—	56,559
Amortization of intangible assets	—	—	—	17,325	—	17,325
Provision for restructuring expenses	103	349	452	783	—	1,235
Total operating expenses	186,196	107,234	293,430	197,620	—	491,050
Income (loss) from operations	50,732	44,689	95,421	(197,620)	—	(102,199)
Interest income	—	—	—	2,105	—	2,105
Equity in losses of unconsolidated affiliates	—	—	—	(279)	—	(279)
Interest expense	—	—	—	(5,526)	—	(5,526)
Other income (expense), net	—	—	—	5,968	—	5,968
Total other income (expense), net	—	—	—	2,268	—	2,268
NET INCOME (LOSS)	$ 50,732	$ 44,689	$ 95,421	$(195,352)	$ —	$ (99,931)
Assets	$ 46,140	$ 23,432	$ 69,572	$ 265,139	$ —	$ 334,711
Capital expenditures for property and equipment	$ —	$ —	$ —	$ 44,142	$ —	$ 44,142
Payment of collocation fees and purchase of other intangible assets	$ —	$ —	$ —	$ 14,889	$ —	$ 14,889
As of and for the year ended December 31, 2002:						
Domestic revenues from unaffiliated customers, net	$ 231,721	$ 151,775	$ 383,496	$ —	$ —	$ 383,496
Intersegment revenues	—	—	—	—	—	—
Total revenues, net	231,721	151,775	383,496	—	—	383,496
Operating expenses	183,384	113,260	296,644	152,384	—	449,028
Depreciation and amortization	—	—	—	112,438	—	112,438
Amortization of intangible assets	—	—	—	14,650	—	14,650
Non-cash litigation-related expenses	—	—	—	(11,628)	—	(11,628)
Total operating expenses	183,384	113,260	296,644	267,844	—	564,488
Income (loss) from operations	48,337	38,515	86,852	(267,844)	—	(180,992)
Interest income	—	—	—	5,122	—	5,122
Equity in losses of unconsolidated affiliates	—	—	—	(806)	—	(806)
Interest expense	—	—	—	(5,581)	—	(5,581)
Other income (expense), net	—	—	—	(2,571)	—	(2,571)
Total other income (expense), net	—	—	—	(3,836)	—	(3,836)
NET INCOME (LOSS)	$ 48,337	$ 38,515	$ 86,852	$(271,680)	$ —	$ (184,828)
Assets	$ 52,173	$ 17,319	$ 69,492	$ 372,669	$ —	$ 442,161
Investments in unconsolidated affiliates: Domestic	$ —	$ —	$ —	$ 1,026	$ —	$ 1,026
Capital expenditures for property and equipment	$ —	$ —	$ —	$ 22,782	$ —	$ 22,782
Payment of collocation fees	$ —	$ —	$ —	$ 3,782	$ —	$ 3,782

	CSP	CBS	Total Segments	Corporate Operations	Intercompany Eliminations	Consolidated Total
As of and for the year ended December 31, 2001:						
Domestic revenues from unaffiliated customers, net	$ 162,054	$ 170,542	$ 332,596	$ —	$ —	$ 332,596
Intersegment revenues	—	—	—	—	—	—
Total revenues, net	162,054	170,542	332,596	—	—	332,596
Operating expenses	206,807	210,586	417,393	243,732	—	661,125
Depreciation and amortization	—	—	—	137,920	—	137,920
Amortization of intangible assets	—	—	—	12,919	—	12,919
Provision for restructuring expenses	—	—	—	14,364	—	14,364
Provision for long-lived asset impairment	—	—	—	11,988	—	11,988
Non-cash litigation-related expenses	—	—	—	31,160	—	31,160
Total operating expenses	206,807	210,586	417,393	452,083	—	869,476
Loss from operations	(44,753)	(40,044)	(84,797)	(452,083)	—	(536,880)
Interest income	—	—	—	24,593	—	24,593
Equity in losses of unconsolidated affiliates	—	—	—	(13,769)	—	(13,769)
Interest expense	—	—	—	(92,782)	—	(92,782)
Other income (expense), net	—	—	—	(70,131)	—	(70,131)
Gain on extinguishment of debt	—	—	—	1,033,727	—	1,033,727
Total other income (expense), net	—	—	—	881,638	—	881,638
NET INCOME (LOSS)	$ (44,753)	$ (40,044)	$ (84,797)	$ 429,555	$ —	$ 344,758
Capital expenditures for property and equipment	$ —	$ —	$ —	$ 15,732	$ —	$ 15,732
Payment of collocation fees	$ —	$ —	$ —	$ 7,940	$ —	$ 7,940

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