Network Solutions, Inc.

Selected Financial Data

(In thousands, except per share data)	1994	1995[1]	1996	1997	1998
		Year Ended December 31,			
Statement of Operations Data:					
Net revenue	$ 5,029	$ 6,486	$18,862	$ 45,326	**$ 93,652**
Cost of revenue	3,073	5,704	14,666	25,798	**38,530**
Gross profit	1,956	782	4,196	19,528	**55,122**
Research and development expenses	—	—	680	1,653	**4,821**
Selling, general and administrative expenses	1,544	2,394	6,280	12,268	**37,144**
Interest income	—	—	(496)	(2,211)	**(6,303)**
Other expenses	109	61	—	116	**116**
Income (loss) from continuing operations before income taxes	303	(1,673)	(2,268)	7,702	**19,344**
Provision (benefit) for income taxes	114	(239)	(643)	3,471	**8,109**
Income (loss) from continuing operations	189	(1,434)	(1,625)	4,231	**11,235**
Loss from discontinued operations, net of income taxes	(1,169)	(1,403)	—	—	**—**
Net income (loss)	$ (980)	$ (2,837)	$ (1,625)	$ 4,231	**$ 11,235**
Basic earnings per share:[2]					
Income (loss) from continuing operations	$ 0.09	$ (0.07)	$ (0.07)	$ 0.16	**$ 0.35**
Loss from discontinued operations	(0.56)	(0.07)	—	—	**—**
Net income (loss)	$ (0.47)	$ (0.14)	$ (0.07)	$ 0.16	**$ 0.35**
Weighted average shares	2,084	20,670	25,000	26,610	**31,957**
Diluted earnings per share:[2]					
Income (loss) from continuing operations	$ 0.09	$ (0.07)	$ (0.07)	$ 0.16	**$ 0.34**
Loss from discontinued operations	(.56)	(0.07)	—	—	**—**
Net income (loss)	$ (0.47)	$ (0.14)	$ (0.07)	$ 0.16	**$ 0.34**
Weighted average shares	2,084	20,670	25,000	26,966	**33,397**
Other Operating Data:[3]					
Net new registrations	24	141	489	960	**1,911**
Registrations not renewed	—	1	39	46	**90**
Net registrations as of period end	37	177	627	1,541	**3,362**
Balance Sheet Data:					
Cash and cash equivalents	$ 136	$ 5	$15,540	$ 41,146	**$ 12,862**
Total marketable securities	—	—	—	40,200	**128,098**
Working capital	1,340	(559)	1,362	50,947	**65,791**
Total assets	2,448	11,748	66,118	149,620	**243,867**
Restricted assets included in total assets	—	1,408	17,453	25,873	**—**
Deferred revenue, net	137	3,346	29,352	61,451	**129,194**
Long-term obligations, excluding current portion	81	1,353	9,440	18,743	**35,721**
Total stockholders' equity	252	3,062	1,437	47,655	**75,130**

(1) The Selected Financial Data for the year ended December 31, 1995 was derived by combining Network Solutions results of operations for the period January 1, 1995 through March 10, 1995 and the period March 11, 1995 through December 31, 1995, which, respectively, are periods before and after the date of the SAIC acquisition. The data for these two periods were prepared on differing bases of accounting and, accordingly, the comparability of such data with other periods is limited, primarily as a result of goodwill amortization, new corporate services agreements and the repayment of outstanding debt balances.

(2) All share and per share data reflect the two-for-one stock split in March 1999.

(3) Net new registrations for each period include gross new registrations less an estimate of registrations that are uncollectible. Net registrations include net new registrations less an estimate of registrations not renewed. Prior to September 14, 1995, net registrations equaled gross registrations because Network Solutions was reimbursed by the National Science Foundation for all registrations under a cost plus fixed-fee contract.

Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis should be read in conjunction with "Selected Financial Data" and the Company's accompanying financial statements and notes thereto. Certain information in this Annual Report contains forward-looking statements. For this purpose, any statements contained herein that are not statements of historical fact may be deemed to be forward-looking statements. Statements regarding the intent, belief or current expectations of the Company are intended to be forward-looking statements which may involve risk and uncertainty. There are a number of factors that could cause the Company's actual results to differ materially from those indicated by such forward-looking statements, including, but not limited to, those discussed in "Factors Affecting Operating Results" as well as those discussed elsewhere in this Annual Report and in the Company's 1998 Form 10-K and its subsequent SEC filings.

Overview

Network Solutions, Inc.

Network Solutions currently acts as the exclusive registry and registrar of Internet domain names within the *.com*, *.org*, *.net* and *.edu* top level domains pursuant to the Cooperative Agreement with the Department of Commerce. Domain names are used to identify a unique site or presence on the Internet. As registry and registrar for these top level domains, Network Solutions registers new domain names and is responsible for the maintenance of the master file of domain names through daily updates to the Internet. Network Solutions also provides Internet Technology Services, focusing on network engineering, network and systems security and network management solutions.

Cumulative net registrations (gross registrations less management's estimate of uncollectible registrations and of non-re-registrations) within the top level domains administered by Network Solutions increased by 118%, from 1,541,000 domain names registered at December 31, 1997 to 3,362,000 domain names registered at December 31, 1998. Net registrations in the *.com* top level domain represent 84% of Network Solutions' total net registrations at December 31, 1998. Of the 3,362,000 cumulative net registrations at December 31, 1998, 1,453,000 registrations will be up for annual re-registration during the next twelve months based upon their respective anniversaries of initial registration. International registrations accounted for 28% of net new registrations during 1998 and 26% of net new registrations during 1997. Net revenue from registration services accounted for 91.5% of Network Solutions' net revenue for the year ended December 31, 1998.

Network Solutions delivers Internet Technology Services to large companies that desire to establish or enhance their Internet presence or re-engineer legacy network infrastructures to accommodate the integration of both Internet connectivity and internal enterprise network, or intranet, technology into their information technology base. Our Internet Technology Services include network engineering, network and systems security and network management. During the year ended December 31, 1998, Network Solutions provided Internet Technology Services to more than 20 companies. Net revenue from Internet Technology Services accounted for 8.5% of Network Solutions' net revenue for the year ended December 31, 1998.

Registration Services

In December 1992, Network Solutions entered into the Cooperative Agreement with the National Science Foundation under which Network Solutions was to provide Internet domain name registration services for five top level domains: *.com*, *.org*, *.net*, *.edu* and *.gov*. These registration services include the initial two year domain name registration and annual re-registration, and throughout the registration term, maintenance of and unlimited modifications to individual domain name records and updates to the master file of domain names. The Cooperative Agreement became effective January 1, 1993. It included a three-month phase-in period, a five-year operational period, commencing April 1, 1993 and ending March 31, 1998, and a six-month flexibility period through September 30, 1998. Effective September 9, 1998, the Department of Commerce took over the administration of the Cooperative Agreement from the National Science Foundation. In October 1998, the Cooperative Agreement was amended to extend the flexibility period until September 30, 2000.

The original terms of the Cooperative Agreement provided for a cost reimbursement plus fixed-fee contract (with an initial fee of 8%). Effective September 14, 1995, the National Science Foundation and Network Solutions amended the Cooperative Agreement to require Network Solutions to begin charging end users a services fee of $50 per year for each domain name in the *.com*, *.org* and *.net* top level domains. Until April 1, 1998, registrants paid a services fee of $100 for two years of domain name services upon each initial registration and an annual re-registration fee of $50 per year thereafter. The National Science Foundation paid the registration fees for domain names within the *.edu* and *.gov* top level domains through March 31, 1997. Commencing April 1, 1997, Network Solutions agreed with the National Science Foundation to provide domain name services within the *.edu* and *.gov* top level domains free of charge. As of October 1, 1997, Network Solutions no longer registers or administers domain names in the *.gov* top level domain.

Under the terms of the September 14, 1995 amendment to the Cooperative Agreement, 30% of the registration fees collected by Network Solutions was required to be set aside for the enhancement of the intellectual infrastructure of the Internet (set aside funds) and, as such, was not recognized as revenue by the Company. Network Solutions has reflected these set aside funds, along with the appropriate percentage of net accounts receivable, as restricted assets and has recorded an equivalent, related current liability. Network Solutions maintained the cash received relating to the set aside funds in a separate interest bearing account. The set aside funds, plus any interest earned, were disbursed at the direction of the National Science Foundation. As of December 31, 1998, the Company had cumulatively disbursed all set aside funds collected and associated interest earned for a total of $62.3 million to the National Science Foundation at their direction. The restricted cash at December 31, 1997 and 1998 was approximately $23,512,000 and $0, respectively.

On March 12, 1998, the National Science Foundation and Network Solutions amended the Cooperative Agreement to eliminate the 30% set aside requirement effective April 1, 1998 and to reduce the registration fees by a corresponding amount. Initial registrations on and after April 1, 1998 are charged $70 for two years of registration services and an annual re-registration fee of $35 per year thereafter. This amendment had no effect on the revenue currently recognized on each registration, $70 for initial registrations and $35 for re-registrations, since Network Solutions previously did not recognize revenue on the 30% set aside funds. Accordingly, while the revenue to Network Solutions on a per registration basis does not change, the amount charged to customers declined.

In order to provide prompt access to new domain names on the Internet, Network Solutions generally invoices customers and permits them to pay their registration fees after their domain names are registered. Network Solutions' experience has been that, for the period from September 1995 through December 1998, approximately 31% of new registrations have ultimately been deactivated for non-payment. Network Solutions believes that this level of uncollectible receivables is due to, among other factors, the large number of individuals and corporations that have registered multiple domain names with the apparent intention of transferring registration for such names at a profit. Such resellers have a greater tendency than other customers to default on their registration fees. As a consequence, Network Solutions has recorded a comparable provision for uncollectible accounts in determining net registration revenue. This provision averaged 30% in 1996 and 1997 and 32% in 1998 and is considered adequate by Network Solutions.

Registration fees charged to customers for registration services are recognized as revenue evenly over the registration term. For example, Network Solutions recognizes $70 on a straight-line basis over the two-year service period for each $70 initial domain name registration, equivalent to $35 per year. Annual re-registrations of domain names are recorded as revenue based upon $35 recognized on a straight-line basis over the one-year service period. This subscription-based model defers revenue recognition until Network Solutions provides the registration services, including maintenance of and unlimited modifications to individual domain name records, over the respective registration terms. At December 31, 1998, Network Solutions had net deferred revenue of $129.2 million.

Expenses for Network Solutions increased each quarter during 1996, 1997 and 1998 as a result of increased business activities, primarily attributable to subscriber growth for Network Solutions' registration services business. Network Solutions believes continued investments in its back office infrastructure as well as significant expansion of its sales and marketing and product development activities are critical to the achievement of its goals and anticipates that costs and expenses will continue to increase in each quarter for the foreseeable future.

Internet Technology Services

Substantially all of Network Solutions' Internet Technology Services revenue is derived from professional services which are generally provided to clients on a time and expense basis and is recognized as services are performed.

The majority of Network Solutions' Internet Technology Services are provided to customers in the financial services industry. Bank of America, formerly NationsBanc, is currently Network Solutions' largest Internet Technology Services client, accounting for 40% of Network Solutions' Internet Technology Services business net revenue and 3% of Network Solutions' total net revenue for the year ended December 31, 1998. NationsBanc originally contracted with Network Solutions in 1993 and Network Solutions currently provides network design and engineering services as well as a variety of project specific services under the contract.

Results of Operations

The following table sets forth, for the periods indicated, the percentage relationship to net revenue of certain items in Network Solutions' Statements of Operations.

	Year Ended December 31,		
	1996	1997	**1998**
Percentage of net revenue:			
Net revenue	100.0%	100.0%	**100.0%**
Cost of revenue	77.8	56.9	**41.1**
Gross profit	22.2	43.1	**58.9**
Research and development expenses	3.6	3.6	**5.1**
Selling, general and administrative expenses	33.3	27.1	**39.7**
Interest and other expense (income)	(2.7)	(4.6)	**(6.6)**
Income (loss) before income taxes	(12.0)	17.0	**20.7**
Provision (benefit) for income taxes	(3.4)	7.7	**8.7**
Net income (loss)	(8.6)%	9.3%	**12.0%**

Comparison of Years Ended December 31, 1997 and 1998

Net Revenue

Net revenue increased 107% from $45.3 million for the year ended December 31, 1997 to $93.7 million for the year ended December 31, 1998. This increase in net revenue was primarily attributable to the increase in the number of domain name registrations, principally in the *.com* top level domain. Net revenue from registration services increased 121% from $38.8 million for the year ended December 31, 1997 to $85.7 million for the year ended December 31, 1998. Net new registrations increased 99% from 960,000 for the year ended December 31, 1997 to 1,911,000 for the year ended December 31, 1998. Growth in net registrations continues to be driven by the widespread use and adoption by businesses of the Internet and intranets on a global basis. Cumulative net registrations as of December 31, 1997 were 1,541,000 as compared to 3,362,000 as of December 31, 1998 for a 118% increase.

Additionally, net new registrations increased 137% from 262,000 for the three months ended December 31, 1997 to 621,000 for the three months ended December 31, 1998. This also represents a 23% increase over the 507,000 net new registrations for the three months ended September 30, 1998. The growth in cumulative net registrations was a 21% increase in Network Solutions' entire customer base since September 30, 1998.

Net revenue from Internet Technology Services increased 22% from $6.5 million for the year ended December 31, 1997 to $8.0 million for the year ended December 31, 1998. Further, the fourth quarter reflected an increase of 117% over the same quarter last year and a 47% increase over the third quarter of 1998. NationsBanc accounted for $1.9 million or 4% of Network Solutions' total net revenue for the year ended December 31, 1997 and $3.2 million or 3% for the year ended December 31, 1998.

During the year ended December 31, 1998, the Internet Technology Services division added new leadership in sales and operations and hired additional technical consultants. In addition, the division continued to emphasize its efforts targeted at lead generation and regional sales and marketing programs by opening offices in New York City and Atlanta, Georgia.

Cost of Revenue

Cost of revenue consists primarily of salaries and employee benefits, fees paid to subcontractors for work performed in connection with revenue producing projects, depreciation and equipment costs, lease costs of the operations infrastructure and the associated operating overhead. Cost of revenue increased from $25.8 million for the year ended December 31, 1997 to $38.5 million for the year ended December 31, 1998. This 49% increase was driven by a $3.0 million increase in labor, a $6.4 million increase in outsourcing costs and $2.7 million in additional depreciation charges and equipment expenditures primarily associated with supporting the growth of Network Solutions' registration services business. In the near term, the continued investment in the back office infrastructure and provision of customer service is expected to partially offset future margin improvements arising from economies of scale.

As a percentage of net revenue, cost of revenue decreased from 56.9% for the year ended December 31, 1997 to 41.1% for the year ended December 31, 1998 principally reflecting economies of scale and other operational efficiencies achieved in Network Solutions' registration business.

Research and Development Expenses

Research and development expenses consist primarily of compensation and consultant expenses to support the creation, development and enhancement of Network Solutions' products, services and technologies. Research and development expenses increased 192% from $1.7 million for the year ended December 31, 1997 to $4.8 million for the year ended December 31, 1998. As a percentage of net revenue, research and development expenses increased from 3.6% for the year ended December 31, 1997 to 5.1% for the year ended December 31, 1998. All significant research and development costs have been expensed as incurred. Network Solutions expects that the level of research and development expenses will continue to increase in the near future in terms of absolute dollars as Network Solutions invests in developing new service offerings.

Selling, General and Administrative Expenses

Selling, general and administrative expenses consist primarily of salaries of business development, general management, administrative and financial personnel, marketing expenses, corporate services from SAIC, legal and other professional costs and amortization of goodwill associated with Network Solutions' 1995 acquisition by SAIC. Selling, general and administrative expenses increased 203% from $12.3 million for the year ended December 31, 1997 to $37.1 million for the year ended December 31, 1998. The increase was attributable to a $16.9 million increase in marketing and business development expenses including television, Internet banner advertising and targeted direct mail campaigns, increased staffing expenses of $1.8 million and an increase in legal and other professional costs of $2.6 million. As a percentage of net revenue, selling, general and administrative expenses increased from 27.1% for the year ended December 31, 1997 to 39.7% for the year ended December 31, 1998. Network Solutions expects that the level of selling, general and administrative expenses will continue to increase significantly in the near future in terms of absolute dollars as operations continue to expand. In particular, sales, marketing and business development expenses will increase as Network Solutions continues to promote the value of a *.com* Web address and other new Internet-based value-added services. Network Solutions also plans to continue to develop its distribution channels, both domestically and internationally.

Interest Income

Network Solutions had net interest income of $2.2 million for the year ended December 31, 1997 as compared to $6.3 million for the year ended December 31, 1998. The increase is attributable to the investment of the positive cash flow resulting primarily from increasing domain name registrations and the net proceeds of Network Solutions' initial public offering.

Income Taxes

The provision for income taxes was 45% of pretax earnings, or $3.5 million for the year ended December 31, 1997, and 42%, or $8.1 million for the year ended December 31, 1998. The difference between the effective rates for both periods presented is principally attributable to the relative impact that non-deductible goodwill had on pretax operating income. Goodwill is being amortized by Network Solutions over five years and is associated with the acquisition of Network Solutions by SAIC in 1995.

Comparison of Years Ended December 31, 1996 and 1997

Net Revenue

Net revenue increased 140% from $18.9 million in 1996 to $45.3 million in 1997. This increase in net revenue was primarily attributable to the increase in the number of domain name registrations, principally in the *.com* top level domain. Net revenue from registration services increased 246% from $11.2 million in 1996 to $38.8 million in 1997. Net new registrations increased 96% from 489,000 during 1996 to 960,000 during 1997. Growth in registrations was driven by the widespread use and adoption by businesses of the Internet and intranets on a global basis. Cumulative net registrations as of December 31, 1996 were 627,000 as compared to 1,541,000 as of December 31, 1997, for a 146% increase.

Net revenue from Internet Technology Services decreased 16% from $7.7 million in 1996 to $6.5 million in 1997. This decrease was primarily attributable to a decrease in business from NationsBanc. NationsBanc, Network Solutions' largest Internet Technology Services client, accounted for $3.7 million or 20% of Network Solutions' total net revenue in 1996 and $1.9 million or 4% of Network Solutions' total net revenue in 1997.

Cost of Revenue

Cost of revenue increased 76% from $14.7 million in 1996 to $25.8 million in 1997. The increase was primarily driven by the growth of Network Solutions' registration business which experienced additional labor costs of $4.2 million and additional outsourcing costs of $1.6 million in support of Network Solutions' invoicing, collection and processing activities. In June 1997, Network Solutions opened a 31,200 square foot facility to support its Internet business operations and in January 1998, Network Solutions signed an agreement to lease an additional 9,100 square feet at the same location.

As a percentage of net revenue, cost of revenue decreased from 77.8% in 1996 to 56.9% in 1997. This decrease primarily reflects economies of scale that Network Solutions achieved due to the growth of its subscription-based domain name registration business.

Research and Development Expenses

Research and development expenses increased 150% from $680,000 in 1996 to $1.7 million in 1997. All of Network Solutions' research and development costs have been expensed as incurred. As a percentage of net revenue, research and development expenses were 3.6% for both 1996 and 1997.

Selling, General and Administrative Expenses

Selling, general and administrative expenses increased 95% from $6.3 million in 1996 to $12.3 million in 1997. The increase is primarily attributable to increased management and administrative labor expenses of $1.8 million, business development expenses of $1.3 million and an increase in legal costs of $1.0 million.

As a percentage of net revenue, selling, general and administrative expenses decreased from 33.3% in 1996 to 27.1% in 1997. The decrease in percentage of net revenue reflects economies of scale Network Solutions achieved due primarily to the growth of its domain name registration business.

Interest Income

Network Solutions had net interest income of $496,000 in 1996 as compared to $2.1 million in 1997. The increase is attributable to the investment of the net proceeds of Network Solutions' stock offering as well as improved cash flow resulting from the increase in domain name registrations.

Income Taxes (Benefit)

The income tax benefit was $643,000 in 1996 as compared to an income tax expense of $3.5 million in 1997. The effective tax rate changed from 28% in 1996 to 45% in 1997. The difference between the effective rates is principally attributable to the relative impact that non-deductible goodwill had on pretax operating income or loss for the year. Goodwill is being amortized by Network Solutions over five years and is associated with the acquisition of Network Solutions by SAIC in 1995.

Factors Affecting Operating Results

The Department of Commerce has adopted a plan, referred to as the Statement of Policy or "White Paper," calling for a phased transition of the Department's responsibilities for the domain name system to a not-for-profit corporation by September 30, 2000. The domain name system is the system by which Internet names and addresses are registered, allocated and used. We face risks from this transition. As the U.S. Government transitions certain responsibilities for domain name system administration to the not-for-profit corporation, corresponding obligations under our Cooperative Agreement with the Department of Commerce may be terminated and, as appropriate, covered in a contract between the not-for-profit corporation and us. We might not reach an acceptable contractual agreement with the not-for-profit corporation for our continuing role in the registration of domain names. The U.S. Government has sent us a letter directing us to treat the Internet Corporation for Assigned Names and Numbers, or ICANN, as the not-for-profit corporation identified in the October amendment to the Cooperative Agreement described above, in the performance of its obligations under the MOU and until such time as the MOU is terminated. We have not yet responded to that letter. We are currently in discussions with ICANN and the U.S. Government regarding implementation of the shared registration system and a wide range of contractual issues. We cannot be sure that these discussions will result in agreements favorable to us. Despite the significant efforts undertaken to date, it is impossible to predict at this time whether or when the process initiated by the Statement of Policy will result in the full transition to the not-for-profit corporation of domain name system responsibilities as and to the extent contemplated in the White Paper and, if it does, the effect on us of such transition. See "Business—Ongoing Privatization of Internet Administration" in Network Solutions' Form 10-K.

Termination, or a change in the terms, of the Cooperative Agreement could harm our business. While the Cooperative Agreement by its terms expires in September 2000, it may be terminated earlier. The Department of Commerce's interpretation of certain provisions of the Cooperative Agreement could differ from ours. For example, the Department of Commerce has publicly expressed concerns about our consolidation into a single Web site of the Web Sites through which our InterNIC registration services and our RegistrationPlus services were offered. These differences in interpretation could lead to disputes between us and the Department of Commerce or the not-for-profit corporation, which may or may not be resolved in our favor. Certain aspects of implementation of the Cooperative Agreement also remain to be fully negotiated, including the maximum price we will charge for registry services in the top level domains for which we now act as registry. If we are unsuccessful in negotiating acceptable terms of implementation, the costs of implementation of the Cooperative Agreement, our relationship with the not-for-profit corporation and other matters affecting our position in a more competitive domain name system environment could be harmed. See "Business—Status of Cooperative Agreement" in Network Solutions' Form 10-K.

Withdrawal of or challenges to the U.S. Government's sponsorship or authorization of certain functions that we perform could create a public perception or result in a legal finding that we lack authority to continue in our current role as registry or registrar within the *.com*, *.org*, *.net* and *.edu* top level domains. The legal authority underlying the roles of the Department of Commerce and the not-for-profit corporation with regard to the domain name system also could be challenged. The impact, if any, of any such public perception or finding is unknown, but it could be harmful to our business.

The introduction of additional competition into the domain name registration business could be harmful to our business. This includes, in particular, competition among registrars within a single top level domain, like *.com*, and competition among registrars and registries of existing and potential new top level domains. In addition, we currently face competition in the domain name registration business from registries for country code top level domains, third level domain name providers such as Internet access providers and registrars and registries of top level domains other than those top level domains which we currently register. A number of entities have already begun to offer competing registration services using other top level domains and when the shared registration system takes effect we will no longer be the exclusive registrar in the *.com*, *.org* and *.net* top level domains. Our revenue could be reduced due to increased competition, pricing pressures or a modification of billing practices. For example, other entities may bundle domain name registrations with other products or services. See "Business—Competition in the Registration Business" in Network Solutions' Form 10-K.

Our future success substantially depends on the continued growth in the use of the Internet. If the use of and interest in the Internet does not continue to grow, our business would be harmed.

Any significant problem with our systems or operations could result in lost revenue, customer dissatisfaction or lawsuits against us. A failure in the operation of our registration system could result in deletion of one or more domain names from the Internet for a period of time. A failure in the operation or update of the master directory that we maintain could result in deletion of one or more top level domains from the Internet and the discontinuation of second level domain names in those top level domains for a period of time. The inability of our registration system and telecommunications systems to meet the demands of the increasing number of domain name registration requests and corresponding customer e-mails and telephone calls could result in substantial degradation in our customer support service and our ability to process registration requests in a timely manner. Our operations depend on our ability to maintain our computer and telecommunications equipment in effective working order and to reasonably protect our systems against interruption. The root zone servers and top level domain zone servers that we operate are critical hardware to our operations.

Our failure, or the failure of third parties on which we rely, to adequately address Year 2000 compliance issues may cause us to lose revenue or to incur significant costs. The primary risks that we face with regard to Year 2000 failures are those which impact our domain name registration business. If we fail to solve a Year 2000 compliance problem with our mission critical business systems and processes, including the domain name servers under our control, telecommunications systems, facilities, data-networking infrastructure, commercial-off-the-shelf hardware, software and components used by our employees, the result could be a failure of or interruption to normal business operations.

On November 16, 1998, we announced the resignation of Gabriel A. Battista from his positions as Chief Executive Officer and Director. We cannot reasonably estimate at this time the potential impact on us of the hiring of a new Chief Executive Officer. We cannot be certain of the timing of our hiring of a new Chief Executive Officer or the effect of any delays in our hiring of a new Chief Executive Officer on the development or implementation of our strategic plan.

Given the relative "newness" and rapid growth of the Internet, there is intense competition for the limited supply of people qualified to work for us. Our future success depends on the continued service of key engineering, sales, marketing, executive and administrative personnel, and our ability to attract, hire, integrate, train and retain such personnel. The loss of the services of any of our senior management team or other key employees or our failure to attract, integrate, train and retain additional key employees could harm our business.

We may not be able to sustain the revenue growth we have experienced in recent periods. In addition, past revenue growth may not be indicative of future operating results. If we do not successfully maintain our current position as a leading provider of domain name registration services or develop or market additional services, our business could be harmed.

Our domain name registration services business generates over 90% of our revenue and is expected to continue to account for a very significant portion of our revenue in at least the near term. Our ability to achieve future revenue growth will also depend on our ability to continue to establish direct sales channels and to develop multiple distribution channels. To do this we must maintain relationships with Internet access providers and other third parties.

Because of our high level of uncollectible receivables, we continually review our billing practices. Any modifications that we implement as a result of these reviews could have unanticipated harmful consequences to our business. We have established a provision for uncollectible accounts which we believe to be adequate to cover anticipated uncollectible receivables; however, actual results could differ from our estimates.

We are involved in several legal proceedings. We cannot reasonably estimate the potential impact of any of these proceedings. An adverse determination in any of these proceedings, however, could harm our business. Legal proceedings in which we are involved are expensive and divert our personnel. See "Item 3—Legal Proceedings" in Network Solutions' Form 10-K.

Our quarterly operating results may fluctuate significantly in the future due to a variety of factors, some of which are beyond our control. In addition, we expect a significant increase in our operating expenses. If the increase in our expenses is not followed by an increase in our revenue, our operating results will be harmed. The fact that in the past our revenues have increased and we have been profitable on a quarterly and annual basis is not indicative of whether our revenues will increase or whether we will be profitable on a quarterly or annual basis in the future.

Selected Quarterly Results of Operations

The following tables set forth certain unaudited quarterly financial information for 1997 and 1998. In the opinion of management, this information has been presented on the same basis as the audited financial statements and all necessary adjustments (consisting only of normal recurring adjustments) have been included in the amounts stated below to present fairly the selected unaudited quarterly results when read in conjunction with the audited financial statements of Network Solutions and notes thereto. The results of operations for any quarter are not necessarily indicative of results for any future periods.

	Quarter Ended							
(In thousands, except per share data)	Mar. 31, 1997	June 30, 1997	Sept. 30, 1997	Dec. 31, 1997	Mar. 31, 1998	June 30, 1998	Sept. 30, 1998	Dec. 31, 1998
Net revenue	$8,655	$10,069	$12,172	$14,430	$16,492	$20,476	$25,427	$31,257
Cost of revenue	5,294	6,141	7,033	7,330	7,348	8,791	10,312	12,079
Gross profit	3,361	3,928	5,139	7,100	9,144	11,685	15,115	19,178
Research and development expenses	311	407	377	558	725	815	1,353	1,928
Selling, general and administrative expenses	2,301	2,487	3,105	4,375	6,182	8,008	10,248	12,706
Interest income	(149)	(335)	(570)	(1,041)	(1,292)	(1,384)	(1,654)	(1,857)
Income before income taxes	898	1,369	2,227	3,208	3,529	4,246	5,168	6,401
Provision for income taxes	382	629	995	1,465	1,480	1,783	2,163	2,683
Net income	$ 516	$ 740	$ 1,232	$ 1,743	$ 2,049	$ 2,463	$ 3,005	$ 3,718
Basic EPS[1]	$ 0.02	$ 0.03	$ 0.05	$ 0.06	$ 0.07	$ 0.08	$ 0.09	$ 0.11
Diluted EPS[1]	$ 0.02	$ 0.03	$ 0.05	$ 0.05	$ 0.06	$ 0.07	$ 0.09	$ 0.11

(1) All per share data reflect the two-for-one stock split in March 1999. Since there are changes in the weighted average number of shares outstanding each quarter, the sum of the quarterly basic and diluted EPS amounts may not equal the basic and diluted EPS for calendar years 1997 and 1998.

(As a percentage of net revenue)	Quarter Ended Mar. 31, 1997	June 30, 1997	Sept. 30, 1997	Dec. 31, 1997	Mar. 31, 1998	June 30, 1998	Sept. 30, 1998	Dec. 31, 1998
Net revenue	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Cost of revenue	61.2	61.0	57.8	50.8	44.6	42.9	40.6	38.6
Gross profit	38.8	39.0	42.2	49.2	55.4	57.1	59.4	61.4
Research and development expenses	3.5	4.0	3.1	3.9	4.4	4.0	5.3	6.1
Selling, general and administrative expenses	26.6	24.7	25.5	30.3	37.4	39.1	40.3	40.7
Interest income	(1.7)	(3.2)	(4.7)	(7.2)	(7.8)	(6.7)	(6.5)	(5.9)
Income before income taxes	10.4	13.5	18.3	22.2	21.4	20.7	20.3	20.5
Provision for income taxes	4.4	6.2	8.2	10.1	9.0	8.7	8.5	8.6
Net income	6.0%	7.3%	10.1%	12.1%	12.4%	12.0%	11.8%	11.9%

Network Solutions has experienced quarterly fluctuations in operating results and anticipates that such fluctuations will continue. These fluctuations may be caused by, among other things, increases in legal and marketing expenses, market acceptance of new products, competitive pricing pressures and general economic conditions. As a result of the foregoing and other factors, Network Solutions believes that period-to-period comparisons of its results of operations are not necessarily meaningful and should not be relied on as indications of future performance. See "Factors Affecting Operating Results" and "Item 1—Business—Risk Factors—Our Quarterly Operating Results May Fluctuate; Our Future Revenue and Profitability are Uncertain," in Network Solutions' 1998 Form 10-K.

Network Solutions' net revenue increased each quarter presented primarily due to an increase in the number of cumulative net registrations in each of those quarters. Network Solutions currently expects registration services revenue for the first quarter of 1999 to show continued growth based upon its existing registration base and net new registrations during the quarter. However, there can be no assurance that net registration revenue will continue to increase at historical rates, or at all, or not decrease in the future, especially when the Cooperative Agreement is terminated or if there is a change in Network Solutions' status as the exclusive registry and registrar for domain names in the *.com*, *.net*, and *.org* top level domains, particularly as a significant portion of Network Solutions' net revenue is attributable to registrations in the *.com* top level domains. Notwithstanding the $129.2 million of deferred revenue at December 31, 1998, of which $93.7 million will be recognized as revenue in 1999, Network Solutions' revenue is dependent in large part on the continued growth of the Internet, Network Solutions' ability to maintain its position as the leading Internet domain name registration service provider worldwide and the evolving nature of Network Solutions' services, products and other factors.

Operating expenses have generally increased in absolute dollars in each quarter shown as Network Solutions has increased staffing and related infrastructure costs in its back office, selling and marketing, and administrative functions. Quarter-to-quarter growth in cost of revenue was primarily attributable to increased staffing levels and increased outsourcing costs which are a function of the number of registrants. Quarter-to-quarter growth in selling, general and administrative expenses are attributable to increased staffing at the management level, continuing legal expenses and marketing costs associated with the introduction of new services and products.

Liquidity and Capital Resources

From the time of its acquisition by SAIC in March 1995 until December 1996, Network Solutions participated in SAIC's centralized cash management system whereby cash received from operations was transferred to SAIC's centralized cash accounts and cash disbursements were funded from such centralized cash accounts. Accordingly, cash requirements for operating purposes and for capital expenditures were met from this source. Beginning in 1997, Network Solutions implemented its own cash management system.

At December 31, 1998, Network Solutions' principal source of liquidity was its cash and cash equivalents of $12.9 million and its short-term investments of $118.8 million, which when combined represent an increase of $50.3 million from the December 31, 1997 balance in those accounts. Network Solutions also has $9.4 million of marketable securities held as long term investments as of December 31, 1998.

At December 31, 1998, Network Solutions' cumulative net obligation to SAIC for intercompany activity was $4.8 million, a net increase of $3.5 million from December 31, 1997. Intercompany activity is primarily comprised of salaries and benefits paid by SAIC on behalf of Network Solutions. Network Solutions currently reimburses SAIC for intercompany activity on a monthly basis. Pursuant to a tax sharing agreement with SAIC dated September 26, 1997, Network Solutions now generally remits income tax payments directly to tax authorities as it no longer is part of SAIC's consolidated group for federal income tax purposes.

Cash provided by operations was $63.4 million for the year ended December 31, 1998. This amount is principally attributed to net income plus the increase in deferred revenue reflecting cash collected in advance of registration services revenue recognition which occurs ratably over the two- and one-year registration terms. Partially offsetting this amount is an increase in deferred tax assets resulting from accelerated revenue recognition for tax purposes and the associated tax liabilities.

Investing activities totaled $104.7 million for the year ended December 31, 1998, of which $78.0 million was net purchases of short-term investments and $13.6 million of long-term investments. These investments are primarily comprised of commercial investment grade securities.

Capital expenditures were $3.2 million and $13.1 million for the years ended December 31, 1997 and December 31, 1998, respectively. These expenditures were primarily for computer equipment. Network Solutions will continue to invest in the back office infrastructure in advance of continued growth in domain name registrations and as Network Solutions designs and builds the shared registration system in accordance with the Cooperative Agreement.

Network Solutions believes that its existing cash balance, investments and cash flows expected from future operations will be sufficient to meet Network Solutions' capital requirements for at least the next 12 months.

Year 2000 Compliance

Network Solutions is continually assessing the potential effects of the "Year 2000" millennium change on Network Solutions' business systems and processes. Network Solutions' Year 2000 project is proceeding on schedule. The project goal is to ensure that Network Solutions' business is not impacted by the date transitions associated with the Year 2000. Based on its inventory and assessment, Network Solutions has found that less than one-half of one percent of the software code of its internal mission critical systems needs to be remediated to be made Year 2000 compliant and has found no material Year 2000 problems with its facilities and telecommunications systems. Network Solutions is also contacting its hardware and software vendors, outsourcing service providers and other parties on which its systems rely to determine such third parties Year 2000 compliance. We can give no assurances that the software or systems of such third parties will be Year 2000 compliant or that the failure of such third parties to achieve Year 2000 compliance will not have a material adverse effect on Network Solutions.

Network Solutions is now in the remediation and testing phases of its project cycle and it has developed an initial contingency and business continuation plan. At this time, Network Solutions believes that its incremental remediation costs, if any, needed to make its current business systems and processes Year 2000 compliant are not material. Network Solutions will continually update its contingency and business continuation plan as appropriate throughout the year. The foregoing Year 2000 discussion and the information contained herein is provided as a "Year 2000 Readiness Disclosure" as defined in the Year 2000 Information and Readiness Disclosure Act of 1998 (Public Law 105-271, 112 Stat. 2386) enacted on October 19, 1998 and contains "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. Such statements, including without limitation, anticipated costs and the dates by which Network Solutions expects to complete certain actions, are based on management's best current estimates, which were derived utilizing numerous assumptions about future events, including the continued availability of certain resources, representations received from third parties and other factors. However, there can be no guarantee that these estimates will be achieved, and actual results could differ materially from those anticipated. See Network Solutions' 1998 Form 10-K Management's Discussion and Analysis of Financial Condition and Results of Operation for a more detailed discussion of our Year 2000 project.

Network Solutions, Inc.

Statements of Financial Position

	December 31, 1997	**December 31, 1998**
Assets		
Current assets:		
Cash and cash equivalents	$ 41,146,000	**$ 12,862,000**
Short-term investments	40,200,000	**118,808,000**
Accounts receivable, net	5,792,000	**22,628,000**
Prepaids and other assets	1,005,000	**4,001,000**
Deferred tax asset	20,153,000	**40,508,000**
Restricted assets	25,873,000	**—**
Total current assets	134,169,000	**198,807,000**
Furniture and equipment, net	6,146,000	**16,005,000**
Long-term investments	—	**13,590,000**
Deferred tax asset	8,128,000	**14,831,000**
Goodwill, net	1,177,000	**634,000**
Total Assets	$149,620,000	**$243,867,000**
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable and accrued liabilities	$ 6,426,000	**$ 28,287,000**
Due to parent	1,250,000	**4,766,000**
Income taxes payable	5,042,000	**5,409,000**
Current portion of capital lease obligations	842,000	**834,000**
Deferred revenue, net	43,789,000	**93,720,000**
Internet fund liability	25,873,000	**—**
Total current liabilities	83,222,000	**133,016,000**
Capital lease obligations	1,081,000	**247,000**
Long-term deferred revenue, net	17,662,000	**35,474,000**
Total liabilities	101,965,000	**168,737,000**
Commitments and contingencies (Note 13)		
Stockholders' equity:		
Preferred stock, $.001 par value, authorized 10,000,000 shares; none issued and outstanding in 1997 and 1998	—	**—**
Class A common stock, $.001 par value; authorized 100,000,000 shares; 7,590,000 and 9,140,372 issued and outstanding in 1997 and 1998	4,000	**9,000**
Class B common stock, $.001 par value; authorized 30,000,000 shares; 23,850,000 issued and outstanding in 1997 and 1998	12,000	**24,000**
Additional paid-in capital	56,451,000	**72,331,000**
Retained earnings (accumulated deficit)	(8,812,000)	**2,407,000**
Accumulated other comprehensive income	—	**359,000**
Total stockholders' equity	47,655,000	**75,130,000**
Total Liabilities and Stockholders' Equity	$149,620,000	**$243,867,000**

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

Network Solutions, Inc.

Statements of Operations

	Year ended December 31, 1996	1997	**1998**
Net revenue	$18,862,000	$45,326,000	**$93,652,000**
Cost of revenue	14,666,000	25,798,000	**38,530,000**
Gross profit	4,196,000	19,528,000	**55,122,000**
Research and development expenses	680,000	1,653,000	**4,821,000**
Selling, general and administrative expenses	6,280,000	12,268,000	**37,144,000**
Interest income	(496,000)	(2,211,000)	**(6,303,000)**
Other expenses	—	116,000	**116,000**
Income (loss) before income taxes	(2,268,000)	7,702,000	**19,344,000**
Provision (benefit) for income taxes	(643,000)	3,471,000	**8,109,000**
Net income (loss)	$ (1,625,000)	$ 4,231,000	**$11,235,000**
Earnings (loss) per common share:			
Basic	$ (0.07)	$ 0.16	**$ 0.35**
Diluted	$ (0.07)	$ 0.16	**$ 0.34**

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

Network Solutions, Inc.

Statements of Changes in Stockholders' Equity

	Class A Common Stock		Class B Common Stock		Additional Paid-in Capital	Accumulated Other Comprehensive Income	Retained Earnings (Deficit)	Comprehensive Income	Total Stockholders' Equity
	Shares	Amount	Shares	Amount					
Balance, December 31, 1995	—	$ —	12,500,000	$12,000	$ 4,468,000	$ —	$ (1,418,000)	$ —	$ 3,062,000
Net loss for the year ended December 31, 1996	—	—	—	—	—	—	(1,625,000)	—	(1,625,000)
Balance, December 31, 1996	—	—	12,500,000	12,000	4,468,000	—	(3,043,000)	—	1,437,000
Declaration of Class B dividend	—	—	—	—	—	—	(10,000,000)	—	(10,000,000)
Conversion of Class B Common Stock	575,000	—	(575,000)	—	—	—	—	—	—
Issuance of Class A Common Stock	3,220,000	4,000	—	—	51,983,000	—	—	—	51,987,000
Net income for the year ended December 31, 1997	—	—	—	—	—	—	4,231,000	—	4,231,000
Balance, December 31, 1997	3,795,000	4,000	11,925,000	12,000	56,451,000	—	(8,812,000)	—	47,655,000
Issuance of common stock pursuant to stock plans	775,000	1,000	—	—	10,273,000	—	—	—	10,274,000
Tax benefit associated with stock plans	—	—	—	—	5,607,000	—	—	—	5,607,000
Two-for-one common stock split effected in the form of a 100% stock dividend	4,570,000	4,000	11,925,000	12,000	—	—	(16,000)	—	—
Comprehensive Income:									
Net income for the year ended December 31, 1998	—	—	—	—	—	—	11,235,000	11,235,000	11,235,000
Other comprehensive income, net of tax, unrealized gains on securities	—	—	—	—	—	359,000	—	359,000	359,000
Comprehensive Income	—	—	—	—	—	—	—	$11,594,000	—
Balance, December 31, 1998	9,140,000	$9,000	23,850,000	$24,000	$72,331,000	$359,000	$ 2,407,000		$ 75,130,000

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

Network Solutions, Inc.

Statements of Cash Flows

	Year ended December 31, 1996	1997	1998
Cash flows from operating activities:			
Net income (loss)	$ (1,625,000)	$ 4,231,000	**$ 11,235,000**
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Depreciation and amortization	1,417,000	2,432,000	**3,754,000**
Provision for uncollectible accounts receivable	3,597,000	8,082,000	**2,247,000**
Deferred income taxes	(12,834,000)	(13,226,000)	**(27,317,000)**
Tax benefit associated with stock plans	—	—	**5,607,000**
Changes in operating assets and liabilities:			
Increase in accounts receivable	(12,144,000)	(1,287,000)	**(19,083,000)**
Increase in prepaids and other assets	(925,000)	(69,000)	**(2,996,000)**
Increase in accounts payable and accrued liabilities	1,226,000	3,845,000	**21,861,000**
Increase in income taxes payable	—	5,042,000	**367,000**
Increase in deferred revenue	26,006,000	32,099,000	**67,743,000**
Net cash provided by operating activities	4,718,000	41,149,000	**63,418,000**
Cash flows from investing activities:			
Purchase of furniture and equipment	(1,901,000)	(3,240,000)	**(13,070,000)**
Purchase of short-term investments, net	—	(40,200,000)	**(77,990,000)**
Purchase of long-term investments	—	—	**(13,590,000)**
Net investment in net assets of discontinued operations	(208,000)	—	**—**
Net cash used in investing activities	(2,109,000)	(43,440,000)	**(104,650,000)**
Cash flows from financing activities:			
Net transactions with SAIC	12,926,000	(14,045,000)	**3,516,000**
Proceeds from issuance of common stock	—	52,405,000	**—**
Dividend paid	—	(10,000,000)	**—**
Issuance of common stock pursuant to stock plans	—	—	**10,274,000**
Repayment of capital lease obligations	—	(463,000)	**(842,000)**
Net cash provided by financing activities	12,926,000	27,897,000	**12,948,000**
Net increase (decrease) in cash and cash equivalents	15,535,000	25,606,000	**(28,284,000)**
Cash and cash equivalents, beginning of year	5,000	15,540,000	**41,146,000**
Cash and cash equivalents, end of year	$15,540,000	$ 41,146,000	**$ 12,862,000**

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

Notes to Financial Statements

Note 1—Company and Summary of Significant Accounting Policies

Network Solutions currently acts as the exclusive registry and registrar of Internet domain names within the *.com*, *.org*, *.net* and *.edu* top level domains pursuant to the Cooperative Agreement with the Department of Commerce. Domain names are used to identify a unique site or presence on the Internet. As registry and registrar for these top level domains, Network Solutions registers new domain names and is responsible for the maintenance of the master file of domain names through daily updates to the Internet. Network Solutions also provides Internet Technology Services, focusing on network engineering, network and systems security and network management solutions.

Cooperative Agreement

In December 1992, Network Solutions entered into the Cooperative Agreement with the National Science Foundation under which Network Solutions was to provide Internet domain name registration services for five top level domains: *.com*, *.org*, *.net*, *.edu* and *.gov*. These registration services include the initial two year domain name registration and annual re-registration, and throughout the registration term, maintenance of and unlimited modifications to individual domain name records and updates to the master file of domain names. The Cooperative Agreement became effective January 1, 1993. It included a three-month phase-in period, a five-year operational period, commencing April 1, 1993 and ending March 31, 1998, and a six-month flexibility period through September 30, 1998. Effective September 9, 1998, the Department of Commerce took over the administration of the Cooperative Agreement from the National Science Foundation. In October 1998, the Cooperative Agreement was amended to extend the flexibility period until September 30, 2000.

The original terms of the Cooperative Agreement provided for a cost reimbursement plus fixed-fee contract (with an initial fee of 8%). Effective September 14, 1995, the National Science Foundation and Network Solutions amended the Cooperative Agreement to require Network Solutions to begin charging end users a services fee of $50 per year for each domain name in the *.com*, *.org* and *.net* top level domains. Until April 1, 1998, registrants paid a services fee of $100 for two years of domain name services upon each initial registration and an annual re-registration fee of $50 per year thereafter. The National Science Foundation paid the registration fees for domain names within the *.edu* and *.gov* top level domains through March 31, 1997. Commencing April 1, 1997, Network Solutions agreed with the National Science Foundation to provide domain name services within the *.edu* and *.gov* top level domains free of charge. As of October 1, 1997, Network Solutions no longer registers or administers domain names in the *.gov* top level domain.

Under the terms of the September 14, 1995 amendment to the Cooperative Agreement, 30% of the registration fees collected by Network Solutions was required to be set aside for the enhancement of the intellectual infrastructure of the Internet (set aside funds) and, as such, was not recognized as revenue by Network Solutions. Network Solutions has reflected these set aside funds, along with the appropriate percentage of net accounts receivable (Note 3), as restricted assets and has recorded an equivalent, related current liability. Network Solutions maintained the cash received relating to the set aside funds in a separate interest bearing account. The set aside funds, plus any interest earned, were disbursed at the direction of the National Science Foundation. As of December 31, 1998, Network Solutions had cumulatively disbursed all set aside funds collected and associated interest earned for a total of $62.3 million to the National Science Foundation at their direction. The restricted cash at December 31, 1997 and 1998 was approximately $23,512,000 and $0, respectively.

On March 12, 1998, the National Science Foundation and Network Solutions amended the Cooperative Agreement to eliminate the 30% set aside requirement effective April 1, 1998 and to reduce the registration fees by a corresponding amount. Initial registrations on and after April 1, 1998 are charged $70 for two years of registration services and an annual re-registration fee of $35 per year thereafter. This amendment had no effect on the revenue currently recognized on each registration, $70 for initial registrations and $35 for re-registrations, since Network Solutions previously did not recognize revenue on the 30% set aside funds. Accordingly, while the revenue to Network Solutions on a per registration basis does not change, the amount charged to customers declined.

For purposes of Network Solutions' statements of cash flows, amounts relating to these restricted assets and the Internet fund liability have been excluded in their entirety.

Revenue Recognition

Registration fees charged to end users for registration services provided by Network Solutions are recognized on a straight-line basis over the life of the registration term, two years for initial registrations and one year for re-registrations. Network Solutions records revenue net of an estimated provision for uncollectible accounts receivable (Note 3).

Substantially all of Network Solutions' Internet Technology Services revenue is derived from professional services which are generally provided to clients on a time and expense basis and is recognized as services are performed.

One Internet Technology Services' customer contributed approximately 20% of net revenue for the year ended December 31, 1996. During the years ended December 31, 1997 and 1998, there were no customers which individually represented more than 4% of net revenues.

Deferred Revenue

Deferred revenue primarily represents the unearned portion of revenue related to the unexpired term of registration fees, net of an estimate for uncollectible accounts receivable (Note 3).

Cash and Cash Equivalents

Network Solutions considers all highly liquid investments with an original maturity of three months or less to be cash equivalents.

Short and Long-Term Investments

Short and long-term investments in marketable securities are classified as available-for-sale. All long-term investments in marketable securities mature within two years. At December 31, 1997 and 1998, the fair value of short and long-term investments approximated cost. Fair value is determined based upon the quoted market prices of the securities as of the balance sheet date.

At December 31, 1998, Network Solutions also held equity interests in a privately-held, information technology company totaling $4,200,000. This investment is included in other long-term assets and is accounted for under the cost method which approximates fair value.

Financial Instruments

The recorded value of Network Solutions' financial instruments, which include short- and long-term investments, accounts receivable and accounts payable, approximates market value. Concentration of credit risks with respect to registration receivables is limited due to the wide variety and number of customers, as well as their dispersion across geographic areas. Network Solutions has no derivative financial instruments.

Furniture and Equipment

Furniture and equipment are stated at cost. Depreciation on furniture, office and computer equipment is calculated principally using a declining-balance method over the useful lives of three to seven years. Equipment under capital leases is amortized using a declining-balance method over the shorter of the assets' useful lives or lease term, ranging from two to three years. Leasehold improvements are amortized using the straight-line method over the shorter of the lease term or the estimated useful lives of the assets, generally six years.

Goodwill

Goodwill represents the excess of the purchase cost over the fair value of net assets acquired in Network Solutions' acquisition by Science Applications International Corporation (SAIC) in 1995 and is amortized over five years using the straight-line method. Amortization expense of $715,000, $686,000 and $543,000 for years ended December 31, 1996, 1997 and 1998, respectively, was included in selling, general and administrative expenses. In connection with Network Solutions' initial public offering during 1997, SAIC sold a portion of its interest in Network Solutions resulting in a corresponding reduction of goodwill in the amount of $418,000 which was charged to additional paid-in capital.

Stock Split

On December 31, 1998, Network Solutions' board of directors approved a two-for-one stock split of the shares of Class A common stock and Class B common stock, to be effected in the form of a 100% stock dividend on shares of Class A common stock and Class B common stock outstanding on February 26, 1999. The stock dividend will be distributed on March 23, 1999. Share and per share information for all periods presented in the accompanying financial statements have been adjusted to reflect the two-for-one stock split.

Software Development Costs

Research and development costs are expensed as incurred. In accordance with Statement of Financial Accounting Standards (SFAS) No. 86, "*Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*," Network Solutions has not capitalized any significant software development costs as of December 31, 1998.

Income Taxes

Deferred taxes are accounted for under SFAS No. 109, "*Accounting for Income Taxes*," whereby deferred tax assets and liabilities are recognized for the expected future tax consequences of temporary differences between financial statement reporting and income tax purposes. A valuation allowance is recorded if it is "more likely than not" that some portion of or all of a deferred tax asset will not be realized.

Until Network Solutions' initial public offering, Network Solutions filed tax returns as part of SAIC's consolidated tax group. Tax expense during this period has been determined as if Network Solutions was a separate taxpayer and was charged to Network Solutions by SAIC. Effective October 1, 1997, Network Solutions is no longer part of SAIC's consolidated tax group for federal income tax purposes and prepares its income tax returns as a separate entity.

Stock Based Compensation

Network Solutions accounts for its stock option and employee stock purchase plans in accordance with the provisions of Accounting Principles Board Opinion (APB) No. 25, "*Accounting for Stock Issued to Employees*." No compensation cost has been recognized by Network Solutions for its employee stock plans. The SFAS No. 123, "*Accounting for Stock-Based Compensation*," provides an alternative accounting method to APB No. 25 and requires additional pro forma disclosures (Note 11). Network Solutions expects to continue to account for its employee stock plans in accordance with the provisions of APB No. 25.

Segment Data

During 1998, Network Solutions adopted SFAS No. 131, "*Disclosures about Segments of an Enterprise and Related Information*." SFAS No. 131 supersedes SFAS No. 14, "*Financial Reporting for Segments of a Business Enterprise*," replacing the "industry segment" approach with the "management" approach. The management approach designates internal reporting that is used by management for making operating decisions and assessing performance as the source of an entity's reportable segments. SFAS No. 131 also requires disclosures about products and services, geographic areas and major customers. The adoption of SFAS No. 131 did not affect results of operations, financial position or segment information disclosures of Network Solutions due to the nature and relative magnitude of its business activities.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make reasonable estimates and assumptions, based upon all known facts and circumstances that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements. Actual results could differ from those estimates.

Newly Issued Accounting Standards

In March 1998, the American Institute of Certified Public Accountants issued Statement of Position 98-1 (SOP 98-1), "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use." This standard requires companies to capitalize qualifying computer software costs which are incurred during the application development stage and amortize them over the software's estimated useful life. SOP 98-1 is effective for fiscal years beginning after December 15, 1998. Network Solutions is currently evaluating the impact of SOP 98-1 on its financial statements and related disclosures.

Note 2—Recapitalization and Initial Public Offering

On June 26, 1997, the Board of Directors amended the Certificate of Incorporation to provide for two classes of common stock, designated as Class A and Class B. The holders of Class A and Class B common stock generally have identical rights except that holders of Class A common stock are entitled to one vote per share while holders of Class B common stock are entitled to ten votes per share. Each share of Class B common stock is convertible at the holder's option into one share of Class A common stock.

On October 1, 1997, Network Solutions completed an initial public offering of 7,590,000 shares of its $.001 par value Class A common stock, including 990,000 shares resulting from the exercise of certain overallotment provisions. Network Solutions' net proceeds from the initial public offering, including overallotment, were $52.5 million based on Network Solutions' direct sale of 6,440,000 shares of Class A common stock.

Prior to the offering, Network Solutions was a wholly-owned subsidiary of SAIC. In conjunction with the initial public offering, SAIC converted 1,150,000 shares (including 150,000 overallotment shares) of Class B common stock into 1,150,000 shares of Class A common stock and directly sold the shares as a selling stockholder. Upon completion of the offering, SAIC owned 100% of the outstanding Class B common stock representing 75.9% of Network Solutions' equity and 96.9% of the combined voting power of Network Solutions' outstanding Class B and Class A common stock.

On August 21, 1997, Network Solutions' Board of Directors declared a $10,000,000 dividend to be paid to SAIC upon consummation of the initial public offering. This dividend was paid to SAIC on October 1, 1997.

Note 3—Accounts Receivable

Accounts receivable consist of the following amounts as of December 31:

	1997	**1998**
Billed	$ 24,483,000	**$ 42,679,000**
Unbilled	1,526,000	**5,695,000**
Total accounts receivable before allowances	26,009,000	**48,374,000**
Less—Allowance for uncollectible accounts	(17,856,000)	**(25,746,000)**
Accounts receivable allocable to 30% NSF set aside (Note 1)	(2,361,000)	**—**
Accounts receivable, net	$ 5,792,000	**$ 22,628,000**

Unbilled receivables consist of registration fees and time and material contract costs which have been incurred but which have not yet been billed.

In accounting for registration fees, Network Solutions initially records the gross amount of the registration fee to accounts receivable and deferred revenue. The allowance for estimated uncollectible accounts is recorded against both accounts receivable and deferred revenue balances (see Note 1 for treatment of the 30% National Science Foundation set aside). From the deferred revenue and allowance balances, Network Solutions records revenue and its provision for uncollectible accounts on a straight-line basis over the registration term. Effective April 1, 1998, Network Solutions consolidates and then amortizes only the net deferred revenue balance as net revenue over the registration term.

The provision for uncollectible accounts receivable, which was separately recorded and deducted from gross registration fees in determining net registration revenue, was $3,597,000, $7,782,000 and $2,168,000, respectively, for the years ended December 31, 1996, 1997 and 1998. An additional $300,000 and $79,000 of bad debt expense was recorded in 1997 and 1998, respectively, for the write-off of Internet Technology Services receivables. Network Solutions' allowance for uncollectible accounts receivable is associated solely with its registration services business. The provision for uncollectible accounts receivable is primarily due to the large number of individuals and corporations that have registered multiple domain names with the apparent intention of transferring registration for such names at a profit. Network Solutions' experience has been that, in contrast to other registrants, such speculative resellers have a higher tendency to default on their registration fees, returning the names into the available pool for subsequent registration.

Note 4—Furniture and Equipment

Furniture and equipment consist of the following amounts as of December 31:

	1997	**1998**
Furniture and office equipment	$ 476,000	**$ 833,000**
Computer equipment	8,619,000	**19,400,000**
Leasehold improvements	288,000	**2,018,000**
Furniture and equipment, at cost	9,383,000	**22,251,000**
Less: Accumulated depreciation and amortization	(3,237,000)	**(6,246,000)**
Furniture and equipment, net	$ 6,146,000	**$16,005,000**

Furniture and equipment includes $2,386,000 of computer equipment acquired during 1997 under capital lease agreements. Amortization expense related to capital leases totaled $915,000 and $1,028,000 in 1997 and 1998, respectively. Total depreciation and amortization expense for the years ended December 31, 1996, 1997 and 1998 was $702,000, $1,746,000 and $3,211,000, respectively.

Note 5—Accounts Payable and Accrued Expenses

Accounts payable and accrued expenses consist of the following amounts as of December 31:

	1997	**1998**
Accounts payable	$1,896,000	**$ 7,647,000**
Accrued expenses	2,384,000	**16,717,000**
Accrued payroll	2,146,000	**3,923,000**
Total accounts payable and accrued expenses	$6,426,000	**$28,287,000**

Note 6—Leases

Future minimum lease payments, including fixed escalation increases for office space and equipment under capital and operating leases with initial or remaining noncancelable lease terms in excess of one year as of December 31, 1998 are:

Year Ending December 31:	Capital Leases	Operating Leases
1999	$ 885,000	$ 3,778,000
2000	252,000	3,099,000
2001	—	1,935,000
2002	—	1,452,000
Total minimum lease payments	1,137,000	$10,264,000
Less: Amounts representing interest	(56,000)	
Present value of minimum lease payments	1,081,000	
Less: Current portion	(834,000)	
Long-term portion of capital lease obligations	$ 247,000	

In December 1992, Network Solutions entered into a lease agreement for its headquarters in Herndon, Virginia. Subsequent to the acquisition, SAIC subleased the facilities to Network Solutions under a lease expiring November 2002. During 1997, Network Solutions leased a second facility in Herndon whose lease term expires in July 2002.

Operating lease expense for the years ended December 31, 1996, 1997 and 1998 was $924,000, $2,188,000 and $3,533,000, respectively. Network Solutions generated rental income from subleases of $187,000, $291,000 and $215,000 for the years ended December 31, 1996, 1997 and 1998, respectively.

Note 7—Interest Expense and Income

For the year ended December 31, 1996, interest income of $496,000 was allocated by SAIC based upon the cost of capital calculation. From its acquisition by SAIC in March 1995 until December 1996, Network Solutions participated in SAIC's centralized cash management system whereby cash received from operations was transferred to SAIC's centralized cash accounts and cash disbursements were funded from such centralized cash accounts. Accordingly, the SAIC cost of capital formula provided for charges and credits to Network Solutions based upon management of certain assets, including accounts receivable and fixed assets. Such amounts are not necessarily indicative of the cost that would have been incurred if Network Solutions had been operated as a separate entity.

Effective January 1, 1997, Network Solutions was no longer subject to SAIC's cost of capital calculation in connection with Network Solutions fulfilling its own treasury function. Interest paid for the years ended December 31, 1996, 1997 and 1998 was $0, $116,000 and $116,000, respectively.

Note 8—Transactions with SAIC

Network Solutions was acquired by SAIC on March 10, 1995 in a stock-for-stock transaction accounted for as a purchase.

The financial statements for the years ended December 31, 1996, 1997 and 1998 include significant transactions with other SAIC business units involving functions and services (such as cash management, tax administration, accounting, legal, data processing and employee benefit plans) that were provided to Network Solutions by centralized SAIC organizations. The costs of these functions and services have been directly charged and/or allocated to Network Solutions using methods that SAIC management believes are reasonable; primarily a percentage of budgeted administrative and overhead costs. Such charges and allocations are not necessarily indicative of the costs that would have been incurred if Network Solutions had been a separate entity. Through August 9, 1996, the amounts allocated by SAIC to Network Solutions included both administrative and overhead costs which are included in selling, general and administrative expenses and cost of revenue, respectively. Effective August 10, 1996, SAIC stopped allocating costs based generally upon pro rata labor and began assessing Network Solutions for corporate services provided by SAIC at a fee equal to 2.5% of annual net revenue. The corporate services fee is negotiated annually and was 2.5% and 1.5% during 1997 and 1998, respectively. The agreement may be terminated by either party upon 180 days' prior written notice.

Amounts charged and allocated to Network Solutions for these functions and services for the years ended December 31, 1996, 1997 and 1998 were $1,196,000, $1,126,000 and $1,447,000, respectively, and are principally included in selling, general and administrative expenses. Additionally, certain interest credits were allocated by SAIC to Network Solutions (Note 7).

Sales as a subcontractor to SAIC for the years ended December 31, 1996, 1997 and 1998 were $1,505,000, $2,445,000 and $525,000, respectively. In addition, because Network Solutions was included in SAIC's consolidated tax returns for periods from acquisition until the initial public offering, Network Solutions was obligated to make payment for its tax liability to SAIC in accordance with the tax sharing arrangement (Note 9). The due to parent balance represents the cumulative net activity of all transactions between Network Solutions and SAIC. Network Solutions reflects this activity in the statements of cash flows on a net basis because of the quick turnover, the large amounts and the short maturities of these related party cash transactions.

Note 9—Provision for Income Taxes

The results of Network Solutions since its acquisition by SAIC until its initial public offering were included in SAIC's consolidated tax returns. Subsequent to the initial public offering, Network Solutions is no longer part of SAIC's consolidated tax group for federal income tax purposes and prepares its income tax returns as a separate entity.

The provision for (benefit) from income taxes consists of the following:

	Year Ended December 31,		
	1996	1997	**1998**
Current:			
Federal	$ 10,171,000	$ 13,931,000	**$ 29,559,000**
State	2,020,000	2,766,000	**5,867,000**
Total current provision	12,191,000	16,697,000	**35,426,000**
Deferred:			
Federal	(10,716,000)	(11,035,000)	**(22,792,000)**
State	(2,118,000)	(2,191,000)	**(4,525,000)**
Total deferred (benefit)	(12,834,000)	(13,226,000)	**(27,317,000)**
Provision for (benefit) from income taxes	$ (643,000)	$ 3,471,000	**$ 8,109,000**

Deferred tax assets are comprised of the following temporary differences as of December 31:

	1997	**1998**
Deferred revenue	$26,295,000	**$46,943,000**
Provision for uncollectible accounts receivable	1,841,000	**8,409,000**
Other	145,000	**(13,000)**
Total deferred tax asset	$28,281,000	**$55,339,000**

Although Network Solutions has a past history of net losses, it has not established a current valuation allowance for its deferred tax assets since, in the opinion of management, it is more likely than not that all of the deferred tax assets will be realized. The deferred tax assets relate primarily to registration fees which are taxable upon initial registration but are recognized in the financial statements over the next 12 to 24 months, the registration term.

A reconciliation of the provision for income taxes to the amount computed by applying the statutory federal income tax rate of 35% to income before income taxes is provided below:

	Year ended December 31, 1996	1997	**1998**
Federal tax at statutory rate	$(794,000)	$2,696,000	**$6,771,000**
State income taxes, net of federal tax benefit	(96,000)	374,000	**1,015,000**
Nondeductible goodwill amortization	281,000	240,000	**213,000**
Other	(34,000)	161,000	**110,000**
Provision for (benefit) from income taxes	$(643,000)	$3,471,000	**$8,109,000**

Network Solutions paid income taxes of $31,235,000 during the year ended December 31, 1998.

Note 10—Computation of Earnings (Loss) Per Share

The following is a reconciliation of the numerator and denominator used in the basic and diluted earnings per share computations:

	Income (Loss) (Numerator)	Shares (Denominator)	Per Share Amount
1996 Loss Per Share:			
Basic	$ (1,625,000)	25,000,000	$(0.07)
Dilutive securities:			
Outstanding options		—	
Diluted	$ (1,625,000)	25,000,000	$(0.07)
1997 Earnings Per Share:			
Basic	$ 4,231,000	26,610,000	$ 0.16
Dilutive securities:			
Outstanding options		356,000	
Diluted	$ 4,231,000	26,966,000	$ 0.16
1998 Earnings Per Share:			
Basic	$11,235,000	31,957,000	$ 0.35
Dilutive securities:			
Outstanding options		1,440,000	
Diluted	$11,235,000	33,397,000	$ 0.34

Common shares issued are weighted for the period the shares were outstanding and incremental shares assumed issued under the treasury stock method for dilutive earnings per share are weighted for the period the underlying options were outstanding. Options outstanding in 1996 are not reflected in the computation of diluted earnings per share because the effects are anti-dilutive and would increase diluted earnings per share.

Note 11—Employee Benefit Plans

1996 Stock Incentive Plan

The 1996 Stock Incentive Plan (the Incentive Plan) of Network Solutions was adopted by the Board of Directors on September 18, 1996. The Incentive Plan provides for awards in the form of restricted shares, stock units, stock appreciation rights, and stock options (including incentive stock options and nonstatutory stock options). A total of 4,613,000 shares of Class A Common Stock have been initially reserved for issuance under the Incentive Plan. The number of shares are increased by 2% of the total number of common shares of Network Solutions outstanding at the end of the most recent calendar year, subject to a cumulative limit of 2,000,000 shares. Through December 31, 1998, an additional 1,789,000 shares were eligible for issuance and have subsequently been reserved for a combined total of 6,401,000 eligible shares under the Incentive Plan.

Following is a summary of activity pursuant to Network Solutions' Incentive Plan:

	Shares	Weighted Average Exercise Price
Balance at January 1, 1996	—	—
Granted	2,451,000	$ 6.49
Exercised	—	—
Cancelled	—	—
Balance at December 31, 1996	2,451,000	$ 6.49
Granted	1,201,000	$ 7.11
Exercised	—	—
Cancelled	(73,000)	$ 7.00
Balance at December 31, 1997	3,579,000	$ 6.68
Granted	1,359,000	$21.95
Exercised	(1,520,000)	$ 6.51
Cancelled	(707,000)	$ 9.26
Balance at December 31, 1998	2,711,000	$13.74

Granted stock options generally become exercisable one year after the date of the grant, vest 30%, 30%, 20% and 20%, respectively, on each anniversary date of the grant and have a term of five years. All options granted to date have been nonstatutory stock options except for 202,000 incentive stock options granted in 1996. No restricted shares, stock units or stock appreciation rights have been granted to date.

The following table summarizes the status of Network Solutions' stock options outstanding and exercisable at December 31, 1998:

	Stock Options Outstanding			Stock Options Exercisable	
Range of Exercise Prices	Shares	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
$ 7.00 – $ 9.25	1,712,000	3.31	$ 7.29	252,000	$7.16
$15.88 – $34.25	918,000	4.58	$21.20	—	—
$65.44 – $69.50	81,000	5.00	$65.59	—	—
$ 7.00 – $69.50	2,711,000	3.79	$13.74	252,000	$7.16

Employee Stock Purchase Plan

Effective January 7, 1998, Network Solutions adopted an Employee Stock Purchase Plan to provide substantially all full time employees an opportunity to purchase shares of its Class A common stock through payroll deductions of up to 10% of eligible compensation. Semiannually, on June 30 and December 31, participant account balances are used to purchase stock at the lesser of 85 percent of the fair market value on the trading day before the participation period starts or the trading day preceding the day on which the participation period ends. A total of 500,000 shares were initially reserved for purchase under the plan. During the year ended December 31, 1998, a total of 30,000 shares were purchased under this plan.

SAIC Benefit Plans

Employees of Network Solutions participate in various SAIC benefit plans, including stock, bonus and retirement plans, subject to the applicable eligibility requirements. SAIC charges Network Solutions directly for the costs of such employee benefit plans. Charges related to the administration of the SAIC benefit plans in which employees of Network Solutions participate are included within SAIC general corporate allocations (Note 8).

SAIC has one principal Cash or Deferred Arrangement plan which allows eligible participants to defer a portion of their income through payroll contributions. Such deferrals are fully vested, are not taxable to the participant until distributed from the Cash or Deferred Arrangement plan upon termination, retirement, permanent disability or death and may be matched by SAIC. SAIC also has an SAIC Employee Stock Purchase Plan which allows eligible employees to purchase shares of SAIC's Class A common stock, with SAIC currently contributing 10% of the existing fair market value.

SAIC has a Bonus Compensation Plan which provides for bonuses to reward outstanding performance. Bonuses are paid in the form of cash, fully vested shares of SAIC Class A common stock or vesting shares of SAIC Class A common stock. Network Solutions participated in this plan during the period from acquisition until December 31, 1996.

During the years ended December 31, 1996 and 1997, a total of 53,000 and 11,000 SAIC options were granted to Network Solutions' employees, respectively, with exercise prices ranging from $19.33 to $22.83 and $25.96 to $34.78 per share, respectively, with a weighted average price of $20.51 and $28.13, respectively. These options were granted under the SAIC 1995 Stock Option Plan to purchase SAIC Class A common stock and vest 20%, 20%, 20% and 40% , respectively, on each anniversary date of grant and have a term of five years. There were no SAIC options granted to Network Solutions' employees during 1998.

Pro Forma Disclosures

The weighted average fair value of the options granted during the years ended December 31, 1996 and 1997 under the SAIC Bonus Compensation Plan were estimated at $4.30 and $7.56, respectively, and $1.38, $2.34 and $14.91, during 1996, 1997 and 1998, respectively, under Network Solutions' Incentive Plan using the Black-Scholes model. The following weighted average assumptions were used in calculating the option fair values.

	SAIC Stock Options			Network Solutions Stock Options		
	Year Ended December 31,			Year Ended December 31,		
	1996	1997	1998	1996	1997	1998
Expected life (years)	4.0	5.0	—	4.0	4.0	4.0
Risk-free interest rate	5.91%	6.30%	—	5.98%	6.25%	5.10%
Volatility	0.00%	0.00%	—	0.00%	20.79%	90.73%
Dividend yield	0.00%	0.00%	—	0.00%	0.00%	0.00%

Under the above models, the total value of SAIC stock options granted during 1996 and 1997 was approximately $228,000 and $87,000, respectively, and $3,379,000, $2,809,000 and $20,322,000, respectively, for Network Solutions' employee stock purchase program and stock options granted in 1996, 1997 and 1998, all of which would be amortized ratably on a pro forma basis over their respective option terms. Had Network Solutions recorded compensation costs for these plans in accordance with SFAS No. 123, Network Solutions' pro forma income (loss) would have been ($1,763,000), $3,510,000 and $9,236,000, respectively for the years ended December 31, 1996, 1997 and 1998. Pro forma earnings (loss) per share on a diluted basis would have been ($0.07), $0.13 and $0.28, respectively, for the years ended December 31, 1996, 1997 and 1998.

Note 12—Comprehensive Income

The changes in the components of accumulated other comprehensive income are reported net of income taxes for the year ended December 31, 1998 as follows:

	Unrealized Gains On Securities	Accumulated Other Comprehensive Income
Pre-tax amount	$618,000	$618,000
Income tax	259,000	259,000
Net of tax amount	$359,000	$359,000

Note 13—Commitments and Contingencies

As of December 31, 1998, Network Solutions was a defendant in two active lawsuits involving domain name disputes between trademark owners and domain name holders. Network Solutions is drawn into such disputes, in part, as a result of claims by trademark owners that Network Solutions is legally required, upon request by a trademark owner, to terminate the right Network Solutions granted to a domain name holder to register a domain name which is alleged to be similar to the trademark in question. The holders of the domain name registrations in dispute have, in turn, questioned Network Solutions' right, absent a court order, to take any action which suspends their use of the domain names in question. Although 46 out of approximately 4,500 of these situations have resulted in suits actually naming us as a defendant, as of December 31, 1998, no adverse judgment has been rendered and no award of damages has ever been made against Network Solutions. Network Solutions believes that it has meritorious defenses and vigorously defends itself against these claims.

On March 20, 1997, PG Media, Inc., a New York-based corporation (PG Media), filed a lawsuit against Network Solutions in the United States District Court, Southern District of New York alleging that Network Solutions had restricted access to the Internet by not adding PG Media's requested top level domains to the Internet root zone system in violation of the Sherman Act. In its complaint, PG Media, in addition to requesting damages, asked that Network Solutions be ordered to include reference to PG Media's top level domains and name servers in the root zone file administered by Network Solutions under the Cooperative Agreement. In June 1997, Network Solutions received written direction from the National Science Foundation not to take any action which would create additional top level domains or to add any new top level domains to the Internet root zone until the National Science Foundation provided further guidance. On September 17, 1997, PG Media filed a Second Amended Complaint adding the National Science Foundation as a defendant. On May 14, 1998, PG Media served Network Solutions with a motion for a preliminary injunction against both defendants to compel both defendants to add PG Media's top level domains to the Internet root zone within 30 days. In response, both defendants filed cross-motions for summary judgment against PG Media. On July 20, 1998, a hearing on all parties' motions occurred. The basic issue before the court is the National Science Foundation's authority to control the Internet's root zone system. The court has taken the issue under advisement and no date has been indicated for the issuance of a decision. With the transition of the Cooperative Agreement from the National Science Foundation to the Department of Commerce, Network Solutions is still required to request written direction from the U.S. Government before making or rejecting any modifications, additions or deletions to the root zone file, in accordance with the October 1998 amendment to the Cooperative Agreement.

On October 17, 1997, a group of six plaintiffs filed a lawsuit (the "Thomas suit") against Network Solutions and the National Science Foundation in the United States District Court, District of Columbia, challenging the legality of fees defendants charge for the registration and renewal of domain names on the Internet and seeking restitution of fees collected from domain name registrants in an amount in excess of $100 million, damages, and injunctive and other relief. Plaintiffs alleged violations of the Sherman Act, the U.S. Constitution, the Administrative Procedures Act and the Independent Offices Appropriations Act. On February 10, 1998, the plaintiffs filed a motion for preliminary injunction against Network Solutions seeking several items of relief. On April 6, 1998, the Court issued its opinion granting summary judgment in favor of the plaintiffs on the Intellectual Infrastructure Fund, ruling it an "unlawful tax." The court also granted Network Solutions' motion to dismiss all other counts (II through X) and simultaneously denied the plaintiffs' preliminary injunction motion against Network Solutions.

On April 30,1998, Congress passed H.R. 3579 which was signed into law by the President on May 1, 1998. Section 8003 of H.R. 3579 legalized, ratified and confirmed the entire Intellectual Infrastructure Fund and authorized and directed the National Science Foundation to deposit the entire fund into the U.S. Treasury. On August 28, 1998, the District Court dismissed the entire case, issuing a final judgment in the matter. In October 1998, the plaintiffs appealed the court's dismissal of their claims, with oral argument scheduled for February 25, 1999.

On October 20, 1998, Network Solutions was included as a defendant in a suit brought by the Pennsylvania Attorney General's office against a domain name holder who has alleged to have used his domain name in connection with a Web site promoting white supremacy and threatening certain state employees. The Pennsylvania Attorney General named all of the communications companies in any way connected with the domain name or Web site. The Pennsylvania Attorney General seeks to permanently enjoin these entities, including Network Solutions, from providing services to this domain name holder in the event that the domain name holder fails to comply with the order of the court. Network Solutions has answered the complaint denying any knowledge or participation in the actions of the primary defendant. No motions are pending and Network Solutions expects to be dismissed from the matter.

Network Solutions believes that it has meritorious defenses and vigorously defends itself against the claims advanced in the PG Media, Thomas or Pennsylvania Attorney General suits. While management cannot reasonably estimate the potential impact of such claims, a successful claim against Network Solutions in any of these proceedings could have a material adverse effect on Network Solutions' business, financial condition and results of operations.

On June 27, 1997, SAIC received a Civil Investigative Demand, or "CID" from the U.S. Department of Justice issued in connection with an investigation to determine whether there is, has been, or may be an antitrust violation under the Sherman Act relating to Internet registration products and services. The CID seeks documents and information from SAIC and Network Solutions relating to their Internet registration business. Network Solutions cannot reasonably estimate the potential impact of the investigation nor can it predict whether a civil action will ultimately be filed by the Department of Justice or the form of relief that might be sought. Any such relief could have a material adverse effect on Network Solutions' business, financial condition and results of operations.

On August 17, 1998, Network Solutions received notice from the Commission of the European Communities, or "EC," of an investigation concerning Network Solutions' Premier Program agreements in Europe. The EC requested production of these agreements and related materials for review. Network Solutions cannot reasonably estimate the potential impact of the investigation nor can Network Solutions predict whether an action will ultimately be brought by the EC or the form of relief that might be sought. Any such relief could harm Network Solutions' business.

Network Solutions is involved in various other investigations, claims and lawsuits arising in the normal conduct of business, none of which, in management's opinion will harm Network Solutions' business.

Legal proceedings in which Network Solutions is involved have resulted and likely will result in, and any future legal proceedings can be expected to result in, substantial legal and other expenses and a diversion of the efforts of Network Solutions' personnel.

Note 14—Subsequent Events

Secondary Stock Offering

On February 12, 1999, Network Solutions completed a secondary stock offering in which a total of 9,160,000 shares of Class A common stock were sold. Concurrent with the offering, SAIC converted 9,000,000 shares of Class B common stock into 9,000,000 shares of Class A common stock sold in the offering. The remaining 160,000 shares of Class A common stock were sold by other selling stockholders after they exercised the applicable stock options simultaneously with the closing of the offering. Network Solutions was not a selling stockholder, and therefore, did not receive any proceeds from the stock offering other than proceeds from options exercised as part of the offering. After the offering, SAIC owns approximately 89% of the combined voting power and approximately 45% of the economic interest of the outstanding common stock.

By May 31, 1999, SAIC intends to convert all of the remaining Class B common stock into an identical number of shares of Class A common stock. After that conversion, Class A common stock will be the only class of common stock outstanding and SAIC will own approximately 45% of the voting power and economic interest of Network Solutions' outstanding common stock.

Litigation

On March 16, 1999, the United States District Court ruled in favor of Network Solutions' and the National Science Foundation's motions for summary judgment in the PG Media antitrust lawsuit. In the decision, Network Solutions was found to be immune to antitrust violations of the Sherman Act for its actions taken pursuant to the Cooperative Agreement.

Report of Independent Accountants

To the Board of Directors and
Stockholders of Network Solutions, Inc.

In our opinion, the accompanying statements of financial position and the related statements of operations, of changes in stockholders' equity and of cash flows present fairly, in all material respects, the financial position of Network Solutions, Inc. (a majority-owned subsidiary of Science Applications International Corporation) at December 31, 1998 and 1997, and the results of its operations and its cash flows for each of the three years ended December 31, 1998 in conformity with generally accepted accounting principles. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with generally accepted auditing standards which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for the opinion expressed above.

PricewaterhouseCoopers LLP

McLean, VA
February 5, 1999

Directors and Officers

Board of Directors

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Chairman of the Board and Acting Chief Executive Officer
Sector Vice President and Sector Manager,
Science Applications International Corporation

J. Robert Beyster[1]
Chief Executive Officer and Chairman of the Board
Science Applications International Corporation

Craig I. Fields[2]
Chairman of Defense Science Board

John E. Glancy[2]
Corporate Executive Vice President
Science Applications International Corporation

J. Dennis Heipt[1]
Senior Vice President for Administration and Secretary
Science Applications International Corporation

William A. Roper, Jr.[2]
Senior Vice President and Chief Financial Officer
Science Applications International Corporation

Stratton D. Sclavos[1]
President, Chief Executive Officer and Director
VeriSign, Inc.

Donald N. Telage
Senior Vice President, Internet Relations and Special Programs
Network Solutions, Inc. and
Group Senior Vice President
Science Applications International Corporation

[1] Member of Compensation Committee
[2] Member of Audit Committee

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Robert J. Korzeniewski
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Michael G. Voslow
Vice President, Finance and Treasurer

James E. Walker
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Richard A. Walsh
Vice President, Operations

Corporate Information

Corporate Headquarters

505 Huntmar Park Drive
Herndon, Virginia 20170
Tel. No. (703) 742-0400
Fax No. (703) 742-3386
Web Site: www.networksolutions.com

Annual Meeting

May 18, 1999 at 9:30 a.m.
Hyatt Regency Reston
1800 Presidents Street
Reston, Virginia 20190

Form 10-K

A copy of Network Solutions Form 10-K, containing additional information of possible interest to shareholders and filed with the Securities and Exchange Commission in March each year, will be sent without charge to any shareholder who requests it.

Write to: Investor Relations
Attention: Mr. Sean McClorey
505 Huntmar Park Drive
Herndon, Virginia 20170
Tel. No. (703) 326-6090

Quarterly earnings releases, corporate news releases and certain Securities and Exchange Commission filings are available on www.networksolutions.com or by contacting Investor Relations. Network Solutions also provides company information by e-mail. To register for this service visit www.networksolutions.com under Investor Relations.

Transfer Agent

ChaseMellon Shareholder Services, L.L.C.
Overpeck Centre, 85 Challenger Road
Ridgefield Park, New Jersey 07660
Tel. No. (800) 526-0801

Independent Public Accountants

PricewaterhouseCoopers LLP
1751 Pinnacle Drive
McLean, Virginia 22102

Stock Exchange Listing

NASDAQ National Market
Ticker Symbol—NSOL

Quarterly Stock Information

The high and low last reported last sales prices of Network Solutions' Class A Common Stock were as follows:

	High	Low
Fourth Quarter 1997 from September 26, 1997	$13 3/8	$ 5 7/8
First Quarter 1998	$18 9/16	$ 6 15/32
Second Quarter 1998	$27 1/2	$16 1/4
Third Quarter 1998	$23 5/32	$12 7/8
Fourth Quarter 1998	$82 23/64	$14 3/16

Trademarks

The blue and yellow GLOBE GEAR DESIGN with NETWORK SOLUTIONS, RegistrationPlus,™ dot com people,™ dot com mail,™ dot com toolkit™ and dot com promotions™ are trademarks of Network Solutions, Inc. This annual report also includes trademarks, service marks and trade names of other companies.

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