

COGENT COMMUNICATIONS GROUP INC

Form 10-K

February 27, 2008

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

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**FORM 10-K**

(Mark One)

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

**For the fiscal year ended December 31, 2007**

**OR**

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

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_  
Commission file number 1-31227**

**COGENT COMMUNICATIONS GROUP, INC.**

(Exact Name of Registrant as Specified in Its Charter)

**Delaware**  
(State or Other Jurisdiction of  
Incorporation or Organization)

**52-2337274**  
(I.R.S. Employer  
Identification No.)

**1015 31 st Street N.W.**  
**Washington, D.C.**  
(Address of Principal Executive Offices)

**20007**  
(Zip Code)

**(202) 295-4200**

Registrant's Telephone Number, Including Area Code

Securities registered pursuant to Section 12(b) of the Act:

**Common Stock, par value \$0.001 per share**

Securities registered pursuant to Section 12(g) of the Act:

**None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ☒ No ☐

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes ☐ No ☒

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ☐

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

Large accelerated filer ☒ Accelerated filer ☐ Non-accelerated filer ☐ Smaller reporting company ☐

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ☐ No ☒

The number of shares outstanding of the issuer's common stock, par value \$0.001 per share, as of February 15, 2008 was 47,912,864.

The aggregate market value of the Common Stock held by non-affiliates of the registrant, based on the closing price of \$29.87 per share on June 29, 2007 as reported by the NASDAQ Global Select Market was approximately \$1.3 billion.

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**COGENT COMMUNICATIONS GROUP, INC.  
FORM 10-K ANNUAL REPORT**

**FOR THE YEAR ENDED DECEMBER 31, 2007**

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**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the registrant's definitive proxy statement for the registrant's 2008 annual shareholders meeting are incorporated by reference in Part III of this Form 10-K.

**SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS**

This report may contain forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended. Forward-looking statements are not statements of historical facts, but rather reflect our current expectations concerning future results and events. You can identify these forward-looking statements by our use of words such as "anticipates," "believes," "continues," "expects," "intends," "likely," "may," "opportunity," "plans," "potential," "project," "will," and similar expressions to identify forward-looking statements, whether in the negative or the affirmative. We cannot guarantee that we actually will achieve these plans, intentions or expectations. These forward-looking statements are subject to risks, uncertainties and other factors, some of which are beyond our control, which could cause actual results to differ materially from those forecasts or anticipated in such forward-looking statements.

You should not place undue reliance on these forward-looking statements, which reflect our view only as of the date of this report. We undertake no obligation to update these statements or publicly release the result of any revisions to these statements to reflect events or circumstances after the date of this report or to reflect the occurrence of unanticipated events.



**PART I**

**ITEM 1. BUSINESS**

**Overview**

We are a leading facilities-based provider of low-cost, high-speed Internet access and Internet Protocol, or IP, communications services. Our network is specifically designed and optimized to transmit data using IP. We deliver our services to small and medium-sized businesses, communications service providers and other bandwidth-intensive organizations through approximately 15,000 customer connections in North America and Europe.

Our primary on-net service is Internet access at a speed of 100 Megabits per second, much faster than typical Internet access currently offered to businesses. We offer this on-net service exclusively through our own facilities, which run all the way to our customers' premises. Because of our integrated network architecture, we are not dependent on local telephone companies to serve our on-net customers. Our typical customers in multi-tenant office buildings are law firms, financial services firms, advertising and marketing firms and other professional services businesses. We also provide on-net Internet access to certain bandwidth-intensive users such as universities, other ISPs and commercial content providers at speeds of up to ten Gigabits per second. For the years ended December 31, 2007, 2006 and 2005 our on-net customers generated 79.0%, 70.6% and 57.9%, respectively, of our total net service revenue.

In addition to providing our on-net services, we also provide Internet connectivity to customers that are not located in buildings directly connected to our network. We serve these off-net customers using other carriers' facilities to provide the "last mile" portion of the link from our customers' premises to our network. For the years ended December 31, 2007, 2006 and 2005, our off-net customers generated 17.3%, 23.1%, and 33.0%, respectively, of our total net service revenue.

Non-core services are those services we acquired and continue to support but do not actively sell. For the years ended December 31, 2007, 2006 and 2005, non-core services generated 3.7% and 6.3% and 9.1%, respectively, of our total net service revenue.

We also operate 34 data centers comprising approximately 300,000 square feet throughout North America and Europe that allow customers to co-locate their equipment and access our network.

**Competitive Advantages**

We believe we address many of the IP data communications needs of small and medium-sized businesses, communications service providers and other bandwidth-intensive organizations by offering them high-quality Internet service at attractive prices.

*Low Cost of Operation.* We offer a streamlined set of products on an integrated network that operates on a single protocol. Our network design allows us to avoid many of the costs associated with circuit-switched networks related to provisioning, monitoring and maintaining multiple transport protocols. We believe that our low cost of operation gives us greater pricing flexibility and an advantage in a competitive environment characterized by falling Internet access prices.

*Independent Network.* Our on-net service does not rely on infrastructure controlled by local incumbent telephone companies. We provide the entire network, including the last mile and the in-building wiring to the customer's suite. This gives us more control over our service, quality and pricing and allows us to provision services more quickly and efficiently. We are typically able to activate customer services in one of our on-net buildings in fewer than ten days.

*High Quality, Reliable Service.* We are able to offer high-quality Internet service due to our network, which was designed solely to transmit IP data, and dedicated intra-city bandwidth for each

customer. This design increases the speed and throughput of our network and reduces the number of data packets dropped during transmission.

*Low Capital Cost to Grow Our Business.* We have incurred relatively minimal indebtedness in growing our business because of our network design of using Internet routers without additional legacy equipment and our strategy of acquiring optical fiber from the excess capacity in existing networks.

*Experienced Management Team.* Our senior management team is composed of seasoned executives with extensive expertise in the telecommunications industry as well as knowledge of the markets in which we operate. The members of our senior management team have an average of over 20 years of experience in the telecommunications industry. Our senior management team has designed and built our network and led the integration of our network assets, customers and service offerings we acquired through 13 acquisitions.

*Convergence.* There is a clear industry and market trend for legacy products (e.g., TDM voice, Private Line, Frame Relay, and Asynchronous Transfer Mode) to converge on IP. Many of our competitors will have to migrate their existing customers and products to IP. This migration can be costly, lengthy, and risky. We do not face this challenge because our network and products are IP.

## **Our Strategy**

We intend to become the leading provider of high quality Internet access and IP communications services and to continue to improve our profitability and cash flow. The principal elements of our strategy include:

*Focus on Providing Low-Cost, High-Speed Internet Access and IP Connectivity.* We intend to further load our high-capacity network to respond to the growing demand for high-speed Internet service generated by bandwidth-intensive applications such as streaming media, online gaming, video, voice over IP (VOIP), remote data storage, distributed computing and virtual private networks. We intend to do so by continuing to offer our high-speed and high capacity services at competitive prices.

*Pursuing On-Net Customer Growth.* We intend to increase usage of our network and operational infrastructure by adding customers in our existing on-net buildings, as well as adding buildings to our network.

*Selectively Pursuing Acquisition Opportunities.* In addition to adding customers through our sales and marketing efforts, we will continue to seek out acquisition opportunities that increase our customer base, allowing us to take advantage of the unused capacity of our network and add revenues with minimal incremental costs. We may also make additional acquisitions to add network assets at attractive prices.

## **Our Network**

Our network is comprised of in-building riser facilities, metropolitan optical networks, metropolitan traffic aggregation points and inter-city transport facilities. We believe that we deliver a high level of technical performance because our network is optimized for IP traffic. We believe that our network is more reliable and delivers IP traffic at lower cost than networks built as overlays to traditional circuit-switched telephone networks.

Our network serves 100 metropolitan markets in North America and Europe and encompasses:

over 900 multi-tenant office buildings strategically located in commercial business districts;

over 300 carrier-neutral Internet aggregation facilities, data centers and single-tenant buildings;

over 250 intra-city networks consisting of over 10,400 fiber miles;

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an inter-city network of more than 26,900 fiber route miles; and

multiple leased high-capacity transatlantic circuits connecting the North American and European portions of our network.

We have created our network by acquiring optical fiber from carriers with large amounts of unused fiber and directly connecting Internet routers to our existing optical fiber national backbone. We have expanded our network through key acquisitions of financially distressed companies or their assets at a significant discount to their original cost. Due to our network design and acquisition strategy, we believe we are positioned to grow our revenue and increase profitability with limited incremental capital expenditures. We expect our 2008 capital expenditure rate to be similar to the rate we experienced in 2007.

### *Inter-city Networks*

Our inter-city network consists of optical fiber connecting major cities in North America and Europe. The North American and European portions of our network are connected by transatlantic circuits. Our network was built by acquiring from various owners of fiber optic networks the right to use one or two strands of optical fiber out of the multiple fibers owned by the carrier. We have installed the optical and electronic equipment necessary to amplify, regenerate, and route the optical signals along these networks. We have the right to use the fiber under long term agreements. We pay these providers fees for the maintenance of the optical fiber and provide our own equipment maintenance. The larger providers of our inter-city optical fiber are WilTel (now part of Level 3) in the United States, LDCOM (now part of Neuf Cegetel in France, MTI in Germany, Telia Sonera in Europe, and RENFE (adif) in Spain.

### *Intra-city Networks*

In each metropolitan area in which we provide high-speed on-net Internet access service, our backbone network is connected to a router connected to one or more of our metropolitan optical networks. We create our intra-city networks by obtaining the right to use optical fiber from carriers with large amounts of dark fiber. These metropolitan networks consist of optical fiber that runs from the central router in a market into routers located in our on-net buildings. In most cases the metropolitan fiber runs in a ring architecture, which provides redundancy so that if the fiber is cut, data can still be transmitted to the central router by directing traffic in the opposite direction around the ring. The router in the building provides a connection to each on-net customer.

Within the cities where we offer off-net Internet access service, we lease circuits from telecommunications carriers, primarily local telephone companies, to provide the last mile connection to the customer's premises. Typically, these circuits are aggregated at various locations in those cities onto higher-capacity leased circuits that ultimately connect the local aggregation route to our network.

### *In-Building Networks*

In office buildings where we provide service to multiple tenants we connect our routers to a cable containing 12 to 288 optical fiber strands that typically run from our equipment in the basement of the building through the building riser to the customer location. Service for customers is initiated by connecting a fiber optic cable from a customer's local area network to the infrastructure in the building riser. The customer then has dedicated and secure access to our network using an Ethernet connection. We believe that Ethernet is the lowest cost network connection technology and is used almost universally for the local area networks that businesses operate.

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### *Internetworking*

The Internet is an aggregation of interconnected networks. We interconnect our network with most major and hundreds of minor Internet Service Providers, or ISPs, at approximately 70 locations. We interconnect our network through public and private peering arrangements. Public peering is the means by which ISPs have traditionally connected to each other at central, public facilities. Larger ISPs also exchange traffic and interconnect their networks by means of direct private connections referred to as private peering.

Peering agreements between ISPs are necessary in order for them to exchange traffic. Without peering agreements, each ISP would have to buy Internet access from every other ISP in order for its customer's traffic, such as email, to reach and be received from customers of other ISPs. We are considered a Tier 1 ISP and, as a result, we have settlement-free peering arrangements with most other providers. This allows us to exchange traffic with those ISPs without payment by either party. In such arrangements, each party exchanging traffic bears its own cost of delivering traffic to the point at which it is handed off to the other party. We also engage in public peering arrangements in which each party also pays a fee to the owner of routing equipment that operates as the central exchange for all the participants. We do not treat our settlement-free peering arrangements as generating revenue or expense related to the traffic exchanged. Where we do not have settlement-free peering connection with an ISP, we exchange traffic through an intermediary, whereby such intermediary receives payment from us. Currently, less than 1% of our traffic is handled this way.

### *Network Management and Control*

Our primary network operations centers are located in Washington, D.C and Madrid, Spain. These facilities provide continuous operational support in both North America and Europe. Our network operations centers are designed to immediately respond to any problems in our network. To ensure the quick replacement of faulty equipment in the intra-city and long-haul networks, we have deployed field engineers across North America and Europe. In addition, we have maintenance contracts with third party vendors that specialize in optical and routed networks.

### **Our Services**

We offer high-speed Internet access and IP connectivity to small and medium-sized businesses, communications providers and other bandwidth-intensive organizations located in North America and Europe.

The table below shows our primary service offerings:

<b>On-Net Services</b>	<b>Bandwidth (Mbps)</b>
Fiber500	0.5
Two Meg	2.0
Fast Ethernet	100
Gigabit Ethernet	1,000
10 Gigabit Ethernet	10,000
Colocation with Internet Access	2 to 10,000
Point-to-Point	1.5 to 10,000
<b>Off-Net Services</b>	
T1 or E1	1.5 or 2.0
T3 or E3	45 or 34
Ethernet	10, 100 or 1,000



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We offer on-net services in 100 metropolitan markets. We serve over 1,200 buildings of which more than 1,050 are located in North America with the remainder located in Europe. Our most popular on-net service in North America is our Fast Ethernet service, which provides Internet access at 100 megabits per second. We typically offer our Fast Ethernet (Internet access) service to our small and medium-sized business customers at \$1,000 a month for month-to-month service. We offer lower prices for longer term commitments typically \$900 per month for a one year term and \$800 per month for a two year term. We also offer Internet access services at higher speeds of up to ten Gigabits per second. These services are generally used by customers that have businesses, such as web hosting, that are Internet based and are generally delivered at data centers and carrier hotels. We believe that, on a per-Megabit basis, this service offering is one of the lowest priced in the marketplace. We also offer colocation services in 34 locations in North America and Europe. This service offers Internet access combined with rack space and power in a Cogent facility, allowing the customer to locate a server or other equipment at that location and connect to our Internet service. Our final on-net service offering is our "Point-to-Point" or "Layer 2" service. These point-to-point connections span North America and Europe and allow customers to connect geographically dispersed local area networks in a seamless manner. We emphasize the sale of on-net services because we believe that we have a competitive advantage in providing these services and our sales of these services generate higher gross profit margins.

We offer off-net services to customers not located in our on-net buildings. These services are provided in the metropolitan markets in North America and Europe in which we offer on-net services and in approximately 5 additional markets. These services are generally provided to small and medium-sized businesses in approximately 2,700 off-net buildings. A significant amount of our off-net revenues were acquired revenues, which have historically churned at a greater rate than our on-net revenues. We expect the revenue from these off-net services to grow at a slower rate than our on-net revenues.

We support certain non-core services assumed with certain of our acquisitions. These services include our managed modem service, voice services in Toronto, Canada, and legacy point-to-point services. Our managed modem service is offered to larger businesses and other Internet service providers that serve individuals that dial in to the Internet. The business or ISP is our customer for this service. Individuals make use of the dial-in access through arrangements with the business or ISP. We expect the revenue from these non-core services to decline. We do not actively sell these services and expect the growth of our on-net Internet services to compensate for this loss.

### **Sales and Marketing**

*Sales.* We employ a direct sales and marketing approach. As of February 1, 2008, our sales force included 204 full-time employees. Our outside direct sales personnel work through direct face-to-face contact with potential customers in, or intending to locate in, on-net buildings. Through agreements with building owners, we are able to initiate and maintain personal contact with our customers by staging various promotional and social events in our on-net buildings. Direct sales personnel are compensated with a base salary plus quota-based commissions and incentives. We use a customer relationship management system to efficiently track activity levels and sales productivity.

*Agent Program.* We also have an agent program used as an alternate channel to distribute our products and services. The agent program consists of value-added resellers, IT consultants, and smaller telecom agents, who are managed by our direct sales personnel, and larger national or regional companies whose primary business is to sell telecommunications, data, and Internet services. The agent program includes over 110 agents.

*Marketing.* Because of our focus on a direct sales force, we have not spent funds on television, radio or print advertising. Our marketing efforts are designed to drive awareness of our products and services, identify qualified leads through various direct marketing campaigns and provide our sales force

with product brochures, collateral materials and relevant sales tools to improve the overall effectiveness of our sales organization. In addition, we conduct public relations efforts focused on cultivating industry analyst and media relationships with the goal of securing media coverage and public recognition of our Internet communications services. Our marketing organization is responsible for our product strategy and direction based upon primary and secondary market research and the advancement of new technologies.

### **Competition**

We face competition from incumbent carriers, Internet service providers and facilities-based network operators, many of whom are much larger than us, have significantly greater financial resources, better-established brand names and large, existing installed customer bases in the markets in which we compete. We also face competition from other new entrants to the communications services market. Many of these companies offer products and services that are similar to our products and services, and we expect the level of competition to intensify in the future. Unlike some of our competitors, we do not have title to most of the dark fiber that makes up our network. Our interests in that dark fiber are in the form of long-term leases or IRUs obtained from their titleholders. We rely on the maintenance of such dark fiber to provide our on-net services to customers. We are also dependent on third-party providers, some of whom are our competitors, for the provision of connections to our off-net customers.

We believe that competition is based on many factors, including price, transmission speed, ease of access and use, breadth of service availability, reliability of service, customer support and brand recognition. Because our fiber optic networks have been recently installed compared to those of the incumbent carriers, our state-of-the-art technology may provide us with cost, capacity, and service quality advantages over some existing incumbent carrier networks; however, our network may not support some of the services supported by these legacy networks, such as circuit-switched voice and frame relay. While the Internet access speeds offered by traditional ISPs typically do not match our on-net offerings, these slower services are usually priced lower than our offerings and thus provide competitive pressure on pricing, particularly for more price-sensitive customers. These and other downward pricing pressures have diminished, and may further diminish, the competitive advantages that we have enjoyed as the result of our service pricing.

### **Regulation**

In the United States, the Federal Communications Commission (FCC) regulates common carriers' interstate services and state public utilities commissions exercise jurisdiction over intrastate basic telecommunications services. Our Internet service offerings are not currently regulated by the FCC or any state public utility commission. However, we may become subject to regulation in the U.S. at the federal and state levels and in other countries. The offerings of many of our competitors and vendors, especially incumbent local telephone companies, are subject to direct federal and state regulations. These regulations change from time to time in ways that are difficult for us to predict.

In the United States, we are subject to the obligations set forth in the Communications Assistance for Law Enforcement Act, which is administered by the FCC. That law requires that we be able to intercept communications when required to do so by law enforcement agencies. We are required to comply or we may face significant fines and penalties.

There is no current legal requirement that owners or managers of commercial office buildings give access to competitive providers of telecommunications services, although the FCC does prohibit carriers from entering contracts that restrict the right of commercial multiunit property owners to permit any other common carrier to access and serve the property's commercial tenants.

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Our subsidiary, Cogent Canada, offers voice and Internet services in Canada. Generally, the regulation of Internet access services and competitive voice services has been similar in Canada to that in the U.S. in that providers of such services face fewer regulatory requirements than the incumbent local telephone company. This may change. Also, the Canadian government has requirements limiting foreign ownership of certain telecommunications facilities in Canada. We are not subject to these restrictions today. We will have to comply with these regulations to the extent they change and to the extent we begin using facilities in a manner that subjects us to these restrictions.

Our European subsidiaries operate in a more highly regulated environment for the types of services they provide. In many European countries, a national license or a notice filed with a regulatory authority is required for the provision of data and Internet services. In addition, our subsidiaries operating in member countries of the European Union are subject to the directives and jurisdiction of the European Union. We believe that each of our subsidiaries has the necessary licenses to provide its services in the markets where it operates today. To the extent we expand our operations or service offerings in Europe or other new markets, we may face new regulatory requirements.

The laws related to Internet telecommunications are unsettled and there may be new legislation and court decisions that may affect our services and expose us to liability.

### Employees

As of February 1, 2008, we had 431 employees. A union represents twenty-two of our employees in France. We believe that we have a satisfactory relationship with our employees.

### Available Information

We make available free of charge through our Internet website our annual report on Form 10-K, our quarterly reports on Form 10-Q, our current reports on Form 8-K, and any amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act. The reports are made available through a link to the SEC's Internet website at [www.sec.gov](http://www.sec.gov). You can find these reports and request a copy of our Code of Conduct on our website at [www.cogentco.com](http://www.cogentco.com) under the "Investor Relations" link.

### ITEM 1A. RISK FACTORS

***If our operations do not consistently produce positive cash flow to pay for our growth or meet our operating and financing obligations, and we are unable to otherwise raise additional capital to meet these needs, our ability to implement our business plan will be materially and adversely affected.***

We currently generate positive cash flow from our operations. If we acquire or invest in additional businesses, assets, services or technologies we may need to raise additional capital beyond that available from our cash flow. We may also face unforeseen capital requirements for new technology required to remain competitive or to comply with new regulatory requirements, for unforeseen maintenance of our network and facilities, and for other unanticipated expenses associated with running our business. In addition, if we do not retain existing customers or add new customers, our cash flow may be impaired and we may be required to raise additional funds through the issuance of debt or equity. We cannot assure you that we will have access to necessary capital, nor can we assure you that any such financing will be available on terms that are acceptable to our stockholders or us. If issuing equity securities raises additional funds, substantial dilution to existing stockholders may result.

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***We need to retain existing customers and continue to add new customers in order to become profitable and remain cash flow positive.***

In order to become profitable and remain consistently cash flow positive, we need to both retain existing customers and continue to add a large number of new customers. The precise number of additional customers required to become profitable and remain consistently cash flow positive is dependent on a number of factors, including the turnover of existing customers and the revenue mix among customers. We may not succeed in adding customers if our sales and marketing plan is unsuccessful. In addition, many of our target customers are existing businesses that are already purchasing Internet access services from one or more providers, often under a contractual commitment, and it has been our experience that such target customers are often reluctant to switch providers due to costs associated with switching providers. Further, as some of our customers grow larger they may decide to build their own Internet networks. While no single customer accounted for more than 2.7% of our 2007 revenues, a migration of a few very large Internet users to their own networks could impair our growth.

***We are experiencing rapid growth of our business and operations and we may not be able to efficiently manage our growth.***

We have rapidly grown our company through acquisitions of companies, assets and customers as well as implementation of our own network expansion and the acquisition of new customers through our own sales efforts. Our expansion places significant strains on our management, operational and financial infrastructure. Our ability to manage our growth will be particularly dependent upon our ability to:

expand, develop and retain an effective sales force and qualified personnel;

maintain the quality of our operations and our service offerings;

maintain and enhance our system of internal controls to ensure timely and accurate compliance with our regulatory reporting requirements; and

expand our accounting and operational information systems in order to support our growth.

If we fail to implement these measures successfully, our ability to manage our growth will be impaired.

***We may experience difficulties in implementing our expansion in Eastern Europe and may incur related unexpected costs and regulatory issues.***

In 2007, we began to expand our network into Eastern Europe. We may have difficulty in acquiring dark fiber and other difficulties in making our network operational in this region. The expansion may cost more than we have planned. We also may experience regulatory issues. Finally, we may be unsuccessful in selling our services in this region. If we are not successful in developing our market presence in Eastern Europe our operating results could be adversely impacted.

***We may experience delays and additional costs in expanding our on-net buildings.***

Currently, we plan to increase our carrier-neutral facilities and other on-net buildings by approximately 100 buildings in 2008 from 1,217 at December 31, 2007. We may be unsuccessful at identifying appropriate buildings or negotiating favorable terms for acquiring access to such buildings, and consequently, may experience difficulty in adding customers to our network and fully using the network's capacity.

***We may not successfully make or integrate acquisitions or enter into strategic alliances.***

As part of our growth strategy, we intend to pursue selected acquisitions and strategic alliances. To date, we have completed 13 acquisitions. We compete with other companies for acquisition opportunities and we cannot assure you that we will be able to effect future acquisitions or strategic alliances on commercially reasonable terms or at all. Even if we enter into these transactions, we may experience:

delays in realizing or a failure to realize the benefits we anticipate;

difficulties or higher-than-anticipated costs associated with integrating any acquired companies, products or services into our existing business;

attrition of key personnel from acquired businesses;

unexpected costs or charges; or

unforeseen operating difficulties that require significant financial and managerial resources that would otherwise be available for the ongoing development or expansion of our existing operations.

In the past, our acquisitions have often included assets, service offerings and financial obligations that are not compatible with our core business strategy. We have expended management attention and other resources to the divestiture of assets, modification of products and systems as well as restructuring financial obligations of acquired operations. In most acquisitions, we have been successful in renegotiating long-term agreements that we have acquired relating to long distance and local transport of data and IP traffic. If we are unable to satisfactorily renegotiate such agreements in the future or with respect to future acquisitions, we may be exposed to large claims for payment for services and facilities we do not need.

Consummating these transactions could also result in the incurrence of additional debt and related interest expense, as well as unforeseen contingent liabilities, all of which could have a material adverse effect on our business, financial condition and results of operations. Because we have purchased financially distressed companies or their assets, and may continue to do so in the future, we have not had, and may not have, the opportunity to perform extensive due diligence or obtain contractual protections and indemnifications that are customarily provided in corporate acquisitions. As a result, we may face unexpected contingent liabilities arising from these acquisitions. We may also issue additional equity in connection with these transactions, which would dilute our existing shareholders.

Revenues generated by the customer contracts that we have acquired have accounted for a substantial portion of our historical growth in non-core and off-net service revenues. However, following an acquisition, we have experienced a decline in revenue attributable to acquired customers as these customers' contracts have expired and they have entered into standard Cogent customer contracts at generally lower rates or have chosen not to renew service with us. We anticipate that we will experience similar declines with respect to customers we have acquired or will acquire.

***We depend upon our key employees and may be unable to attract or retain sufficient qualified personnel.***

Our future performance depends upon the continued contribution of our executive management team and other key employees, in particular, our Chairman and Chief Executive Officer, Dave Schaeffer. As founder of our company, Mr. Schaeffer's knowledge of our business and our industry combined with his deep involvement in every aspect of our operations and planning make him particularly well-suited to lead our company and difficult to replace.

***Our connections to the Internet require us to establish and maintain relationships with other providers, which we may not be able to maintain.***

The Internet is composed of various public and private network providers who operate their own networks and interconnect them at public and private interconnection points. Our network is one such network. In order to obtain Internet connectivity for our network, we must establish and maintain relationships with other providers and incur the necessary capital costs to locate our equipment and connect our network at these various interconnection points.

By entering into what are known as settlement-free peering arrangements, providers agree to exchange traffic between their respective networks without charging each other. Our ability to avoid the higher costs of acquiring dedicated network capacity and to maintain high network performance is dependent upon our ability to establish and maintain peering relationships. The terms and conditions of our peering relationships may also be subject to adverse changes, which we may not be able to control. For example, several network operators with large numbers of individual users are arguing that they should be able to charge or charge more to network operators and businesses that send traffic to those users. If we are not able to maintain or increase our peering relationships in all of our markets on favorable terms, we may not be able to provide our customers with high performance or affordable services, which could have a material adverse effect on our business. We have in the past encountered some disputes with certain of our providers regarding our peering arrangements, but we have generally been able to route our traffic through alternative peering arrangements, resolve such disputes, or terminate such peering arrangements with a minimal adverse impact on our business. In the past we had two such disputes that resulted in a temporary disruption of the exchange of traffic between our network and the network of the other carrier. We continue to experience resistance from certain incumbent telephone companies, especially in Europe, to the upgrade of settlement free peering connections necessary to accommodate the growth of traffic we send to such carriers. We cannot assure you that we will be able to continue to establish and maintain relationships with providers or favorably resolve disputes with providers.

We make some of our connections to other Internet networks pursuant to agreements through carriers that make data transmission capacity available to us at negotiated rates. In some instances these agreements have minimum and maximum volume commitments. If we fail to meet the minimum, or exceed the maximum, volume commitments, our costs may rise.

***Our business could suffer because telephone companies and cable companies may provide better delivery of Internet content originating on their own networks.***

Broadband connections provided by cable TV and telephone companies have become the predominant means by which consumers connect to the Internet. The providers of these broadband connections may treat Internet content delivered from different sources differently. The possibility of this has been characterized as an issue of "net neutrality." As many of our customers operate websites and services that deliver content to consumers our ability to sell our services would be negatively impacted if Internet content delivered by us was less easily received by consumers than Internet content delivered by others.

***We have substantial debt which we may not be able to repay when due.***

We have \$200.0 million of senior convertible notes outstanding. The holders of the notes have the right to compel us to repurchase for cash on June 15, 2014, June 15, 2017 and June 15, 2022, all or some of their notes. They also have the right to be paid the principal upon default and upon certain designated events, such as certain changes of control. We may not have sufficient funds to pay the principal at the time we are obligated to do so, which could result in bankruptcy, or we may only be able to raise the funds on unfavorable terms.

***The holders of our senior convertible notes have the right to convert their notes to common stock.***

The holders of our senior convertible notes are under certain circumstances able to convert their notes into common stock at a conversion price of \$49.18 per share of common stock and to obtain additional shares of common stock. If our share price exceeds \$49.18 and the conversion right is exercised by the holders of the notes the number of our shares of common stock outstanding will increase which could reduce further appreciation in our stock price and impact our per share earnings. Rather than issue the stock we are permitted to pay the cash equivalent in value to the stock to be issued. We might not have sufficient funds to do this or doing so might have other detrimental impacts on us.

***Our operations outside of the United States expose us to economic, regulatory and other risks.***

The nature of our European and Canadian business involves a number of risks, including:

fluctuations in currency exchange rates;

exposure to additional regulatory and legal requirements, including import restrictions and controls, exchange controls, tariffs and other trade barriers;

difficulties in staffing and managing our foreign operations;

changes in political and economic conditions; and

exposure to additional and potentially adverse tax regimes.

As we continue to expand our European and Canadian businesses, our success will depend, in part, on our ability to anticipate and effectively manage these and other risks. Our failure to manage these risks and grow our European and Canadian operations may have a material adverse effect on our business and results of operations.

***Fluctuations in foreign exchange rates may adversely affect our financial position and results of operations.***

Our European and Canadian operations expose us to currency fluctuations and exchange rate risk. For example, while we record revenues and financial results from our European operations in euros, these results are reflected in our consolidated financial statements in U.S. dollars. Therefore, our reported results are exposed to fluctuations in the exchange rates between the U.S. dollar and the euro. We fund our euro-based operating expenses and associated cash flow requirements of our European operations, including IRU obligations, in U.S. dollars. Accordingly, in the event that the euro strengthens versus the dollar to a greater extent than we anticipate, the expenses and cash flow requirements associated with our European operations may be significantly higher in U.S.-dollar terms than planned.

***Our business could suffer delays and problems due to the actions of network providers on whom we are partially dependent.***

Our off-net customers are connected to our network by means of communications lines that are provided as services by local telephone companies and others. We may experience problems with the installation, maintenance and pricing of these lines and other communications links, which could adversely affect our results of operations and our plans to add additional customers to our network using such services. We have historically experienced installation and maintenance delays when the network provider is devoting resources to other services, such as traditional telephony. We have also experienced pricing problems when a lack of alternatives allows a provider to charge high prices for services in an area. We attempt to reduce this problem by using many different providers so that we have alternatives for linking a customer to our network. Competition among the providers tends to improve installation, maintenance and pricing.

***Our network could suffer serious disruption if certain locations experience serious damage.***

There are certain locations through which a large amount of our Internet traffic passes. Examples are facilities in which we exchange traffic with other carriers, the facility through which our transatlantic traffic passes, and certain of our network hub sites. If any of these facilities were destroyed or seriously damaged a significant amount of our network traffic could be disrupted. Because of the large volume of traffic passing through these facilities our ability (and the ability of carriers with whom we exchange traffic) to quickly restore service would be challenged. There could be parts of our network or the networks of other carriers that could not be quickly restored or that would experience substantially reduced service for a significant time. If such a disruption occurs, our reputation could be negatively impacted which may cause us to lose customers and adversely affect our ability to attract new customers and our operating results.

***If the information systems that we depend on to support our customers, network operations, sales, billing and financial reporting do not perform as expected, our operations and our financial results may be adversely affected.***

We rely on complex information systems to operate our network and support our other business functions. Our ability to track sales leads, close sales opportunities, provision services, bill our customers for those services and prepare our financial statements depends upon the effective integration of our various information systems. If our systems, individually or collectively, fail or do not perform as expected, our ability to process and provision orders, to make timely payments to vendors, to ensure that we collect revenue owed to us and prepare our financial statements would be adversely affected. Such failures or delays could result in increased capital expenditures, customer and vendor dissatisfaction, loss of business or the inability to add new customers or additional services, and prepare accurate and timely financial statements all of which would adversely affect our business and results of operations.

***We have historically incurred operating losses and these losses may continue for the foreseeable future.***

Since we initiated operations in 2000, we have generated operating losses and these losses may continue for the foreseeable future. In 2005 we had an operating loss of \$62.1 million, in 2006 we had an operating loss of \$46.6 million and in 2007 we had an operating loss of \$29.9 million. As of December 31, 2007, we had an accumulated deficit of \$296.0 million. Continued losses may prevent us from pursuing our strategies for growth or may require us to seek unplanned additional capital and could cause us to be unable to meet our debt service obligations, capital expenditure requirements or working capital needs.

***We may have difficulty intercepting communications as required by the U.S. Communications Assistance for Law Enforcement Act.***

The U.S. Communications Assistance for Law Enforcement Act requires that we be able to intercept communications when required to do so by law enforcement agencies. We may experience difficulties and incur significant costs in complying with the law. If we are unable to comply with the laws we could be subject to fines of up to \$1.0 million per event and other penalties.

***Our business could suffer from an interruption of service from our fiber providers.***

The carriers from whom we have obtained our inter-city and intra-city dark fiber maintain that fiber. If these carriers fail to maintain the fiber or disrupt our fiber connections for other reasons, such as business disputes with us and governmental takings, our ability to provide service in the affected markets or parts of markets would be impaired. The companies that maintain our inter-city dark fiber and many of the companies that maintain our intra-city dark fiber are also competitors of ours.



Consequently, they may have incentives to act in ways unfavorable to us. While we have successfully mitigated the effects of prior service interruptions and business disputes in the past, we may incur significant delays and costs in restoring service to our customers in connection with future service interruptions, and we may lose customers if delays are substantial.

***Our business depends on agreements with colocation operators, which we could fail to obtain or maintain.***

Our business depends upon access to customers in carrier neutral colocation centers, which are facilities in which many large users of the Internet house the computer servers that deliver content and applications to users by means of the Internet and provide access to multiple Internet access networks. Most colocation centers allow any carrier to operate within the facility (for a standard fee). We expect to enter into additional colocation agreements as part of our growth plan. Current government regulations do not require colocation operators to allow all carriers access on terms that are reasonable or nondiscriminatory. We have been successful in obtaining agreements with these operators in the past and have generally found that the operators want to have us in their colocation facilities because we offer low-cost, high capacity Internet service to their other customers. Any deterioration in our existing relationships with these colocation center operators could harm our sales and marketing efforts and could substantially reduce our potential customer base.

***Our business depends on license agreements with building owners and managers, which we could fail to obtain or maintain.***

Our on-net business depends upon our in-building networks. Our in-building networks depend on access agreements with building owners or managers allowing us to install our in-building networks and provide our services in these buildings. These agreements typically have terms of five to ten years, with one or more renewal options. Any deterioration in our existing relationships with building owners or managers could harm our sales and marketing efforts and could substantially reduce our potential customer base. We expect to enter into additional access agreements as part of our growth plan. Current federal and state regulations do not require building owners to make space available to us or to do so on terms that are reasonable or nondiscriminatory. While the FCC has adopted regulations that prohibit common carriers under its jurisdiction from entering into exclusive arrangements with owners of multi-tenant commercial office buildings, these regulations do not require building owners to offer us access to their buildings. Building owners or managers may decide not to permit us to install our networks in their buildings or may elect not to renew or amend our access agreements. The initial term of most of our access agreements will conclude in the next several years. Most of these agreements have one or more automatic renewal periods and others may be renewed at the option of the landlord. While we have historically been successful in renewing these agreements and no single building access agreement is material to our success, the failure to obtain or maintain a number of these agreements would reduce our revenue, and we might not recover our costs of procuring building access and installing our in-building networks.

***We may not be able to obtain or construct additional building laterals to connect new buildings to our network.***

In order to connect a new building to our network we need to obtain or construct a lateral from our metropolitan network to the building. We may not be able to obtain fiber in an existing lateral at an attractive price from a provider and may not be able to construct our own lateral due to the cost of construction or municipal regulatory restrictions. Failure to obtain fiber in an existing lateral or to construct a new lateral could keep us from adding new buildings to our network and from increasing our revenues.

***Impairment of our intellectual property rights and our alleged infringement on other companies' intellectual property rights could harm our business.***

We are aware of several other companies in our and other industries that use the word "Cogent" in their corporate names. One company has informed us that it believes our use of the name "Cogent" infringes on their intellectual property rights in that name. If such a challenge is successful, we could be required to change our name and lose the goodwill associated with the Cogent name in our markets.

***The sector in which we operate is highly competitive, and we may not be able to compete effectively.***

We face significant competition from incumbent carriers, Internet service providers and facilities-based network operators. Relative to us, many of these providers have significantly greater financial resources, more well-established brand names, larger customer bases, and more diverse strategic plans and service offerings.

Intense competition from these traditional and new communications companies has led to declining prices and margins for many communications services, and we expect this trend to continue as competition intensifies in the future. Decreasing prices for high-speed Internet services have somewhat diminished the competitive advantage that we have enjoyed as a result of our service pricing.

Our competitors may also introduce new technology or services that make our services less attractive to potential customers. For example, some providers are introducing a new version of the Internet protocol (IPv6) that we do not plan to introduce at this time. If this becomes important to Internet users our ability to compete may be lessened or we may have to incur additional costs in order to accommodate this technology.

***We issue projected results and estimates for future periods from time to time, and such projections and estimates are subject to inherent uncertainties and may prove to be inaccurate.***

Financial information, results of operations and other projections that we may issue from time to time are based upon our assumptions and estimates. While we believe these assumptions and estimates to be reasonable when they are developed, they are inherently subject to significant business, economic and competitive uncertainties and contingencies, many of which are beyond our control. You should understand that certain unpredictable factors could cause our actual results to differ from our expectations and those differences may be material. No independent expert participates in the preparation of these estimates. These estimates should not be regarded as a representation by us as to our results of operations during such periods as there can be no assurance that any of these estimates will be realized. In light of the foregoing, we caution you not to place undue reliance on these estimates. These estimates constitute forward-looking statements.

***Network failure or delays and errors in transmissions expose us to potential liability.***

Our network uses a collection of communications equipment, software, operating protocols and proprietary applications for the high-speed transportation of large quantities of data among multiple locations. Given the complexity of our network, it is possible that data will be lost or distorted. Delays in data delivery may cause significant losses to one or more customers using our network. Our network may also contain undetected design faults and software bugs that, despite our testing, may not be discovered in time to prevent harm to our network or to the data transmitted over it. The failure of any equipment or facility on the network could result in the interruption of customer service until we effect necessary repairs or install replacement equipment. Network failures, delays and errors could also result from natural disasters, power losses, security breaches, computer viruses, denial of service attacks and other natural or man-made events. Our off-net services are dependent on the networks of other providers or on local telephone companies. Network failures, faults or errors could cause delays or

service interruptions, expose us to customer liability or require expensive modifications that could have a material adverse effect on our business.

*As an Internet access provider, we may incur liability for information disseminated through our network.*

The law relating to the liability of Internet access providers and on-line services companies for information carried on or disseminated through their networks is unsettled. As the law in this area develops and as we expand our international operations, the potential imposition of liability upon us for information carried on and disseminated through our network could require us to implement measures to reduce our exposure to such liability, which may require the expenditure of substantial resources or the discontinuation of certain products or service offerings. Any costs that are incurred as a result of such measures or the imposition of liability could harm our business.

*Legislation and government regulation could adversely affect us.*

As an enhanced service provider, we are not subject to substantial regulation by the FCC or the state public utilities commissions in the United States. Internet service is also subject to minimal regulation in Europe and in Canada. If we decide to offer traditional voice services or otherwise expand our service offerings to include services that would cause us to be deemed a common carrier, we will become subject to additional regulation. Additionally, if we offer voice service using IP (voice over IP) or offer certain other types of data services using IP we may become subject to additional regulation. This regulation could impact our business because of the costs and time required to obtain necessary authorizations, the additional taxes than we may become subject to or may have to collect from our customers, and the additional administrative costs of providing voice services, and other costs. Even if we do not decide to offer additional services, governmental authorities may decide to impose additional regulation and taxes upon providers of Internet service. All of these could inhibit our ability to remain a low cost carrier.

Much of the law related to the liability of Internet service providers remains unsettled. For example, many jurisdictions have adopted laws related to unsolicited commercial email or "spam" in the last several years. Other legal issues, such as the sharing of copyrighted information, transborder data flow, universal service, and liability for software viruses could become subjects of additional legislation and legal development. We cannot predict the impact of these changes on us. Regulatory changes could have a material adverse effect on our business, financial condition or results of operations.

*Terrorist activity throughout the world and military action to counter terrorism could adversely impact our business.*

The September 11, 2001 terrorist attacks in the United States and the continued threat of terrorist activity and other acts of war or hostility have had, and may continue to have, an adverse effect on business, financial and general economic conditions internationally. Effects from these events and any future terrorist activity, including cyber terrorism, may, in turn, increase our costs due to the need to provide enhanced security, which would adversely affect our business and results of operations. These circumstances may also damage or destroy the Internet infrastructure and may adversely affect our ability to attract and retain customers, our ability to raise capital and the operation and maintenance of our network access points. We are particularly vulnerable to acts of terrorism because our largest customer concentration is located in New York, our headquarters is in Washington, D.C., and we have significant operations in Paris and Madrid, cities that have historically been targets for terrorist attacks.

## **ITEM 2. DESCRIPTION OF PROPERTIES**

We lease and own space for offices, data centers, colocation facilities, and points-of-presence.

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Our headquarters facility consists of approximately 15,370 square feet located in Washington, D.C. The lease for our headquarters is with an entity controlled by our Chief Executive Officer. The lease expires on August 31, 2010.

We also lease a total of approximately 414,000 square feet of space in 63 locations to house our colocation facilities, corporate headquarters, regional offices and operations centers. The remaining term of these leases ranges from 6 months to 8 years with, in many cases, options to renew.

We believe that these facilities are generally in good condition and suitable for our operations.

### **ITEM 3. LEGAL PROCEEDINGS**

We are involved in legal proceedings in the normal course of our business that we do not expect to have a material adverse affect on our business, financial condition or results of operations. For a discussion of the significant proceedings in which we are involved, see Note 7 to our consolidated financial statements.

### **ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.**

No matters were submitted to a vote of our security holders during the quarter ended December 31, 2007.

**PART II****ITEM 5. MARKET FOR THE REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS**

Our sole class of common equity is our common stock, par value \$0.001, which is currently traded on the NASDAQ Global Select Market under the symbol "CCOI". Prior to March 6, 2006, our common stock traded on the American Stock Exchange under the symbol "COI". Prior to February 5, 2002 no established public trading market for our common stock existed.

As of February 1, 2008, there were approximately 155 holders of record of shares of our common stock holding 48,025,164 shares of our common stock.

The table below shows, for the quarters indicated, the reported high and low trading prices of our common stock.

	<u>High</u>	<u>Low</u>
<b><i>Calendar Year 2006</i></b>		
First Quarter	\$ 9.77	\$ 5.13
Second Quarter	12.41	7.79
Third Quarter	11.77	7.78
Fourth Quarter	17.00	11.14
<b><i>Calendar Year 2007</i></b>		
First Quarter	\$ 24.91	\$ 15.74
Second Quarter	30.09	22.07
Third Quarter	34.90	20.08
Fourth Quarter	30.16	19.67

We have not paid any dividends on our common stock since our inception and do not anticipate paying any dividends in the foreseeable future. Any future determination to pay dividends will be at the discretion of our board of directors and will be dependent upon then-existing conditions, including our financial condition, results of operations, contractual restrictions, capital requirements, business prospects and other factors our board of directors deems relevant.

**Performance Graph**

The Company, in connection with its merger with Allied Riser Communications Corporation, began trading shares of its common stock on the American Stock Exchange in February 2002. On March 6, 2006, the Company's shares of Common Stock began trading on the NASDAQ National Market. The Company's common stock currently trades on the NASDAQ Global Select Market. The chart below compares the relative changes in the cumulative total return of the Company's Common Stock for the period December 31, 2002 to December 31, 2007, against the cumulative total return for the same period of the (1) The Standard & Poor's 500 (S&P 500) Index and (2) an industry peer group consisting of Savvis Communications Corporation (NASDAQ: SVVS); Internap Network Services Corporation (NASDAQ: INAP); and Time Warner Telecom Inc. (NASDAQ: TWTC). The comparison assumes \$100 was invested on December 31, 2002 in the Company's common stock, the S&P 500 Index and the industry peer group, with dividends, if any, reinvested.

**COMPARISON OF 5 YEAR CUMULATIVE TOTAL RETURN\***  
**AMONG COGENT COMMUNICATIONS GROUP, INC. THE S&P 500 INDEX**  
**AND A PEER GROUP**

**Value of \$100 Invested on December 31, 2002.**

	<u>12/02</u>	<u>12/03</u>	<u>12/04</u>	<u>12/05</u>	<u>12/06</u>	<u>12/07</u>
Cogent Communications Group	100.00	307.89	284.21	72.24	213.42	311.97
S&P 500	100.00	128.68	142.69	149.70	173.34	182.87
Peer Group(1)	100.00	513.27	226.31	235.85	639.14	548.98

\*

\$100 invested on 12/31/02 in stock or index-including reinvestment of dividends.  
Fiscal year ending December 31.

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[www.researchdatagroup.com/S&P.htm](http://www.researchdatagroup.com/S&P.htm)



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## Unregistered Sales of Equity Securities and Use of Proceeds.

On August 14, 2007, the Company announced that on August 14, 2007 its Board of Directors had authorized a plan to permit the repurchase of up to \$50.0 million of shares of the Company's common stock in negotiated and open market transactions through December 31, 2008. As of December 31, 2007, the Company had purchased 445,990 shares of its common stock pursuant to this authorization for an aggregate of \$9.9 million; approximately \$40.1 million remained available for such negotiated and open market transactions concerning the Company's common stock. The Company may purchase shares from time to time depending on market, economic, and other factors. The authorization will continue unless withdrawn by the Board of Directors.

The following table summarizes the Company's common stock repurchases during the fourth quarter of 2007 made pursuant to this authorization. During the quarter, the Company did not purchase shares outside of this program, and all purchases were made by or on behalf of the Company and not by any "affiliated purchaser" (as defined by Rule 10b-18 of the Securities Exchange Act of 1934).

### Issuer Purchases of Equity Securities

Period	Total Number of Shares (or Units) Purchased	Average Price Paid per Share (or (Unit)	Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs	Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs
October 1 - 31, 2007	0	0	193,989	\$ 45,563,602
November 1 - 30, 2007	217,001	\$ 21.93	410,990	\$ 40,805,206
December 1 - 31, 2007	35,000	\$ 20.07	445,990	\$ 40,102,717



**ITEM 6. SELECTED CONSOLIDATED FINANCIAL DATA**

The annual financial information set forth below has been derived from our audited consolidated financial statements. The information should be read in connection with, and is qualified in its entirety by reference to, Management's Discussion and Analysis, the consolidated financial statements and notes included elsewhere in this report and in our SEC filings.

	Years Ended December 31,				
	2003	2004	2005	2006	2007
	(dollars in thousands)				
CONSOLIDATED STATEMENT OF OPERATIONS DATA:					
Service revenue, net	\$ 59,422	\$ 91,286	\$ 135,213	\$ 149,071	\$ 185,663
Operating expenses:					
Network operations	47,017	63,466	85,794	80,106	87,548
Equity-based compensation expense network operations	1,307	858	399	315	208
Selling, general, and administrative SG&A	26,570	40,382	41,344	46,593	52,011
Equity-based compensation expense SG&A	17,368	11,404	12,906	10,194	10,176
Terminated public offering costs		779			
Lease restructuring charges		1,821	1,319		
Depreciation and amortization	48,387	56,645	55,600	58,414	65,638
Total operating expenses	140,649	175,355	197,362	195,622	215,581
Operating loss	(81,227)	(84,069)	(62,149)	(46,551)	(29,918)
Gains lease obligation restructurings		5,292	844	255	2,110
Gain Allied Riser note exchange	24,802				
Gains Cisco credit facility	215,432		842		
Gains dispositions of assets			3,372	254	95
Interest income (expense) and other, net	(18,264)	(10,883)	(10,427)	(7,715)	(3,312)
Net income (loss)	140,743	(89,660)	(67,518)	(53,757)	(31,025)
Beneficial conversion charges	(52,000)	(43,986)			
Net income (loss) applicable to common shareholders	\$ 88,743	\$ (133,646)	\$ (67,518)	\$ (53,757)	\$ (31,025)
Net income (loss) per common share available to common shareholders basic and diluted	\$ 11.18	\$ (175.03)	\$ (1.96)	\$ (1.16)	\$ (0.65)
Weighted-average common shares basic	7,935,831	763,540	34,439,937	46,343,372	47,800,159
Weighted-average common shares diluted	7,938,838	763,540	34,439,937	46,343,372	47,800,159
CONSOLIDATED BALANCE SHEET DATA (AT PERIOD END):					
Cash and cash equivalents	\$ 7,875	\$ 13,844	\$ 29,883	\$ 42,642	\$ 177,021
Total assets	344,440	378,586	351,373	336,876	455,325
Long-term debt (including capital leases and current portion) (net of unamortized discount of \$5,026 in 2004, \$3,478 in 2005, \$1,213 in 2006 and \$4,133 in 2007)	83,702	126,382	99,105	97,024	288,441
Preferred stock	97,681	139,825			
Stockholders' equity	244,754	212,490	221,001	215,632	138,830

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Years Ended December 31,

OTHER OPERATING DATA:

Net cash (used in) provided by operating activities	(27,357)	(26,425)	(9,062)	5,285	48,630
Net cash used in investing activities	(25,316)	(2,701)	(14,055)	(19,478)	(30,864)
Net cash provided by financing activities	20,562	34,486	39,824	27,045	116,305

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**ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

*You should read the following discussion and analysis together with "Selected Consolidated Financial and Other Data" and our consolidated financial statements and related notes included in this report. The discussion in this report contains forward-looking statements that involve risks and uncertainties, such as statements of our plans, objectives, expectations and intentions. The cautionary statements made in this report should be read as applying to all related forward-looking statements wherever they appear in this report. Our actual results could differ materially from those discussed here. Factors that could cause or contribute to these differences include those discussed in "Risk Factors," as well as those discussed elsewhere. You should read "Risk Factors" and "Special Note Regarding Forward-Looking Statements."*

**General Overview**

We are a leading facilities-based provider of low-cost, high-speed Internet access and IP communications services. Our network is specifically designed and optimized to transmit data using IP. IP networks are significantly less expensive to operate and are able to achieve higher performance levels than the traditional circuit-switched networks used by our competitors when providing Internet access services, thus, we believe, giving us cost and performance advantages. We deliver our services to small and medium-sized businesses, communications service providers and other bandwidth-intensive organizations through approximately 15,000 customer connections in North America and Europe. Our primary on-net service is Internet access at a speed of 100 Megabits per second, much faster than typical Internet access currently offered to businesses. We offer this on-net service exclusively through our own facilities, which run all the way to our customers' premises.

Our network is comprised of in-building riser facilities, metropolitan optical fiber networks, metropolitan traffic aggregation points and inter-city transport facilities. The network is physically connected entirely through our facilities to over 1,215 buildings in which we provide our on-net services, including over 910 multi-tenant office buildings. We also provide on-net services in carrier-neutral colocation facilities, data centers and single-tenant office buildings. Because of our integrated network architecture, we are not dependent on local telephone companies to serve our on-net customers. We emphasize the sale of on-net services because we believe we have a competitive advantage in providing these services and our sales of these services generate higher gross profit margins than our off-net and non-core services.

We also provide Internet connectivity to customers that are not located in buildings directly connected to our network. We serve these off-net customers using other carriers' facilities to provide the last mile portion of the link from our customers' premises to our network. We also provide certain non-core services which are legacy services which we acquired and continue to support but do not actively sell.

We believe our key opportunity is provided by our high-capacity network, which provides us with the ability to add a significant number of customers to our network with minimal incremental costs. Our focus is to add customers to our network in a way that maximizes its use and at the same time provides us with a customer mix that produces profit margins. We are responding to this opportunity by increasing our sales and marketing efforts including increasing our number of sales representatives. In addition, we may add customers to our network through strategic acquisitions.

We are expanding our network to locations that we believe can be economically integrated and represent significant concentrations of Internet traffic. One of our keys to developing a profitable business will be to carefully match the expense of extending our network to reach new customers with the revenue generated by those customers.

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We believe the two of the most important trends in our industry are the continued growth in Internet traffic and a decline in Internet access prices. As Internet traffic continues to grow and prices per unit of traffic continue to decline, we believe our ability to load our network and gain market share from less efficient network operators will expand. However, continued erosion in Internet access prices will likely have a negative impact on the rate at which we can increase our revenues and our profit margins.

Our on-net service consists of high-speed Internet access and IP connectivity ranging from 0.5 Megabits per second to 10 Gigabits per second of bandwidth. We offer our on-net services to customers located in buildings that are physically connected to our network. Off-net services are sold to businesses that are connected to our network primarily by means of T1, T3, E1 and E3 and Ethernet link lines obtained from other carriers. Our non-core services, which consist of legacy services of companies whose assets or businesses we have acquired, include managed modem services, voice services (only provided in Toronto, Canada) and point to point private line services. We do not actively market these non-core services and expect the net service revenue associated with them to continue to decline.

Due to our strategic acquisitions of network assets and equipment, we believe we are positioned to grow our revenue base. We continue to purchase and deploy network equipment to parts of our network to maximize the utilization of our assets and to expand our network. Our future capital expenditures will be based primarily on our planned expansion of our network, the addition of on-net buildings and the concentration and growth of our customer base. We plan to continue to expand our network and to increase our number of on-net buildings by approximately 100 buildings by December 31, 2008 from 1,217 buildings at December 31, 2007. We expect our 2008 capital expenditures to be similar to our 2007 capital expenditure rate, or approximately \$30.0 million.

Historically, our operating expenses have exceeded our net service revenue resulting in operating losses of \$62.1 million, \$46.6 million and \$29.9 million in 2005, 2006 and 2007, respectively. In each of these periods, our operating expenses consisted primarily of the following:

Network operations expenses, which consist primarily of the cost of leased circuits, sites and facilities; telecommunications licenses, maintenance expenses, and salaries of, and expenses related to, employees who are directly involved with the maintenance and operation of our network.

Selling, general and administrative expenses, which consist primarily of salaries, commissions and related benefits paid to our employees and related selling and administrative costs including professional fees and bad debt expenses.

Depreciation and amortization expenses, which result from the depreciation of our property and equipment, including the assets associated with our network and the amortization of intangible assets.

Equity-based compensation expenses that result from the grants of stock options and restricted stock.

### Results of Operations

Our management reviews and analyzes several key performance indicators in order to manage our business and assess the quality of and potential variability of our net service revenues and cash flows. These key performance indicators include:

net service revenues, which are an indicator of our overall business growth and the success of our sales and marketing efforts;

gross profit, which is an indicator of both our service offering mix, competitive pricing pressures and the cost of our network operations;

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growth in our on-net customer base, which is an indicator of the success of our on net focused sales efforts;

growth in our on-net buildings; and

cash flows.

### *Year Ended December 31, 2006 Compared to the Year Ended December 31, 2007*

The following summary table presents a comparison of our results of operations for the year ended December 31, 2005 and 2006 with respect to certain key financial measures. The comparisons illustrated in the table are discussed in greater detail below.

	Year Ended December 31,		
	2006	2007	Percent Change
	(in thousands)		
Net service revenue	\$ 149,071	\$ 185,663	24.5%
On-net revenues	105,275	146,604	39.3%
Off-net revenues	34,416	32,123	(6.7)%
Non-core revenues	9,380	6,936	(26.1)%
Network operations expenses(1)	80,106	87,548	9.3%
Gross profit(2)	68,965	98,115	42.3%
Selling, general, and administrative expenses(3)	46,593	52,011	11.6%
Equity-based compensation expense	10,509	10,384	(1.2)%
Depreciation and amortization expenses	58,414	65,638	12.4%
Gains lease obligations and asset sales	509	2,205	333.2%
Net loss	(53,757)	(31,025)	42.3%

- (1) Excludes equity-based compensation expense of \$315 and \$208 in the years ended December 31, 2006 and 2007, respectively, which, if included would have resulted in a period-to-period change of 9.1%.
- (2) Excludes equity-based compensation expense of \$315 and \$208 in the years ended December 31, 2006 and 2007, respectively, which if included would have resulted in a period-to-period change of 42.6%.
- (3) Excludes equity-based compensation expense of \$10,194 and \$10,176 in the years ended December 31, 2006 and 2007, respectively, which, if included would have resulted in a period-to-period change of 9.5%.

**Net Service Revenue.** Our net service revenue increased 24.5% from \$149.1 million for the year ended December 31, 2006 to \$185.7 million for the year ended December 31, 2007. The impact of exchange rates resulted in approximately \$4.2 million of the \$36.6 million increase in revenues. For the years ended December 31, 2006 and 2007, on-net, off-net and non-core revenues represented 70.6%, 23.1% and 6.3% and 79.0%, 17.3% and 3.7% of our net service revenues, respectively.

Our on-net revenues increased 39.3% from \$105.3 million for the year ended December 31, 2006 to \$146.6 million for the year ended December 31, 2007. Our on-net revenues increased as we increased the number of our on-net customer connections by 43.9% from approximately 7,800 at December 31, 2006 to approximately 11,200 at December 31, 2007. On-net customer connections increased at a greater rate than on-net revenues due to a decline in the revenue per on-net customer connection. This decline is partly attributed to a shift in the customer connection mix. Due to the increase in the size of our sales force, we are now able to focus not only on customers who purchase high-bandwidth connections, as we have done historically, but also on customers who purchase lower-



bandwidth connections. We expect to continue to focus our sales efforts on a broad mix of customers. Additionally, on-net customers who cancel their service, in general, have greater revenue per connection than new customers. These trends and, to a lesser extent, an increase in customers receiving a discount for purchasing longer term contracts, resulted in a reduction to our revenue per on-net connection. We believe that our on-net revenues as a percentage of total revenues will continue to increase as we are allocating the majority of our sales and marketing resources toward obtaining additional on-net customers.

Our off-net revenues decreased 6.7% from \$34.4 million for the year ended December 31, 2006 to \$32.1 million for the year ended December 31, 2007. Our off-net customer connections declined 15.4% from approximately 3,500 at December 31, 2006 to approximately 3,000 at December 31, 2007. Off-net customer connections decreased at a greater rate than the decline in off-net revenues due to an increase in the revenue per off-net customer connection. Off-net customers who cancel their service, in general, have revenue per connection that is less than new off-net customers who generally purchase higher-bandwidth connections. Additionally, a significant amount of our off-net revenues were acquired revenues, which have historically churned at a greater rate than our on-net revenues. We expect the revenue from these off-net services to grow at a substantially slower rate than our on-net revenues as we are allocating the majority of our sales and marketing resources toward obtaining additional on-net customers.

Our non-core revenues decreased 26.1% from \$9.4 million for the year ended December 31, 2006 to \$6.9 million for the year ended December 31, 2007. The number of our non-core customer connections declined 20.3% from approximately 1,000 at December 31, 2006 to approximately 800 at December 31, 2007. We do not actively market these acquired non-core services and expect that the net service revenue associated with them will continue to decline.

*Network Operations Expenses.* Our network operations expenses, excluding equity-based compensation expense, increased 9.3% from \$80.1 million for the year ended December 31, 2006 to \$87.5 million for the year ended December 31, 2007. The increase is primarily attributable to an increase in costs related to our network and facilities expansion activities partly offset by the decline in network operations expenses associated with the decline in our off-net and non-core revenues. The impact of exchange rates resulted in approximately \$1.8 million of this \$7.4 million increase in network operations expenses.

*Gross Profit.* Our gross profit, excluding equity-based compensation expense, increased 42.3% from \$69.0 million for the year ended December 31, 2006 to \$98.1 million for the year ended December 31, 2007. We determine gross profit by subtracting network operation expenses, excluding equity-based compensation expense, from our net service revenue and do not allocate depreciation and amortization expense to our network operations expense. The increase is primarily attributed to the increase in higher gross margin on-net revenues as a percentage of net service revenue. Our gross profit margin expanded from 46.3% for the year ended December 31, 2006 to 52.8% for the year ended December 31, 2007. Our gross profit has benefited from the limited incremental expenses associated with providing service to an increasing number of on-net customers and the decline in off-net revenues which carry a lower gross margin due to the associated leased circuit required to provide this service. Our gross profit margin may be impacted by the timing and amounts of disputed circuit costs and the additional costs of expanding our network and operating our existing network. We generally record disputed circuit costs amounts when billed by the vendor and reverse these amounts when the vendor credit has been received or the dispute has been otherwise resolved. We believe that our gross profit margin will continue to increase as we are allocating the majority of our sales and marketing resources toward obtaining additional on-net customers and as sales of these services generate higher gross profit margins than our off-net and non-core services.

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*Selling, General, and Administrative Expenses ("SG&A").* Our SG&A expenses, excluding equity-based compensation expense, increased 11.6% from \$46.6 million for the year ended December 31, 2006 to \$52.0 million for the year ended December 31, 2007. SG&A expenses increased primarily from the increase in salaries and related costs required to support our expanding sales and marketing efforts. The impact of exchange rates resulted in approximately \$1.4 million of this \$5.4 million increase in SG&A expenses.

*Equity-based Compensation Expense.* Equity-based compensation expense is related to restricted stock and stock options. The total equity-based compensation expense decreased 1.2% from \$10.5 million for the year ended December 31, 2006 to \$10.4 million for the year ending December 31, 2007. During 2007, we issued approximately 1.0 million shares of restricted stock to our employees. These grants were valued at our closing stock price on the date of grant and will vest over periods ranging from two to four years. These grants resulted in approximately \$7.1 million in equity-based compensation expense for the year ended December 31, 2007. The increase was partly offset by a \$6.8 million decrease in equity-based compensation expense associated with certain 2003 restricted stock grants which ended in August 2006 when these shares became fully vested. As of December 31, 2007 there was approximately \$22.6 million of total unrecognized compensation cost related to non-vested equity-based compensation awards. That cost is expected to be recognized over a weighted average period of approximately twenty-one months.

*Depreciation and Amortization Expenses.* Our depreciation and amortization expense increased 12.4% from \$58.4 million for the year ended December 31, 2006 to \$65.6 million for the year ended December 31, 2007 due to an increase in deployed fixed assets.

*Gains lease obligations and asset sales.* In September 2007, we entered into a settlement agreement under which we were released from our obligation under an abandoned facility lease acquired in an acquisition. This settlement agreement resulted in a gain of approximately \$2.1 million. In September 2006, Cogent Spain negotiated modifications to an IRU capital lease that reduced its quarterly IRU lease payments and extended the lease term. The modification to this IRU capital lease resulted in a gain of approximately \$0.3 million. In 2006, we sold a building and land for net proceeds of \$0.8 million. This sale resulted in a gain of approximately \$0.3 million.

*Net Loss.* Our net loss was \$53.8 million for the year ended December 31, 2006 as compared to a net loss of \$31.0 million for the year ended December 31, 2007. Our net loss decreased by \$22.7 million primarily due to a \$29.2 million increase in our gross profit partially offset by a \$5.4 million increase in SG&A, and a \$7.2 million increase in depreciation and amortization expense. Included in net loss for the year ended December 31, 2006 are gains of approximately \$0.5 million. Included in net loss for the year ended December 31, 2007 are gains of approximately \$2.2 million.

*Buildings On-net.* As of December 31, 2006 and 2007 we had a total of 1,107 and 1,217 on-net buildings connected to our network, respectively. We plan to increase our number of on-net buildings by approximately 100 buildings by December 31, 2008.



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Year Ended December 31, 2005 Compared to the Year Ended December 31, 2006

The following summary table presents a comparison of our results of operations for the year ended December 31, 2005 and 2006 with respect to certain key financial measures. The comparisons illustrated in the table are discussed in greater detail below.

	Year Ended December 31,		Percent Change
	2005	2006	
	(in thousands)		
Net service revenue	\$ 135,213	\$ 149,071	10.2%
On-net revenues	78,324	105,275	34.4%
Off-net revenues	44,642	34,416	(22.9)%
Non-core revenues	12,245	9,380	(23.4)%
Network operations expenses(1)	85,794	80,106	(6.6)%
Gross profit(2)	49,419	68,965	39.6%
Selling, general, and administrative expenses(3)	41,344	46,593	12.7%
Lease restructuring charge	1,319		(100.0)%
Equity-based compensation expense	13,305	10,509	(21.0)%
Depreciation and amortization expenses	55,600	58,414	5.1%
Gains lease obligations, debt restructurings and asset sales	5,058	509	(89.9)%
Net loss	(67,518)	(53,757)	20.4%

(1)

Excludes equity-based compensation expense of \$399 and \$315 in the years ended December 31, 2005 and 2006, respectively, which, if included would have resulted in a period-to-period change of (6.7)%.

(2)

Excludes equity-based compensation expense of \$399 and \$315 in the years ended December 31, 2005 and 2006, respectively, which if included would have resulted in a period-to-period change of 40.0%.

(3)

Excludes equity-based compensation expense of \$12,906 and \$10,194 in the years ended December 31, 2005 and 2006, respectively, which, if included would have resulted in a period-to-period change of 4.7%.

**Net Service Revenue.** Our net service revenue increased 10.2% from \$135.2 million for the year ended December 31, 2005 to \$149.1 million for the year ended December 31, 2006. For the years ended December 31, 2005 and 2006, on-net, off-net and non-core revenues represented 57.9%, 33.0% and 9.1% and 70.6%, 23.1% and 6.3% of our net service revenues, respectively.

Our on-net revenues increased 34.4% from \$78.3 million for the year ended December 31, 2005 to \$105.3 million for the year ended December 31, 2006. Our on-net revenues increased as we increased the number of our on-net customer connections from approximately 4,700 at December 31, 2005 to approximately 7,800 at December 31, 2006. On-net customer connections increased at a greater rate than on-net revenues due to a decline in the revenue per on-net customer connection. This decline is partly attributed to a shift in the customer connection mix. Due to the increase in the size of our sales force, we focused not only on customers who purchase high-bandwidth connections, as we have done historically, but also on customers who purchase lower-bandwidth connections. We expect to continue to focus our sales efforts on such a broad mix of customers. Additionally, on-net customers who cancel their service from our installed base of customers, in general, have revenue per connection that is larger than new customers. These trends resulted in a reduction to our revenue per on-net connection.

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Our off-net revenues decreased 22.9% from \$44.6 million for the year ended December 31, 2005 to \$34.4 million for the year ended December 31, 2006 primarily because a December 2004 acquisition of off-net customers resulted in a substantial increase in the number of our off-net customers in 2005 and many of these acquired customers either cancelled service or re-priced their contracts at lower rates. Our off-net customer connections declined from approximately 4,000 at December 31, 2005 to approximately 3,500 at December 31, 2006. Our non-core revenues decreased 23.4% from \$12.2 million for the year ended December 31, 2005 to \$9.4 million for the year ending December 31, 2006. The number of our non-core customer connections declined from approximately 1,300 at December 31, 2005 to approximately 1,000 at December 31, 2006. We do not actively market these acquired non-core services.

*Network Operations Expenses.* Our network operations expenses, excluding equity-based compensation expense, decreased 6.6% from \$85.8 million for the year ended December 31, 2005 to \$80.1 million for the year ended December 31, 2006. The decrease is primarily attributable to a decline in leased circuit costs related to the decline in off-net revenues. We provide Internet connectivity to our off-net customers using other carriers' facilities to provide the last mile portion of the link from our customers' premises to our network and incur leased circuit costs to provide these services.

*Gross Profit.* Our gross profit, excluding equity-based compensation expense, increased 39.6% from \$49.4 million for the year ended December 31, 2005 to \$69.0 million for the year ended December 31, 2006. We determine gross profit by subtracting network operations expenses, excluding equity-based compensation expense, from our net service revenue and do not allocate depreciation and amortization expense to our network operations expense. The increase is primarily attributed to the increase in higher gross margin on-net revenues as a percentage of net service revenue. Our gross profit margin expanded from 36.5% for the year ended December 31, 2005 to 46.3% for the year ended December 31, 2006. Our gross profit has benefited from the limited incremental expenses associated with providing service to an increasing number of on-net customers and the decline in off-net revenues which carry a lower gross margin due to the associated leased circuit required to provide this service. Our gross profit margin may be impacted by the timing and amounts of disputed circuit costs. We generally record these disputed amounts when billed by the vendor and reverse these amounts when the vendor credit has been received or the dispute has been otherwise resolved.

*Selling, General, and Administrative Expenses ("SG&A").* Our SG&A expenses, excluding equity-based compensation expense, increased 12.7% from \$41.3 million for the year ended December 31, 2005 to \$46.6 million for the year ended December 31, 2006. SG&A expenses increased primarily from the increase in salaries and related costs required to support our expanding sales and marketing efforts.

*Equity-based Compensation Expense.* Equity-based compensation expense is related to restricted stock and stock options. The total equity-based compensation expense decreased 21.0% from \$13.3 million for the year ended December 31, 2005 to \$10.5 million for the year ending December 31, 2006. The decrease is primarily attributed to a \$3.4 million decrease in equity-based compensation expense associated with certain 2003 restricted stock grants which ended in August 2006 when these shares became fully vested. Equity-based compensation expense for the year ended December 31, 2006 includes \$0.7 million in compensation costs associated with the adoption of Statement No. 123 (revised 2004), *Share-Based Payment* ("SFAS 123(R)") on January 1, 2006 using the modified-prospective-transition method.

*Depreciation and Amortization Expenses.* Our depreciation and amortization expense increased 5.1% from \$55.6 million for the year ended December 31, 2005 to \$58.4 million for the year ended December 31, 2006 due to an increase in deployed fixed assets. In the fourth quarter of 2005, we revised the number of lease renewal periods used in determining the lease term for purposes of amortizing certain of our leasehold improvements. This resulted in a net increase in depreciation expense of approximately \$3.0 million.

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**Lease restructuring charge.** In 2004, we abandoned the Paris office obtained in our Cogent Europe acquisition and located these operations in another Cogent Europe facility. In 2005, we revised our estimate for sublease income, and recorded an additional \$1.3 million restructuring charge.

**Gains lease obligations, asset sales and debt restructurings.** In September 2005, Cogent Spain negotiated modifications to an IRU capital lease that reduced its quarterly IRU lease payments and extended the lease term. The modification to the IRU capital lease resulted in a gain of approximately \$0.8 million. In June 2005, we repaid our \$17.0 million amended and restated Cisco note. The repayment resulted in a gain of \$0.8 million representing the amount of the estimated future interest payments that were not required to be paid. In 2005, we sold a building and land for net proceeds of \$5.1 million. This sale resulted in a gain of approximately \$3.9 million.

In September 2006, Cogent Spain negotiated modifications to an IRU capital lease that reduced its quarterly IRU lease payments and extended the lease term. The modification to this IRU capital lease resulted in a gain of approximately \$0.3 million. In 2006, we sold another building and land for net proceeds of \$0.8 million. This sale resulted in a gain of approximately \$0.3 million.

**Net Loss.** Our net loss was \$67.5 million for the year ended December 31, 2005 as compared to a net loss of \$53.8 million for the year ended December 31, 2006. Our net loss decreased by \$13.8 million primarily due to a \$19.5 million increase in our gross profit partially offset by a \$5.2 million increase in SG&A, and a \$2.8 million increase in depreciation and amortization expense. Included in net loss for the year ended December 31, 2005 is a \$1.3 million lease restructuring charge and gains of approximately \$5.1 million. Included in net loss for the year ended December 31, 2006 are gains of approximately \$0.5 million.

**Buildings On-net.** As of December 31, 2005 and 2006 we had a total of 1,040 and 1,107 on-net buildings connected to our network, respectively.

### Liquidity and Capital Resources

In assessing our liquidity, management reviews and analyzes our current cash balances, short-term investments, accounts receivable, accounts payable, accrued liabilities, capital expenditure commitments, and required capital lease and debt payments and other obligations.

#### Cash Flows

The following table sets forth our consolidated cash flows for the years ended December 31, 2005, 2006, and 2007.

	Year Ended December 31,		
	2005	2006	2007
	(in thousands)		
Net cash (used in) provided by operating activities	\$ (9,062)	\$ 5,285	\$ 48,630
Net cash used in investing activities	(14,055)	(19,478)	(30,864)
Net cash provided by financing activities	39,824	27,045	116,305
Effect of exchange rates on cash	(668)	(93)	308
Net increase in cash and cash equivalents during period	\$ 16,039	\$ 12,759	\$ 134,379

**Net Cash (Used in) Provided By Operating Activities.** Our primary sources of operating cash are receipts from our customers who are billed on a monthly basis for our services. Our primary uses of operating cash are payments made to our vendors and employees. Net cash used in operating activities was \$9.1 million for the year ended December 31, 2005 compared to net cash provided by operating

activities of \$5.3 million for 2006. The increase in cash provided by operating activities was due to an increase in our operating profit partly offset by changes in operating assets and liabilities from a use of cash of \$7.2 million for the year ended December 31, 2005 to a use of cash of \$11.6 million for the year ended December 31, 2006. Net cash provided by operating activities was \$5.3 million for the year ended December 31, 2006 compared to net cash provided by operating activities of \$48.6 million for 2007. The increase in cash provided by operating activities is due to an increase in our operating profit and an improvement in the changes in operating assets and liabilities from a use of cash of \$11.6 million for the year ended December 31, 2006 to an increase of cash of \$4.9 million for the year ended December 31, 2007. The increase in the changes in operating assets and liabilities from the year ended December 31, 2006 to the year ended December 31, 2007 was primarily due to the timing of certain vendor payments.

*Net Cash Used In Investing Activities.* Net cash used in investing activities was \$14.1 million for the year ended December 31, 2005, \$19.5 million for the year ended December 31, 2006 and \$30.9 million for the year ended December 31, 2007. Our primary uses of investing cash during 2005 were \$17.3 million for the purchase of property and equipment, \$0.9 million for the final payment on the purchase of a network in Germany and \$0.8 million for the net purchases of short-term investments. Our primary uses of investing cash during 2006 were \$21.5 million for the purchase of property and equipment. Our primary uses of investing cash during 2007 were \$30.4 million for the purchase of property and equipment and \$0.7 million for the purchases of short-term investments. Our primary source of investing cash in 2005 was \$5.1 million from the proceeds of the sales of assets. Our primary sources of investing cash in 2006 were \$1.2 million from the proceeds of short-term investments and \$0.9 million from the proceeds of the sales of assets. Our primary source of investing cash in 2007 was \$0.3 million from the proceeds of the sales of assets. The increase in purchases of property and equipment from the year ended December 31, 2006 to the year ended December 31, 2007 is primarily due to our increase in our network expansion activities.

*Net Cash Provided by Financing Activities.* Financing activities provided net cash of \$39.8 million for the year ended December 31, 2005, \$27.0 million for the year ended December 31, 2006 and \$116.3 million for the year ended December 31, 2007. Net cash from financing activities during 2005 resulted from \$63.7 million of net proceeds from our June 2005 public offering, \$10.0 million from the issuance of our subordinated note and \$10.0 million borrowed under our credit facility. Net cash used in financing activities for 2005 included \$17.0 million for the repayment of our Cisco note, \$10.0 million for the repayment of our subordinated note, \$10.0 million for the repayment of the amount outstanding under our credit facility and \$6.9 million in principal payments under our capital leases. Net cash from financing activities during 2006 resulted from \$36.5 million of net proceeds from our June 2006 public offering and \$0.4 million from the proceeds from the exercises of stock options. Net cash used in financing activities for 2006 included \$9.9 million in principal payments under our capital leases. Our primary source of financing cash for the year ended December 31, 2007 was \$195.1 million of net proceeds from the issuance of our 1.00% Convertible Senior Notes and \$1.1 million of proceeds from the exercises of stock options. Our primary use of financing cash for the year ended December 31, 2007 was \$59.9 million for the purchase of shares of our common stock, \$10.2 million for the repayment of our convertible subordinated notes on their June 15, 2007 maturity date and \$9.8 million of principal payments under our capital lease obligations.

## Indebtedness

Our total indebtedness, net of discount, at December 31, 2007 was \$288.4 million and our total cash and cash equivalents and short-term investments were \$177.8 million. Our total indebtedness at December 31, 2007 includes \$92.6 million of capital lease obligations for dark fiber primarily under 15-25 year IRUs, of which approximately \$7.7 million is considered a current liability.

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### *Convertible Senior Notes*

In June 2007, we issued 1.00% Convertible Senior Notes (the "Notes") due June 15, 2027, for an aggregate principal amount of \$200.0 million in a private offering for resale to qualified institutional buyers pursuant to SEC Rule 144A. The Notes are unsecured and bear interest at 1.00% per annum. The Notes will rank equally with any future senior debt and senior to any future subordinated debt and will be effectively subordinated to all of our subsidiary's existing and future liabilities and to any secured debt that we may issue to the extent of the value of the collateral. Interest is payable in cash semiannually in arrears on June 15 and December 15, of each year, beginning on December 15, 2007. We received proceeds of approximately \$195.1 million after deducting the original issue discount of 2.25% and issuance costs. We used \$10.6 million of the proceeds to repay principal and accrued interest on our existing convertible subordinated notes on June 15, 2007 and approximately \$50.1 million to repurchase approximately 1.8 million shares of our common stock. These 1.8 million common shares were subsequently retired. We intend to use the remaining proceeds for general corporate purposes and to fund additional purchases of our common stock.

The Notes are convertible into shares of our common stock at an initial conversion price of \$49.18 per share, or 20.3355 shares for each \$1,000 principal amount of Notes, subject to adjustment for certain events as set forth in the indenture. Upon conversion of the Notes, we will have the right to deliver shares of our common stock, cash or a combination of cash and shares of our common stock. The Notes are convertible (i) during any fiscal quarter after the fiscal quarter ending September 30, 2007, if the closing sale price of our common stock for 20 or more trading days in a period of 30 consecutive trading days ending on the last trading day of the immediately preceding fiscal quarter exceeds 130% of the conversion price in effect on the last trading day of the immediately preceding fiscal quarter, or (ii) specified corporate transactions occur, or (iii) the trading price of the Notes falls below a certain threshold, or (iv) if we call the Notes for redemption, or (v) on or after April 15, 2027, until maturity. In addition, following specified corporate transactions, we will increase the conversion rate for holders who elect to convert Notes in connection with such corporate transactions, provided that in no event may the shares issued upon conversion, as a result of adjustment or otherwise, result in the issuance of more than 35.5872 common shares per \$1,000 principal amount, or approximately 7.1 million shares. The Notes include an "Irrevocable Election of Settlement" whereby we may choose, in our sole discretion, and without the consent of the holders of the Notes, to waive our right to settle the conversion feature in either cash or stock or in any combination, at our option.

The Notes may be redeemed by us at any time after June 20, 2014 at a redemption price of 100% of the principal amount plus accrued interest. Holders of the Notes have the right to require us to repurchase for cash all or some of their Notes on June 15, 2014, 2017 and 2022 and upon the occurrence of certain designated events at a redemption price of 100% of the principal amount plus accrued interest.

Under the terms of the Notes, we are required to use reasonable efforts to file and maintain a shelf registration statement with the SEC covering the resale of the Notes and the common stock issuable on the conversion of the Notes. If we fail to meet these terms, we will be required to pay special interest on the Notes in the amount of 0.25% for the first 90 days after the occurrence of the failure to meet and 0.50% thereafter. In addition to the special interest, additional interest of 0.25% per annum will accrue in the event of default as defined in the indenture. We filed a shelf registration statement registering the Notes and common stock issuable on conversion of the Notes in July 2007.

### *Convertible Subordinated Notes*

Our \$10.2 million 7.50% convertible subordinated notes were due on June 15, 2007. These notes and accrued interest were paid on June 15, 2007 with a portion of the proceeds from the Notes.

### Credit Facility

On March 9, 2005, we entered into a credit facility with a commercial bank. The credit facility expired on April 1, 2007.

### Second \$50.0 Million Common Stock Buyback Program

In August 2007, our board of directors approved a common stock buyback program. Under the buyback program we are authorized to purchase up to \$50.0 million of our common stock prior to December 31, 2008. During 2007, we purchased 445,990 shares of our common stock at an average price of \$22.19 per share for approximately \$9.9 million under the program. From January 1, 2008 to February 26, 2008, we purchased 689,000 additional shares of our common stock at an average price of \$18.59 per share for approximately \$12.8 million under the program. All purchased common shares were subsequently retired.

### Contractual Obligations and Commitments

The following table summarizes our contractual cash obligations and other commercial commitments as of December 31, 2007.

	Payments due by period				
	Total	Less than 1 year	1-3 years	3-5 years	After 5 years
	(in thousands)				
Long term debt(1)	\$ 213,000	2,000	4,000	4,000	203,000
Capital lease obligations	154,705	15,651	28,919	21,612	88,523
Operating leases(2)	224,710	34,669	54,836	43,034	92,171
Unconditional purchase obligations(3)	47,722	15,734	3,780	3,770	24,438
<b>Total contractual cash obligations</b>	<b>\$ 640,137</b>	<b>\$ 68,054</b>	<b>\$ 91,535</b>	<b>\$ 72,416</b>	<b>\$ 408,132</b>

- (1) The Senior Convertible Notes are assumed to be outstanding until June 15, 2014 which is the earliest put date and these amounts include interest and principal payment obligations.
- (2) These amounts include \$225.4 million of operating lease, maintenance, building access and tenant license agreement obligations, reduced by sublease agreements of \$0.7 million.
- (3) As of December 31, 2007, we had committed to additional dark fiber IRU lease agreements totaling approximately \$40.4 million in future payments for fiber lease and maintenance services. These amounts are included in unconditional purchase obligations and are to be paid in periods of up to 20 years beginning once the related fiber is accepted.

**Capital Lease Obligations.** The capital lease obligations above were incurred in connection with IRUs for inter-city and intra-city dark fiber underlying substantial portions of our network. These capital leases are presented on our balance sheet at the net present value of the future minimum lease payments, or \$92.6 million at December 31, 2007. These leases generally have terms of 15 to 25 years.

**Letters of Credit.** We are also party to letters of credit totaling \$1.0 million at December 31, 2007. These obligations are fully secured by our restricted investments, and as a result, are excluded from the contractual cash obligations above.

## **Future Capital Requirements**

We believe that our cash on hand and cash generated from our operating activities will be adequate to meet our working capital, capital expenditure, debt service, common stock buyback program and other cash requirements if we execute our business plan.

Any future acquisitions or other significant unplanned costs or cash requirements may require that we raise additional funds through the issuance of debt or equity. We cannot assure you that such financing will be available on terms acceptable to us or our stockholders, or at all. Insufficient funds may require us to delay or scale back the number of buildings that we serve, reduce our planned increase in our sales and marketing efforts, suspend or terminate our stock buyback program, or require us to otherwise alter our business plan or take other actions that could have a material adverse effect on our business, results of operations and financial condition. If issuing equity securities raises additional funds, substantial dilution to existing stockholders may result.

## *Off-Balance Sheet Arrangements*

We do not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. In addition, we do not engage in trading activities involving non-exchange traded contracts. As such, we are not materially exposed to any financing, liquidity, market or credit risk that could arise if we had engaged in these relationships.

## *Income taxes*

Due to the uncertainty surrounding the realization of our net deferred tax asset, consisting primarily of net operating loss carry-forwards, we have recorded a valuation allowance for the full amount of our net deferred tax asset. Should we achieve taxable income, our deferred tax assets may be available to offset future income tax liabilities. We have combined net operating loss carry-forwards of approximately \$1.0 billion. The federal and state net operating loss carry-forwards for the United States of approximately \$407 million expire from 2023 to 2027. We have net operating loss carry-forwards related to our European operations of approximately \$600 million, of which approximately \$108 million of expire beginning in 2016. The remaining \$492 million of European net operating loss carry-forwards do not expire. The federal and state net operating loss carry-forwards of Allied Riser Communications Corporation of approximately \$183 million are subject to certain limitations on annual utilization due to the change in ownership as a result of the merger as prescribed by federal and state tax laws. Our other net operating loss carry-forwards could also be subject to certain additional limitations on annual utilization if certain changes in ownership have occurred or were to occur as prescribed by the laws in the respective jurisdictions. Should a change in ownership occur, or have occurred, we may be unable to benefit from the full amount of these net operating loss carry-forwards.

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

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses, and the related disclosure of contingent assets and liabilities. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

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The accounting policies we believe to be most critical to understanding our financial results and condition or that require complex, significant and subjective management judgments are discussed below.

### *Revenue Recognition*

We recognize service revenue when the services are performed, evidence of an arrangement exists, the fee is fixed and determinable and collection is probable. Service discounts and incentives offered to certain customers are recorded as a reduction of revenue when granted. Fees billed in connection with customer installations are deferred and recognized ratably over the estimated customer life. We determine the estimated customer life using a historical analysis of customer retention. If our estimated customer life increases, we will recognize installation revenue over a longer period. We expense direct costs associated with sales as incurred.

### *Allowances for Sales Credits and Unfulfilled Customer Purchase Obligations*

We have established allowances to account for sales credits and unfulfilled contractual purchase obligations.

Our allowance for sales credits is recorded as a reduction to our service revenue to provide for situations when customers are granted a service termination adjustment for amounts billed in advance or a service level agreement credit or discount. This allowance is determined by actual credits granted during the period and an estimate of unprocessed credits.

Our allowance for unfulfilled contractual customer purchase obligations is designed to account for the possible non-payment of amounts under agreements that we have with certain of our customers that place minimum purchase obligations on them. Although we vigorously seek payments due pursuant to these purchase obligations, we have historically collected only a small portion of these billed obligations. In order to allow for this, we reduce our gross service revenue by the amount that has been invoiced to these customers. We reduce this allowance and recognize the related service revenue only upon the receipt of cash payments in respect of these invoices. This allowance is determined by the amount of unfulfilled contractual purchase obligations invoiced to our customers and with respect to which we are continuing to seek payment.

### *Valuation Allowances for Doubtful Accounts Receivable and Deferred Tax Assets*

We have established allowances associated with uncollectible accounts receivable and our deferred tax assets.

Our valuation allowance for uncollectible accounts receivable is designed to account for the expense associated with accounts receivable that we estimate will not be collected. We assess the adequacy of this allowance by evaluating general factors, such as the length of time individual receivables are past due, historical collection experience, and changes in the credit-worthiness of our customers. We also assess the ability of specific customers to meet their financial obligations to us and establish specific allowances based on the amount we expect to collect from these customers.

Our valuation allowance for our net deferred tax asset reflects the uncertainty surrounding the realization of our net operating loss carry-forwards and our other deferred tax assets. For federal and state tax purposes, our net operating loss carry-forwards, including those that we have generated through our operations and those acquired in the Allied Riser merger could be subject to significant limitations on annual use. To reflect for this uncertainty and the uncertainty



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of future taxable income we have recorded a valuation allowance for the full amount of our net deferred tax asset.

### *Impairment of Long-Lived Assets*

We review our long-lived assets, including property and equipment, and intangible assets for impairment whenever events or changes in circumstances indicate that the carrying amount should be addressed pursuant to the Financial Accounting Standards Board's (FASB) Statement of Financial Accounting Standards (SFAS) No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. Pursuant to SFAS No. 144, impairment is determined by comparing the carrying value of these long-lived assets to our estimate of future undiscounted cash flows expected to result from the use of the assets. In the event that there are changes in the planned use of our long-lived assets, or our expected future undiscounted cash flows are reduced significantly, our assessment of our ability to recover the carrying value of these assets under SFAS No. 144 could change. No impairment existed at December 31, 2006 or 2007.

### *Convertible Senior Notes*

We evaluated the embedded conversion option of our 1.00% Convertible Senior Notes (the "Notes") in accordance with SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities", EITF Issue No. 00-19 "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in a Company's Own Stock" and EITF Issue No. 01-6 "The Meaning of Indexed to a Company's Own Stock." We concluded that the embedded conversion option contained within the Notes should not be accounted for separately because the conversion option is indexed to our common stock and would be classified within stockholders' equity, if issued on a standalone basis.

We evaluated the terms of the Notes for a beneficial conversion feature in accordance with EITF No. 98-5, "Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios" and EITF No. 00-27, "Application of Issue 98-5 to Certain Convertible Instruments." We concluded that there was no beneficial conversion feature at the commitment date based on the conversion rate of the Notes relative to the commitment date stock price. We will continue to evaluate potential future beneficial conversion charges based upon potential future triggering conversion events.

### *Equity-based Compensation*

Generally we grant options for shares of our common stock to all new employees with a strike price equal to the market value at the grant date. We grant shares of restricted stock to our senior management team, board of directors and to certain employees who have met our service requirements on the grant date. We determine the fair value of grants of restricted stock by the closing trading price of our common stock on the grant date. Grants of shares of restricted stock vest over periods ranging from immediate vesting to over a four-year period. Compensation expense for all awards is recognized ratably over the service period.

Effective January 1, 2006, we adopted FASB Statement No. 123(R), *Share-Based Payment* ("Statement 123(R)"), using the modified-prospective-transition method. The adoption of Statement 123(R) requires us to make additional estimates and judgments that affect our financial statements. These estimates include the following which impact the amount of compensation expense recorded under Statement 123(R).

**Expected Dividend Yield** We have never declared or paid dividends and have no plans to do so in the foreseeable future.

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**Expected Volatility** We use the historical volatility since our June 2005 public offering to estimate expected volatility because less than 3% of our fully diluted shares were publicly traded before that date.

**Risk-Free Interest Rate** We use the zero coupon U.S. Treasury rate during the quarter having a term that most closely resembles the expected term of the option.

**Expected Term of the Option** We estimate the expected life of the option term by analyzing historical stock option exercises and other relevant data.

**Forfeiture Rates** We estimate the forfeiture rate based on historical data with further consideration given to the class of employees to whom the options were granted.

### *Other Accounting Policies*

We record assets and liabilities under capital leases at the lesser of the present value of the aggregate future minimum lease payments or the fair value of the assets under lease. We establish the number of renewal option periods used in determining the lease term, if any, based upon our assessment at the inception of the lease of the number of option periods that are reasonably assured in accordance with SFAS No. 13 *Accounting for Leases*. We estimate the fair value of leased assets using market data for similar assets.

We capitalize the direct costs incurred prior to an asset being ready for service. These costs include costs under the related construction contract and the compensation costs of employees directly involved with construction activities. Our capitalization of these costs is based upon estimates of time for our employees involved in construction activities.

We estimate our litigation accruals based upon our estimate of the expected outcome after consultation with legal counsel.

We estimate our accruals for disputed leased circuit obligations based upon the nature and age of the dispute. Our network costs are impacted by the timing and amounts of disputed circuit costs. We generally record these disputed amounts when billed by the vendor and reverse these amounts when the vendor credit has been received or the dispute has otherwise been resolved.

We estimate the useful lives of our property and equipment based upon historical usage with consideration given to technological changes and trends in the industry that could impact the asset utilization. We establish the number of renewal option periods used in determining the lease term, if any, for amortizing leasehold improvements based upon our assessment at the inception of the lease of the number of option periods that are reasonably assured in accordance with SFAS No. 13 *Accounting for Leases*.

### **Recent Accounting Pronouncements**

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements" ("SFAS 157"). SFAS 157 defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. In February 2008, the FASB issued FSP No. 157-1, "Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13" and FSP No. 157-2, "Effective Date of FASB Statement No. 157" as amendments to SFAS 157, which exclude lease transactions from the scope of SFAS 157 and also defer the effective date of the adoption of SFAS 157 for non-financial assets and non-financial liabilities that are nonrecurring. The provisions of SFAS 157 are effective for the fiscal year beginning January 1, 2008, except for certain non-financial assets and liabilities for which the effective date has been deferred to January 1, 2009. The adoption of SFAS 157 and its related

pronouncements are not expected to have a material effect on our consolidated financial position, results of operations or cash flows.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities" ("SFAS 159"). SFAS 159 permits entities to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. SFAS 159 will be effective for the first fiscal year that begins after November 15, 2007. We will not adopt the alternative provided in this statement.

In June 2006, the Financial Accounting Standards Board ("FASB") issued FASB Interpretation No. ("FIN") 48, "Accounting for Uncertainty in Income Taxes - an Interpretation of FASB Statement No. 109." FIN No. 48 requires that management determine whether a tax position is more likely than not to be sustained upon examination based on the technical merits of the position. Once it is determined that a position meets this recognition threshold, the position is measured to determine the amount of benefit to be recognized in the financial statements. We adopted the provisions of FIN No. 48 on January 1, 2007. As of the date of adoption of FIN No. 48, we did not have any accrued interest or penalties associated with any unrecognized tax positions, and there was no interest expense or expense associated with penalties recognized during the year ended December 31, 2007. The adoption of FIN No. 48 did not have a material effect on our results of operations or financial position.

In June 2006, the Emerging Issues Task Force of the Financial Accounting Standards Board (the "EITF") reached a conclusion on EITF Issue No. 06-3 "How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement." The scope of EITF Issue No. 06-3 includes any tax assessed by a governmental authority that is both imposed on and concurrent with a specific revenue-producing transaction between a seller and a customer, and may include, but is not limited to, sales, use, value added, and some excise taxes. The EITF Issue No. 06-3 requires that the presentation of taxes on either a gross basis (included in revenues and costs) or a net basis (excluded from revenues) and is an accounting policy decision that should be disclosed. We collect services and value added taxes from customers and record these amounts on a net basis, which is within the scope of EITF Issue No. 06-3. EITF Issue No. 06-3 applied to financial reports for interim and annual reporting periods beginning after December 15, 2006. The adoption of EITF Issue No. 06-3 did not have an impact on our results of operations or our financial position.

In December 2007, the FASB issued SFAS No. 141R, "Business Combinations". SFAS 141R requires the acquiring entity in a business combination to record all assets acquired and liabilities assumed at their respective acquisition-date fair values, changes the recognition of assets acquired and liabilities assumed arising from contingencies, changes the recognition and measurement of contingent consideration, and requires the expensing of acquisition-related costs as incurred. SFAS 141R also requires additional disclosure of information surrounding a business combination, such that users of the entity's financial statements can fully understand the nature and financial impact of the business combination. SFAS 141R applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. An entity may not apply it before that date. The provisions of SFAS 141R will only impact us if we are party to a business combination after the pronouncement has been adopted.

**ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

We are exposed to certain market risks. These risks, which include interest rate risk and foreign currency exchange risk, arise in the normal course of business rather than from trading activities.

***Interest Rate Risk***

Our cash flow exposure due to changes in interest rates related to our debt is limited as our 1.00% \$200.0 million Convertible Senior Notes (the "Notes") have a fixed interest rate. The fair value of the Notes may increase or decrease for various reasons, including fluctuations in the market price of our common stock, fluctuations in market interest rates and fluctuations in general economic conditions. Based upon the quoted market price at December 31, 2007, the fair value of our Notes was approximately \$184.0 million.

Our interest income is sensitive to changes in the general level of interest rates. However, based upon the nature and current level of our investments, which are primarily money market funds included in cash and cash equivalents, we believe that there is no material interest rate exposure related to our investments.

***Foreign Currency Exchange Risk***

Our European and Canadian operations expose us to potentially unfavorable adverse movements in foreign currency rate changes. We have not entered into forward exchange contracts related to our foreign currency exposure. While we record financial results from our European and Canadian operations in euros and the Canadian dollar, respectively, these results are reflected in our consolidated financial statements in U.S. dollars. The assets and liabilities associated with our European and Canadian operations are translated into U.S. dollars and reflected in our consolidated financial statements in U.S. dollars. Therefore, our reported results are exposed to fluctuations in the exchange rates between the U.S. dollar and the euro and the Canadian dollar. In addition, we fund the euro-based operating expenses and associated cash flow requirements of our European operations, including IRU and expansion related obligations, in U.S. dollars. Accordingly, in the event that the euro strengthens versus the dollar to a greater extent than planned the revenues, expenses and cash flows associated with our European operations may be significantly higher in U.S.-dollar terms than planned.

**ITEM 8. INDEX TO CONSOLIDATED FINANCIAL STATEMENTS**

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**Report of Independent Registered Public Accounting Firm**

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

We have audited the accompanying consolidated balance sheets of Cogent Communications Group, Inc. and subsidiaries (the "Company") as of December 31, 2006 and 2007, and the related consolidated statements of operations, changes in stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2007. Our audits also included the financial statement schedule listed in the index at 15(a) 2. These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Cogent Communications Group, Inc. and subsidiaries at December 31, 2006 and 2007, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2007, in conformity with U.S. generally accepted accounting principles. Also in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

As discussed in Note 1 to the consolidated financial statements, in 2006, the Company adopted Statement of Financial Accounting Standards No. 123(R), Share Based Payment.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Cogent Communications Group, Inc.'s internal control over financial reporting as of December 31, 2007, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 26, 2008 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

McLean, VA  
February 26, 2008

## COGENT COMMUNICATIONS GROUP, INC., AND SUBSIDIARIES

## CONSOLIDATED BALANCE SHEETS

AS OF DECEMBER 31, 2006 AND 2007

(IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA)

	2006	2007
<b>Assets</b>		
<b>Current assets:</b>		
Cash and cash equivalents	\$ 42,642	\$ 177,021
Short term investments (\$0 and \$812 restricted, respectively)	80	812
Accounts receivable, net of allowance for doubtful accounts of \$1,233 and \$1,159, respectively	20,053	21,760
Prepaid expenses and other current assets	5,339	6,636
Total current assets	68,114	206,229
<b>Property and equipment:</b>		
Property and equipment	512,321	561,907
Accumulated depreciation and amortization	(249,053)	(316,487)
Total property and equipment, net	263,268	245,420
<b>Intangible assets, net</b>	1,150	165
<b>Deposits and other assets (\$1,118 and \$306 restricted, respectively)</b>	4,344	3,511
Total assets	\$ 336,876	\$ 455,325
<b>Liabilities and stockholders' equity</b>		
<b>Current liabilities:</b>		
Accounts payable	\$ 9,096	\$ 12,868
Accrued and other current liabilities	11,779	12,891
Convertible subordinated notes, net of discount of \$1,213	8,978	
Current maturities, capital lease obligations	6,027	7,717
Total current liabilities	35,880	33,476
<b>Capital lease obligations, net of current maturities</b>	82,019	84,857
<b>Convertible senior notes, net of discount of \$4,133</b>		195,867
<b>Other long term liabilities</b>	3,345	2,295
Total liabilities	121,244	316,495
<b>Commitments and contingencies</b>		
<b>Stockholders' equity:</b>		
Common stock, \$0.001 par value; 75,000,000 shares authorized; 48,928,108 and 47,929,874 shares issued and outstanding, respectively	49	48
Additional paid-in capital	478,140	430,402
Stock purchase warrants	764	764
Accumulated other comprehensive income foreign currency translation adjustment	1,638	3,600
Accumulated deficit	(264,959)	(295,984)
Total stockholders' equity	215,632	138,830
<b>Total liabilities and stockholders' equity</b>	\$ 336,876	\$ 455,325

The accompanying notes are an integral part of these consolidated balance sheets.





## COGENT COMMUNICATIONS GROUP, INC., AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF OPERATIONS

FOR THE YEARS ENDED DECEMBER 31, 2005, DECEMBER 31, 2006 AND DECEMBER 31, 2007

(IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA)

	2005	2006	2007
<b>Service revenue, net</b>	\$ 135,213	\$ 149,071	\$ 185,663
<b>Operating expenses:</b>			
Network operations (including \$399, \$315 and \$208 of equity-based compensation expense, respectively, exclusive of amounts shown separately)	86,193	80,421	87,756
Selling, general, and administrative (including \$12,906, \$10,194 and \$10,176 of equity-based compensation expense, and \$4,574, \$2,584 and \$2,005 of bad debt expense, respectively)	54,250	56,787	62,187
Lease restructuring charge	1,319		
Depreciation and amortization	55,600	58,414	65,638
<b>Total operating expenses</b>	<b>197,362</b>	<b>195,622</b>	<b>215,581</b>
<b>Operating loss</b>	<b>(62,149)</b>	<b>(46,551)</b>	<b>(29,918)</b>
<b>Gain Cisco credit facility</b>	<b>842</b>		
<b>Gains lease obligation restructurings</b>	<b>844</b>	<b>255</b>	<b>2,110</b>
<b>Gains disposition of assets</b>	<b>3,372</b>	<b>254</b>	<b>95</b>
<b>Interest income and other</b>	<b>1,320</b>	<b>2,969</b>	<b>6,914</b>
<b>Interest expense</b>	<b>(11,747)</b>	<b>(10,684)</b>	<b>(10,226)</b>
<b>Net loss</b>	<b>\$ (67,518)</b>	<b>\$ (53,757)</b>	<b>\$ (31,025)</b>
<b>Net loss per common share:</b>			
<b>Basic and diluted net loss per common share</b>	<b>\$ (1.96)</b>	<b>\$ (1.16)</b>	<b>\$ (0.65)</b>
<b>Weighted-average common shares basic and diluted</b>	<b>34,439,937</b>	<b>46,343,372</b>	<b>47,800,159</b>

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

**COGENT COMMUNICATIONS GROUP, INC., AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY**  
**FOR THE YEARS ENDED DECEMBER 31, 2005 DECEMBER 31, 2006 AND DECEMBER 31, 2007**  
**(IN THOUSANDS, EXCEPT SHARE AMOUNTS)**

	Common Stock						Preferred Stock F		Preferred Stock G		Preferred Stock H		Preferred Stock I	
	Shares	Amount	Additional Paid-in Capital	Deferred Compensation	Treasury Stock	Warrants	Shares	Amount	Shares	Amount	Shares	Amount	Shares	Amount
Balance at December 31, 2004	827,487	1	236,692	(22,533)	(90)	764	11,000	10,904	41,021	40,778	45,821	44,309	2,575	2,545
Total, December 31, 2004														
Forfeitures of shares granted to employees	(23,069)		(686)	697							(14)	(11)		
Equity-based compensation				13,306										
Foreign currency translation														
Issuances of common stock, net	11,719,231	11	64,712	(1,150)										
Conversion of preferred stock into common stock	31,569,003	32	139,782				(11,000)	(10,904)	(41,021)	(40,778)	(45,807)	(44,298)	(2,575)	(2,545)
Net loss														
Balance at December 31, 2005	44,092,652	44	440,500	(9,680)	(90)	764								
Total, December 31, 2005														
Forfeitures of shares granted to employees	(646)													
Adoption of SFAS 123(R) reclassification of deferred compensation			(9,680)	9,680										
Equity-based compensation			10,509											
Foreign currency translation														
Issuances of common stock, net	4,732,500	5	36,474											
Exercises of options	103,602		427											
Treasury stock retirement			(90)		90									
Net loss														
Balance at December 31, 2006	48,928,108	49	478,140			764								
Total, December 31, 2006														
Forfeitures of shares granted to employees	(22,659)													
Equity-based compensation			11,105											
Foreign currency translation														
Issuances of common stock, net	1,033,404	1												
Exercises of options	216,311		1,103											
Common stock purchases and retirement	(2,225,290)	(2)	(59,946)											
Net loss														
Balance at December 31, 2007	47,929,874	\$ 48	\$ 430,402	\$	\$	\$ 764	\$		\$		\$			\$
Total, December 31, 2007														

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



**COGENT COMMUNICATIONS GROUP, INC., AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (Continued)**  
**FOR THE YEARS ENDED DECEMBER 31, 2005 DECEMBER 31, 2006 AND DECEMBER 31, 2007**  
**(IN THOUSANDS, EXCEPT SHARE AMOUNTS)**

	Preferred Stock J		Preferred Stock K		Preferred Stock L		Preferred Stock M		Foreign Currency Translation Adjustment	Accumulated Deficit	Total Stockholders' Equity	Comprehensive Loss
	Shares	Amount	Shares	Amount	Shares	Amount	Shares	Amount				
<b>Balance at December 31, 2004</b>	<b>3,891</b>	<b>19,421</b>	<b>2,600</b>	<b>2,588</b>	<b>185</b>	<b>927</b>	<b>3,701</b>	<b>18,353</b>	<b>1,515</b>	<b>(143,684)</b>	<b>212,490</b>	
<b>Total, Year Ended December 31, 2004</b>												<b>(88,773)</b>
Forfeitures of shares granted to employees												
Equity-based compensation											13,306	
Foreign currency translation									(850)		(850)	(850)
Issuances of common stock, net											63,573	
Conversion of preferred stock into common stock	(3,891)	(19,421)	(2,600)	(2,588)	(185)	(927)	(3,701)	(18,353)				
Net loss										(67,518)	(67,518)	(67,518)
<b>Balance at December 31, 2005</b>									<b>665</b>	<b>(211,202)</b>	<b>221,001</b>	
<b>Total, Year Ended December 31, 2005</b>												<b>(68,368)</b>
Forfeitures of shares granted to employees												
Adoption of SFAS 123(R) reclassification of deferred compensation												
Equity-based compensation											10,509	
Foreign currency translation									973		973	973
Issuances of common stock, net											36,479	
Exercises of options											427	
Treasury stock retirement												
Net loss										(53,757)	(53,757)	(53,757)
<b>Balance at December 31, 2006</b>									<b>1,638</b>	<b>(264,959)</b>	<b>215,632</b>	
<b>Total, Year Ended December 31, 2006</b>												<b>(52,784)</b>
Forfeitures of shares granted to employees												
Equity-based compensation											11,105	
Foreign currency translation									1,962		1,962	1,962
Issuances of common stock, net											1	
Exercises of options											1,103	
Common stock purchases and retirement											(59,948)	
Net loss										(31,025)	(31,025)	(31,025)
<b>Balance at December 31, 2007</b>		<b>\$</b>		<b>\$</b>		<b>\$</b>		<b>\$</b>	<b>\$ 3,600</b>	<b>\$ (295,984)</b>	<b>\$ 138,830</b>	
<b>Total, Year Ended December 31, 2007</b>												<b>\$ (29,063)</b>

<u>Preferred Stock J</u>	<u>Preferred Stock K</u>	<u>Preferred Stock L</u>	<u>Preferred Stock M</u>
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The accompanying notes are an integral part of these consolidated statements.

## COGENT COMMUNICATIONS GROUP, INC., AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE YEARS ENDED DECEMBER 31, 2005, DECEMBER 31, 2006 AND DECEMBER 31, 2007

(IN THOUSANDS)

	2005	2006	2007
<b>Cash flows from operating activities:</b>			
Net loss	\$ (67,518)	\$ (53,757)	\$ (31,025)
Adjustments to reconcile net loss to net cash (used in) provided by operating activities:			
Depreciation and amortization	55,600	58,414	65,638
Amortization of debt discount convertible notes	1,548	2,265	1,576
Equity-based compensation expense (net of amounts capitalized)	13,305	10,509	10,384
Gains Cisco credit facility	(842)		
Gains lease restructurings dispositions of assets and other, net	(3,983)	(540)	(2,853)
Changes in assets and liabilities:			
Accounts receivable	(3,645)	(2,758)	(399)
Prepaid expenses and other current assets	34	(1,321)	(679)
Deposits and other assets	(3,700)	563	1,003
Accounts payable, accrued liabilities and other long-term liabilities	139	(8,090)	4,985
Net cash (used in) provided by operating activities	(9,062)	5,285	48,630
<b>Cash flows from investing activities:</b>			
Purchases of property and equipment	(17,342)	(21,526)	(30,389)
Purchases of intangible assets	(129)	(100)	
(Purchases) maturities of short term investments	(774)	1,203	(732)
Purchase of fiber optic network in Germany	(932)		
Proceeds from asset sales	5,122	945	257
Net cash used in investing activities	(14,055)	(19,478)	(30,864)
<b>Cash flows from financing activities:</b>			
Proceeds from issuance of senior convertible notes, net			195,147
Purchases of common stock			(59,949)
Repayment of convertible subordinated notes			(10,187)
Proceeds from sales of common stock, net	63,723	36,479	
Repayment of capital lease obligations	(6,899)	(9,861)	(9,809)
Proceeds from exercises of common stock options		427	1,103
Proceeds from issuance of subordinated note	10,000		
Repayment of subordinated note	(10,000)		
Repayment of Cisco note	(17,000)		
Borrowings under credit facility	10,000		
Repayments under credit facility	(10,000)		
Net cash provided by financing activities	39,824	27,045	116,305
<b>Effect of exchange rate changes on cash</b>	(668)	(93)	308
<b>Net increase in cash and cash equivalents</b>	16,039	12,759	134,379
<b>Cash and cash equivalents, beginning of year</b>	13,844	29,883	42,642
<b>Cash and cash equivalents, end of year</b>	\$ 29,883	\$ 42,642	\$ 177,021
<b>Supplemental disclosures of cash flow information:</b>			
Cash paid for interest	\$ 12,598	\$ 12,235	\$ 9,248
Non-cash financing activities			

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	2005	2006	2007
Capital lease obligations incurred	1,213	2,087	11,498

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

**COGENT COMMUNICATIONS GROUP, INC., AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**DECEMBER 31, 2005, 2006 and 2007**

**1. Description of the business and summary of significant accounting policies:**

**Description of business**

Cogent Communications Group, Inc. (the "Company") is a Delaware corporation and is headquartered in Washington, DC. The Company is a facilities-based provider of low-cost, high-speed Internet access and Internet Protocol ("IP") communications services. The Company's network is specifically designed and optimized to transmit data using IP. The Company delivers its services to small and medium-sized businesses, communications service providers and other bandwidth-intensive organizations through approximately 15,000 customer connections in North America and Europe.

The Company offers on-net Internet access services exclusively through its own facilities, which run all the way to its customers' premises. Because of its integrated network architecture, the Company is not dependent on local telephone companies to serve its on-net customers. The Company provides on-net Internet access to certain bandwidth-intensive users such as universities, other Internet service providers, telephone companies, cable television companies and commercial content providers at speeds up to 10 Gigabits per second. These customers generally receive service in colocation facilities and the Company's data centers. The Company also offers Internet access services in multi-tenant office buildings typically serving law firms, financial services firms, advertising and marketing firms and other professional services businesses. The Company operates data centers throughout North America and Europe that allow customers to collocate their equipment and access the Company's network.

In addition to providing on-net services, the Company also provides Internet connectivity to customers that are not located in buildings directly connected to its network. The Company serves these off-net customers using other carriers' facilities to provide the "last mile" portion of the link from its customers' premises to the Company's network. The Company also provides certain non-core services that resulted from acquisitions. The Company continues to support but does not actively sell these non-core services.

The Company has created its network by acquiring optical fiber from underlying carriers and directly connecting Internet routers to this optical fiber. Through 2004, the Company expanded its network through several acquisitions of financially distressed companies or their assets. Since then, it has primarily focused on the growth of its on-net Internet access services.

**Summary of Significant Accounting Policies**

*Principles of consolidation*

The consolidated financial statements have been prepared in accordance with United States generally accepted accounting principles and include the accounts of the Company and all of its wholly owned and majority-owned subsidiaries. All intercompany balances and transactions have been eliminated in consolidation.

*Reclassification*

Certain previously reported December 31, 2006 balance sheet amounts have been reclassified in order to be consistent with the December 31, 2007 presentation.



COGENT COMMUNICATIONS GROUP, INC., AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

DECEMBER 31, 2005, 2006 and 2007

*Use of estimates*

The preparation of consolidated financial statements in conformity with United States generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results may differ from these estimates.

*Revenue recognition and allowance for doubtful accounts*

The Company recognizes revenue in accordance with Staff Accounting Bulletin No. 104, "Revenue Recognition." The Company's service offerings consist of telecommunications services provided under month-to-month or annual contracts billed monthly in advance. Net revenues from telecommunication services are recognized when the services are performed, evidence of an arrangement exists, the fee is fixed and determinable and collection is probable. The probability of collection is determined by an analysis of a new customer's credit history and historical payment patterns for existing customers. Service discounts and incentives related to telecommunication services are recorded as a reduction of revenue when granted. Fees billed in connection with customer installations are deferred and recognized ratably over the estimated customer life determined by a historical analysis of customer retention.

The Company invoices certain customers for amounts contractually due for unfulfilled minimum contractual obligations and recognizes a corresponding sales allowance equal to this revenue resulting in the recognition of no net revenue at the time the customer is billed. The Company vigorously seeks payment of these amounts. The Company recognizes net revenue as these billings are collected in cash.

The Company establishes a valuation allowance for doubtful accounts and other sales credit adjustments. Valuation allowances for sales credits are established through a reduction of revenue, while valuation allowances for doubtful accounts are established through a charge to selling, general and administrative expenses. The Company assesses the adequacy of these reserves by evaluating general factors, such as the length of time individual receivables are past due, historical collection experience, and changes in the credit worthiness of its customers. If circumstances relating to specific customers change or economic conditions change such that the Company's past collection experience and assessment of the economic environment are no longer appropriate, the Company's estimate of the recoverability of its trade receivables could be impacted.

*Network operations*

Network operations include costs associated with service delivery, network management, and customer support. This includes the costs of personnel and related operating expenses associated with these activities, network facilities costs, fiber and equipment maintenance fees, leased circuit costs, and access fees paid to building owners. The Company estimates its accruals for any disputed leased circuit obligations based upon the nature and age of the dispute. Network operations costs are impacted by the timing and amounts of disputed circuit costs. The Company generally records these disputed amounts when billed by the vendor and reverses these amounts when the vendor credit has been received or the dispute has otherwise been resolved. The Company does not allocate depreciation and amortization expense to its network operations expense.

COGENT COMMUNICATIONS GROUP, INC., AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

DECEMBER 31, 2005, 2006 and 2007

*Foreign currency translation adjustment and comprehensive income (loss)*

The functional currency of Cogent Canada is the Canadian dollar. The functional currency of Cogent Europe is the euro. The consolidated financial statements of Cogent Canada, and Cogent Europe, are translated into U.S. dollars using the period-end foreign currency exchange rates for assets and liabilities and the average foreign currency exchange rates for revenues and expenses. Gains and losses on translation of the accounts of the Company's non-U.S. operations are accumulated and reported as a component of other comprehensive income (loss) in stockholders' equity.

Statement of Financial Accounting Standards ("SFAS") No. 130, "Reporting of Comprehensive Income" requires "comprehensive income" and the components of "other comprehensive income" to be reported in the financial statements and/or notes thereto. The Company's only components of "other comprehensive income" are currency translation adjustments for all periods presented.

*Financial instruments*

The Company considers all highly liquid investments with an original maturity of three months or less at purchase to be cash equivalents. The Company determines the appropriate classification of its investments at the time of purchase and evaluates such designation at each balance sheet date. At December 31, 2006 and 2007, the Company's investments consisted of money market accounts (included in cash equivalents) and certificates of deposit.

At December 31, 2006 and 2007, the carrying amount of cash and cash equivalents, short-term investments, accounts receivable, prepaid and other current assets, accounts payable, and accrued expenses approximated fair value because of the short-term nature of these instruments. Based upon the quoted market price at December 31, 2007, the fair value of the Company's \$200.0 million convertible senior notes was approximately \$184.0 million.

*Short-term investments*

Short-term investments consist of certificates of deposit with original maturities beyond three months, but less than twelve months. Such short-term investments are carried at amortized cost, which approximates fair value due to the short period of time to maturity. Investments underlying the Company's cash equivalents and short-term investments are classified as "held-to-maturity" in accordance with SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities."

The Company was party to letters of credit totaling approximately \$1.0 million as of December 31, 2006 and December 31, 2007. These letters of credit are secured by certificates of deposit of approximately \$1.1 million at December 31, 2006 and December 31, 2007, that are restricted and included in short-term investments and other assets.

*Credit risk*

The Company's assets that are exposed to credit risk consist of its cash and cash equivalents, short-term investments, other assets and accounts receivable. As of December 31, 2006 and 2007, approximately \$37.4 million (4 funds) and \$171.9 million (7 funds) of the Company's cash equivalents were invested in money market funds. The largest amount in an individual fund was \$30.9 million at December 31, 2006 and \$50.7 million at December 31, 2007. The Company places its cash equivalents and short-term investments in instruments that meet high-quality credit standards as specified in the Company's investment policy guidelines. Accounts receivable are due from customers located in major

## COGENT COMMUNICATIONS GROUP, INC., AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

DECEMBER 31, 2005, 2006 and 2007

metropolitan areas in the United States, Europe and Canada. Receivables from the Company's net centric (wholesale) customers and customers obtained through business combinations are subject to a higher degree of credit risk than other customers.

*Property and equipment*

Property and equipment are recorded at cost and depreciated once deployed using the straight-line method over the estimated useful lives of the assets. Useful lives are determined based on historical usage with consideration given to technological changes and trends in the industry that could impact the asset utilization. System infrastructure costs include the capitalized compensation costs of employees directly involved with construction activities and costs incurred by third party contractors. Assets and liabilities under capital leases are recorded at the lesser of the present value of the aggregate future minimum lease payments or the fair value of the assets under lease. Leasehold improvements include costs associated with building improvements. The Company determines the number of renewal option periods, if any, included in the lease term for purposes of amortizing leasehold improvements based upon its assessment at the inception of the lease of the number of option periods that are reasonably assured in accordance with SFAS No. 13 "Accounting for Leases." Expenditures for maintenance and repairs are expensed as incurred.

Depreciation and amortization periods are as follows:

Type of asset	Depreciation or amortization period
Indefeasible rights of use (IRUs)	Shorter of useful life or IRU lease agreement; generally 15 to 20 years, beginning when the IRU is ready for use
Network equipment	3 to 8 years
Leasehold improvements	Shorter of lease term or useful life
Software	5 years
Owned buildings	40 years
Office and other equipment	3 to 7 years
System infrastructure	5 to 10 years

*Long-lived assets*

The Company's long-lived assets include property and equipment and identifiable intangible assets. These long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount should be addressed pursuant to SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." Pursuant to SFAS No. 144, impairment is determined by comparing the carrying value of these long-lived assets to management's probability weighted estimate of the future undiscounted cash flows expected to result from the use of the assets. In the event an impairment exists, a loss is recognized based on the amount by which the carrying value exceeds the fair value of the asset, which would be determined by using quoted market prices or valuation techniques such as the discounted present value of expected future cash flows, appraisals, or other pricing models. Management believes that no such impairment existed as of December 31, 2006 or 2007. In the event there are changes in the planned use of the Company's long-term assets or the Company's expected future undiscounted cash flows are reduced significantly, the Company's assessment of its ability to recover the carrying value of these assets under SFAS No. 144 could change.

**COGENT COMMUNICATIONS GROUP, INC., AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**DECEMBER 31, 2005, 2006 and 2007**

*Asset retirement obligations*

In accordance with SFAS No. 143, See discussion of Recent Accounting Pronouncements in Note 1 to the condensed consolidated financial statements included in Part I, Item 1 of this Report.

**Item 3—Quantitative and Qualitative Disclosures About Market Risk**

Our direct exposure to financial market risk results from fluctuations in foreign currency exchange rates and interest rates. There have been no material changes to our market risks as disclosed in our Annual Report on Form 10-K, for the fiscal year ended August 28, 2016.

Table of Contents**Item 4—Controls and Procedures**

As of the end of the period covered by this Quarterly Report on Form 10-Q, we performed an evaluation under the supervision and with the participation of management, including our Chief Executive Officer and Chief Financial Officer, of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities and Exchange Act of 1934 (the Exchange Act)). Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that, as of the end of the period covered by this Quarterly Report, our disclosure controls and procedures are effective.

In the first quarter of fiscal 2017, we implemented a new accounting system for the U.S. and Canada, which required changes to certain of our business processes and internal controls over financial reporting. The initial design and documentation of these processes and procedures are complete. They will be updated as necessary to ensure continued effective internal control over financial reporting.

There have been no other changes in our internal control over financial reporting (as defined in Rules 13a-15(f) or 15d-15(f) of the Exchange Act) during our most recently completed fiscal quarter that have materially affected or are reasonably likely to materially affect our internal control over financial reporting.

**PART II—OTHER INFORMATION****Item 1—Legal Proceedings**

See discussion of Legal Proceedings in Note 8 to the condensed consolidated financial statements included in Part I, Item 1 of this Report.

**Item 1A—Risk Factors**

In addition to the other information set forth in the Quarterly Report on Form 10-Q, you should carefully consider the factors discussed in Part I, Item 1A, "Risk Factors" in our Annual Report on Form 10-K, for the fiscal year ended August 28, 2016. There have been no material changes in our risk factors from those disclosed in our Annual Report on Form 10-K.

**Item 2—Unregistered Sales of Equity Securities and Use of Proceeds**

The following table sets forth information on our common stock repurchase program activity for the first quarter of fiscal 2017 (amounts in millions, except share and per share data):

Period	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Programs <sup>(1)</sup>	Maximum Dollar Value of Shares that May Yet be Purchased Under the Programs <sup>(1)</sup>
August 29, 2016 - September 25, 2016	273,000	\$153.84	273,000	\$ 3,180
September 26, 2016 - October 23, 2016	350,000	150.21	350,000	3,127
October 24, 2016 - November 20, 2016	186,000	148.33	186,000	3,100
Total first quarter	809,000	\$151.00	809,000	

(1) Our stock repurchase program is conducted under a \$4,000 authorization approved by of our Board of Directors in April 2015, which expires in April 2019.

**Item 3—Defaults Upon Senior Securities**

None.

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## Item 4—Mine Safety Disclosures

Not applicable.

## Item 5—Other Information

None.

## Item 6—Exhibits

The following exhibits are filed as part of this Quarterly Report on Form 10-Q or are incorporated herein by reference.

Exhibit Number	Exhibit Description	Filed Herewith	Incorporated by Reference		
			Form	Period Ending	Filing Date
3.1	Articles of Incorporation as amended of the registrant		10-Q	2/15/2015	3/11/2015
3.2	Bylaws as amended of the registrant		8-K		9/30/2016
10.1*	Executive Employment Agreement, effective January 1, 2017, between Craig Jelinek and Costco Wholesale Corporation	x			
10.2*	Fiscal 2017 Executive Bonus Plan		8-K		11/3/2016
31.1	Rule 13(a) – 14(a) Certifications	x			
32.1	Section 1350 Certifications	x			
101.INS	XBRL Instance Document	x			
101.SCH	XBRL Taxonomy Extension Schema Document	x			
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document	x			
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document	x			
101.LAB	XBRL Taxonomy Extension Label Linkbase Document	x			
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document	x			

\* Management contract, compensatory plan or arrangement

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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized.

**COSTCO WHOLESALE CORPORATION**  
(Registrant)

December 15, 2016 By /s/ W. CRAIG JELINEK

Date W. Craig Jelinek  
President, Chief Executive Officer and Director

December 15, 2016 By /s/ RICHARD A. GALANTI

Date Richard A. Galanti  
Executive Vice President, Chief Financial Officer and Director