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Arizona Corporation Commission
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March 23, 20076

Ms. Candrea Allen
Utilities Division
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

RE: Cbeyond Communications - Docket No. T-20497A-06-0802

Dear Ms. Allen:

Enclosed as a supplement to Cbeyond's response to Staff Request No. 1-5, please find excerpts from Cbeyond, Inc.'s 10K, which includes the audited financial information you requested.

If you have any questions, please let me know.

Sincerely,

Michael W. Patten

MWP:mi
Enclosures
cc: Docket Control

10-K 1 d10k.htm FORM 10-K FOR THE YEAR ENDED DECEMBER 31, 2006

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

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

For the fiscal year ended December 31, 2006

OR

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

For the transition period from __________ to __________.

Commission file number 000-51588

CBEYOND, INC.
(Exact name of registrant as specified in its charter)

Delaware **(State or other jurisdiction of incorporation or organization)**	**59-3636526** **(I.R.S. Employer Identification No.)**
320 Interstate North Parkway, Suite 300 **Atlanta, Georgia** **(Address of principal executive offices)**	**30339** **(Zip Code)**

Registrant's telephone number, including area code: (678) 424-2400

Securities registered pursuant to 12(b) of the Act:
Common Stock, $0.01 par value
(Title of Class)

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 ☒

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, or a non-accelerated filer. (see definition of "accelerated filer" and "large accelerated filer" in Rule 12b-2 of the Exchange Act).

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Item 8. Financial Statements and Supplementary Data

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM
ON INTERNAL CONTROL OVER FINANCIAL REPORTING

The Board of Directors and Stockholders
Cbeyond, Inc. and Subsidiaries

We have audited management's assessment, included in the accompanying Management's Annual Report On Internal Control Over Financial Reporting, that Cbeyond, Inc. and Subsidiaries maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Cbeyond, Inc.'s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

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

In our opinion, management's assessment that Cbeyond, Inc. and Subsidiaries maintained effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on the COSO criteria. Also, in our opinion, Cbeyond, Inc. and Subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Cbeyond, Inc. and Subsidiaries as of December 31, 2005 and 2006 and the related consolidated statements of operations, stockholders' equity (deficit) and cash flows for each of the three years in the period ended December 31, 2006 of Cbeyond, Inc. and Subsidiaries and our report dated March 15, 2007 expressed an unqualified opinion thereon.

/s/ ERNST & YOUNG LLP

Atlanta, Georgia
March 15, 2007

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM ON THE CONSOLIDATED FINANCIAL STATEMENTS

The Board of Directors and Stockholders
Cbeyond, Inc. and Subsidiaries

We have audited the accompanying consolidated balance sheets of Cbeyond, Inc. and Subsidiaries (the "Company") as of December 31, 2005 and 2006, and the related consolidated statements of operations, stockholders' equity (deficit) and cash flows for each of the three years in the period ended December 31, 2006. Our audits also included the financial statement schedule listed in the Index at Item 15(a). 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 consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company at December 31, 2005 and 2006, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2006, 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 2 and Note 8 to the consolidated financial statements, effective January 1, 2006, the Company adopted the provisions of Statement of Financial Accounting Standards No. 123(R), *Share-Based Payments*.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company's internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 15, 2007 expressed an unqualified opinion therein.

/s/ ERNST & YOUNG LLP

Atlanta, Georgia
March 15, 2007

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CBEYOND, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(Amounts in thousands, except per share amounts)

	December 31	
	2005	2006
Assets		
Current assets:		
Cash and cash equivalents	$ 27,752	$ 34,113
Marketable securities	10,170	9,995
Accounts receivable from customers, net of allowance for doubtful accounts of $1,811 and $2,586 as of December 31, 2005 and 2006, respectively	10,688	18,595
Prepaid expenses	3,395	4,046
Inventory	—	811
Other current assets	933	968
Total current assets	52,938	68,528
Property and equipment, net	57,068	72,790
Restricted cash equivalents and marketable securities	1,637	1,020
Other non-current assets	3,189	2,055
Total assets	$ 114,832	$ 144,393
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	$ 9,364	$ 7,538
Accrued telecommunication costs	9,445	14,644
Deferred customer revenue	3,447	7,260
Other accrued liabilities	17,097	23,085
Current portion of capital lease obligations	382	98
Total current liabilities	39,735	52,625
Other non-current liabilities	511	660
Stockholders' equity:		
Common stock, $0.01 par value; 50,000 shares authorized at December 31, 2005 and 2006; 26,560 and 27,419 shares issued and outstanding at December 31, 2005 and 2006, respectively	266	274
Preferred stock, $0.01 par value; 15,000 shares authorized at December 31, 2005 and 2006; no shares issued and outstanding at December 31, 2005 and 2006	—	—
Deferred stock compensation	(701)	(22)
Additional paid-in capital	230,797	238,852
Accumulated deficit	(155,776)	(147,996)
Total stockholders' equity	74,586	91,108
Total liabilities and stockholders' equity	$ 114,832	$ 144,393

See accompanying notes.

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CBEYOND, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(Amounts in thousands, except per share data)

	Year ended December 31		
	2004	2005	2006
Revenue			
Customer revenue	$108,863	$154,883	$208,574
Terminating access revenue	4,448	4,214	5,312
Total revenue	113,311	159,097	213,886
Operating expenses:			
Cost of service (exclusive of depreciation and amortization of $17,611, $20,038, and $21,463 respectively, shown separately below)	31,725	47,161	64,294
Selling, general and administrative (exclusive of depreciation and amortization of $5,036, $4,122, and $5,733 respectively, shown separately below)	65,159	86,453	114,408
Public offering expenses	1,103	—	945
Depreciation and amortization	22,647	24,160	27,196
Total operating expenses	120,634	157,774	206,843
Operating income (loss)	(7,323)	1,323	7,043
Other income (expense):			
Interest income	637	1,325	1,919
Interest expense	(2,788)	(2,424)	(163)
Gain from write-off of carrying value of debt in excess of principal	—	4,060	—
Loss on disposal of property and equipment	(1,746)	(539)	(601)
Other income (expense), net	(236)	(9)	12
Income (loss) before income taxes	(11,456)	3,736	8,210
Income tax expense	—	—	(430)
Net income (loss)	(11,456)	3,736	7,780
Dividends accreted on preferred stock	(7,083)	(8,550)	—
Net income (loss) attributable to common stockholders	$ (18,539)	$ (4,814)	$ 7,780
Net income (loss) attributable to common stockholders per common share:			
Basic	$ (143.71)	$ (1.16)	$ 0.29
Diluted	$ (143.71)	$ (1.16)	$ 0.27
Weighted average common shares outstanding:			
Basic	129	4,159	26,951
Diluted	129	4,159	28,971

See accompanying notes.

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CBEYOND, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY (DEFICIT)

(Amounts in thousands)

	Common Stock					
	Shares	Par Value	Additional Paid-in Capital	Deferred Compensation	Accumulated Deficit	Total Stockholders' Equity (Deficit)
Balance at December 31, 2003	124	$ 1	$ 78,543	$ (1,432)	$ (132,423)	$ (55,311)
Exercise of stock options	8	—	30	—	—	30
Issuance of stock options to employees	—	—	191	(191)	—	—
Issuance of stock options to non-employees for services	—	—	78	(78)	—	—
Deferred stock compensation expense	—	—	—	375	—	375
Forfeiture of options	—	—	(116)	116	—	—
Accretion of preferred dividends	—	—	—	—	(7,083)	(7,083)
Accretion of issuance costs	—	—	(128)	—	—	(128)
Net and comprehensive loss	—	—	—	—	(11,456)	(11,456)
Balance at December 31, 2004	132	1	78,598	(1,210)	(150,962)	(73,573)
Exercise of stock options	34	1	129	—	—	130
Issuance of stock options to non-employees for services	—	—	16	(16)	—	—
Deferred stock compensation expense	—	—	—	324	—	324
Forfeiture of options	—	—	(201)	201	—	—
Accretion of preferred dividends	—	—	—	—	(8,550)	(8,550)
Accretion of issuance costs	—	—	(149)	—	—	(149)
Issuance of common stock, net	6,848	69	64,961	—	—	65,030
Issuance of common stock upon conversion of Preferred stock	19,546	195	87,443	—	—	87,638
Net and comprehensive income	—	—	—	—	3,736	3,736
Balance at December 31, 2005	26,560	266	230,797	(701)	(155,776)	74,586
Exercise of stock options	854	8	4,084	—	—	4,092
Issuance of stock grant awards	5	—	106	—	—	106
Share-based compensation expense	—	—	4,227	22	—	4,249
Excess tax benefit from stock option exercises	—	—	290	—	—	290
Elimination of deferred stock compensation relating to employee options	—	—	(657)	657	—	—
Adjustment to offering costs	—	—	5	—	—	5
Net and comprehensive income	—	—	—	—	7,780	7,780
Balance at December 31, 2006	27,419	$274	$238,852	$ (22)	$ (147,996)	$ 91,108

See accompanying notes.

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CBEYOND, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Amounts in thousands)

	Year ended December 31		
	2004	2005	2006
Operating activities			
Net income (loss)	$(11,456)	$ 3,736	$ 7,780
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Depreciation and amortization	22,647	24,160	27,196
Provision for doubtful accounts	2,393	3,468	3,629
Loss on disposal of property and equipment	1,746	539	601
Interest expense offset by reduction in carrying value in excess of principal	(2,281)	(1,618)	—
Write-down of marketable securities to fair value	235	—	—
Gain from write-off of carrying value of debt in excess of principal	—	(4,060)	—
Non-cash share-based compensation	362	286	4,355
Excess tax benefit relating to share-based payments	—	—	(290)
Issuance of stock options to vendors for services	13	38	—
Changes in operating assets and liabilities:			
Accounts receivable	(3,574)	(8,800)	(11,536)
Inventory	—	—	(811)
Prepaid expenses and other current assets	(603)	(1,861)	(603)
Other assets	516	(2,454)	1,242
Accounts payable	(446)	4,037	(1,826)
Other accrued expenses	3,916	12,176	13,923
Net cash provided by operating activities	13,468	29,647	43,660

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CBEYOND, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS—(CONTINUED)
(Amounts in thousands)

	Year ended December 31		
	2004	2005	2006
Investing activities			
Purchases of property and equipment	(9,783)	(21,329)	(42,092)
Decrease (increase) from restricted cash equivalents and marketable securities	61	(875)	617
Purchases of marketable securities	(11,790)	(10,556)	(65,929)
Redemption of marketable securities	18,000	15,287	66,104
Proceeds from disposal of fixed assets	—	—	6
Net cash used in investing activities	(3,512)	(17,473)	(41,294)
Financing activities			
Proceeds from borrowings of long-term debt	1,003	741	—
Repayment of long-term debt and capital leases	(9,861)	(73,014)	(284)
Proceeds from issuance of stock, net of issuance cost	16,917	65,006	—
Excess tax benefit relating to share-based payments	—	—	290
Proceeds from exercise of stock options	30	130	4,092
Equity issuance costs	—	—	5
Financing issuance costs	(312)	(145)	(108)
Net cash provided by (used in) financing activities	7,777	(7,282)	3,995
Net increase in cash and cash equivalents	17,733	4,892	6,361
Cash and cash equivalents at beginning of period	5,127	22,860	27,752
Cash and cash equivalents at end of period	$ 22,860	$ 27,752	$ 34,113
Supplemental disclosure			
Interest paid	$ 5,070	$ 4,026	$ 119
Income taxes paid	$ —	$ —	$ 224
Non-cash purchases of property and equipment	$ 13,958	$ 8,437	$ 1,775

See accompanying notes.

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CBEYOND, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2006
(Amounts in thousands, except per share amounts)

1. Description of Business

Cbeyond, Inc., a managed service provider, was incorporated on March 28, 2000 in Delaware, for the purpose of providing integrated packages of voice, mobile and broadband data services to small businesses in major metropolitan areas across the United States. As of December 31, 2006, these services were provided in the metropolitan Atlanta, Dallas, Denver, Houston, Chicago and Los Angeles areas, and as of January 2007, San Diego.

2. Summary of Significant Accounting Policies

Principles of Consolidation

The consolidated financial statements include the accounts of Cbeyond, Inc. and its wholly-owned subsidiaries (collectively, the "Company"). All intercompany balances and transactions have been eliminated in the consolidation process.

Use of Estimates

The preparation of financial statements in conformity with U.S. generally accepted accounting principles (GAAP) requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results will differ from those estimates.

Revenue Recognition

Revenues are recognized when the services are delivered and earned. Revenue derived from local voice and data services is billed monthly in advance and deferred until earned. Revenues derived from other telecommunications services, including long distance, excess charges over monthly rate plans and terminating access fees from other carriers, are recognized monthly as services are provided and billed in arrears.

Revenue derived from customer installation is deferred and amortized over the average estimated customer life of three years on a straight-line basis. Related installation costs are deferred only to the extent that revenue is deferred and are amortized on a straight-line basis in proportion to revenue recognized. Mobile handset revenue is recognized at the time of shipment. Contractual termination fees are billed to the customer, but revenue from these fees is not recognized until payment is received.

The Company's marketing promotions include various rebates and customer reimbursements that fall under the scope of Emerging Issues Task Force (EITF) Issue No. 00-22, *Accounting for "Points" and Certain Other Time-Based or Volume-Based Sales Incentive Offers, and Offers for Free Products or Services to be Delivered in the Future*, and EITF Issue No. 01-09, *Accounting for Consideration Given by a Vendor to a Customer*. In accordance with these pronouncements, the Company records any promotion as a reduction in revenue when earned by the customer. For promotions earned over time, the Company ratably allocates the cost of honoring the promotion over the underlying promotion period as a reduction in revenue. EITF 01-09 additionally requires that measurement of the obligation should be based on the estimated number of customers that will ultimately earn and claim the promotion. Prior to 2005, sufficient historical information did not exist to reasonably estimate the amount of the obligation that would ultimately be earned and claimed. Accordingly, the Company recorded the full liability. During 2005, the Company had accumulated sufficient historical experience to reasonably estimate this amount for certain of its promotions and recognized approximately $336 as the initial change in estimate for

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CBEYOND, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

these promotions. During 2006, the Company gained sufficient historical experience to begin estimating this amount for the remaining promotions for which enough history did not exist in 2005 and recognized approximately $776 as the initial change in estimate for these promotions.

Allowance for Doubtful Accounts

The allowance for doubtful accounts is established based upon the amount the Company ultimately expects to collect from customers, and is estimated based on a number of factors, including a specific customer's ability to meet its financial obligations to the Company, as well as general factors, such as length of time the receivables are past due, historical collection experience and the general economic environment. Customer accounts are written off against the allowance upon disconnection of the customers' service, at which time the accounts are deemed to be uncollectible. Generally, customer accounts are considered delinquent and the service disconnection process begins when they are sixty days in arrears. The Company recognized $2,393, $3,468 and $3,629 relating to bad debts during 2004, 2005 and 2006, respectively.

Cash and Cash Equivalents

Cash and cash equivalents include all U.S. government backed highly liquid investments with original maturities of three months or less at the date of purchase. The carrying amount of cash and cash equivalents approximates fair value.

Restricted Cash Equivalents and Marketable Securities

Restricted cash equivalents and marketable securities consist of certificates of deposit held as collateral for letters of credit issued on behalf of the Company. Some vendors providing services to the Company require letters of credit to be redeemed in the event the Company cannot meet its obligations to the vendor. These letters of credit are issued to the Company's vendors, and in return, the Company is required to maintain cash or cash equivalents on hand with the bank at a dollar amount equal to the letters of credits outstanding, the majority of which is maintained in certificates of deposit, with the remainder in a restricted cash account with a commercial bank. In the event market conditions change and the letters of credit outstanding increase beyond the level of cash on hand at a commercial bank, the Company will be required to provide additional capital. The Company's collateral requirements (restricted cash) were $1,637 and $1,020 as of December 31, 2005 and 2006, respectively.

Marketable Securities

Marketable securities consist of commercial paper and are classified as investments available for sale. The Company's investments available for sale are carried at fair value or at cost, which approximates fair value. The Company considered the unrealized losses at December 31, 2004 to be other than temporary because the underlying securities held by the mutual fund were interest rate sensitive and unlikely to recover their value in the near future. Further, during 2005 the Company liquidated its mutual fund holdings and realized all losses on the investment. The Company recorded losses of $235 in 2004 and $13 in 2005 to adjust the cost basis of its investments to fair value.

The adjusted cost bases, which equal fair value, are as follows:

	December 31	
	2005	2006
Commercial Paper	$10,170	$9,995
Total Marketable Securities	$10,170	$9,995

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CBEYOND, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

As of December 31, 2005, the Company held debt securities consisting of commercial paper maturing in January 2006. As of December 31, 2006, the Company held debt securities consisting of commercial paper maturing in January 2007.

Inventories

The Company states its inventories at the lower of cost or market. Inventories consist primarily of mobile devices and are stated using the first-in, first-out (FIFO) method. Shipping and handling costs incurred in conjunction with the sale of inventory are included as an element of cost of service.

Property and Equipment

Property and equipment is stated at cost and depreciated over estimated useful lives using the straight-line method. Leasehold improvements are amortized over the shorter of the life of the lease or the duration of their economic value to the Company. Repair and maintenance costs are expensed as incurred. The Company pays certain equipment maintenance costs in advance under multi-year maintenance contracts, which are included in current and non-current assets. The amortization of these long-term prepaid expenses account for the decline in other non-current assets between 2005 and 2006.

Network engineering costs incurred during the construction phase of the Company's networks are capitalized as part of property and equipment and recorded as construction-in progress until the projects are completed and placed into service.

The Company capitalizes internal-use software in accordance with Statement of Position 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use* (SOP 98-1). For the years ended December 31, 2005 and 2006, the Company capitalized $2,284 and $4,107, respectively, associated with these development efforts. These costs are amortized to expense generally over a period of three years depending on the useful life of the related asset.

Income Taxes

The Company accounts for income taxes in accordance with Statement of Financial Accounting Standard No. 109, *Accounting for Income Taxes* (SFAS 109), which requires companies to recognize deferred income tax assets and liabilities for temporary differences between the financial reporting and tax bases of recorded assets and liabilities and the expected benefits of net operating loss and credit carryforwards. SFAS 109 requires that deferred income tax assets be reduced by a valuation allowance if it is more likely than not that some portion or all of the deferred income tax assets will not be realized. The Company evaluates the realizability of its deferred income tax assets, primarily resulting from net operating loss carryforwards, and adjusts its valuation allowance, if necessary.

The Company is currently using Regular and Alternative Minimum Tax (AMT) net operating losses to offset taxable income expected to be generated for the year. The Company has performed a study and determined that there is no limitation on the Company's ability to utilize net operating loss carryforwards under Internal Revenue Code Section 382 due to changes in ownership occurring through September 13, 2006. Subsequent to this study, the Company facilitated a secondary offering of its common stock in October 2006. The effects of this offering and any other transactions subsequent to September 13, 2006 have not been evaluated as to their impact on the Company's ability to utilize net operating loss carryforwards.

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CBEYOND, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Beginning in 2007, the Company's operations in Dallas and Houston, Texas will be subject to a new state income tax, referred to as the Texas margin tax. This tax will substantially increase our state income tax liability. Had this new tax been in effect in 2006, the Company's state income tax expense would have increased by approximately $500.

Impairment and Other Losses on Long-Lived Assets

The Company evaluates impairment losses on long-lived assets used in operations when events and circumstances indicate that the assets might be impaired. If the Company's review indicates that the carrying value of an asset will not be recoverable, based on a comparison of the carrying value of the asset to the undiscounted cash flows when possible, the impairment will be measured by comparing the carrying value of the asset to the fair value. Fair value will be determined based on quoted market values, discounted cash flows or appraisals. The Company's review will be at the lowest levels for which there are identifiable cash flows that are largely independent of the cash flows of other business units.

During 2004 and 2006, the Company replaced certain categories of network equipment with newer equipment having greater functionality in order to improve network efficiency and performance. The equipment being replaced had no further use in the network, and the replacement of this class of assets comprised a substantial portion of the loss on disposal of fixed assets. The Company also wrote off certain software assets that we replaced due to obsolescence or upgrade. During the normal course of operations, the Company also writes equipment off that it is not able to recover from former customers. This equipment resides at customer locations to enable connection to the Company's telecommunications network. The gross value of equipment written off during 2004, 2005 and 2006 was $3,073, $641 and $3,352, respectively.

Marketing Costs

The Company expenses marketing costs, including advertising, in support of its sales efforts as these costs are incurred. Such costs amounted to approximately $1,021, $1,819 and $2,185 during 2004, 2005 and 2006, respectively.

Deferred Financing Costs

During 2004 and 2005, respectively, the Company recorded $312 and $42 of deferred costs associated with amendments to its credit facility with Cisco Systems Capital Corporation (Cisco Capital). Of these costs, approximately $38 and $50 were amortized to interest expense in 2004 and 2005, respectively. Upon the payoff of the Cisco Capital facility in November 2005, the net remaining deferred financing costs were written off as a reduction of the gain recognized upon the payoff of the related debt (see Note 6).

The Company has incurred a total of $256 of loan costs in connection with obtaining a five year line of credit facility commitment from Bank of America that was finalized in 2006 (the "line of credit"). In accordance with the Company's policy, deferred loan costs are amortized from the effective date of the agreement or amendment over the then remaining life of the facility, which resulted in approximately $45 of amortization to interest expense in 2006.

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CBEYOND, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Concentrations of Risk

Financial instruments that potentially subject the Company to significant concentrations of credit risk consist of trade accounts receivable, which are unsecured. The Company's risk is limited due to the fact that there is no significant concentration with one customer or group of customers. Because the Company's operations were conducted in Atlanta, Georgia; Dallas, Texas; Houston, Texas; Denver, Colorado; Chicago, Illinois; and Los Angeles, California through 2006 and, additionally, San Diego, California beginning in 2007, its revenues and receivables were geographically concentrated in these cities.

Fair Value

The Company has used the following methods and assumptions in estimating its fair value disclosures for financial instruments:

- The carrying amounts reflected in the consolidated balance sheets for cash and cash equivalents, restricted cash and cash equivalents, marketable securities and accounts receivable equals or approximates their respective fair values.
- The carrying amounts reported in the consolidated balance sheets for capital leases approximate fair value due to the use of imputed interest rates based on the variable interest rates of the Company's prior debt.

Share-Based Compensation

Prior to January 1, 2006, the Company accounted for share-based compensation under the recognition and measurement provisions of APB Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25), and related interpretations, as permitted by Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation* (SFAS 123). Under this guidance, the Company recognized non-cash compensation expense for stock options by measuring the excess, if any, of the estimated fair value of the common stock at the date of grant over the amount an employee must pay to acquire the stock and amortizing that excess on a straight-line basis over the vesting period of the applicable stock options. Additional paid-in capital and deferred compensation were recorded at the date of the grants to reflect the intrinsic value of the awards. Under APB 25, the deferred compensation was amortized to expense over the vesting periods on a straight line basis, with adjustments for forfeitures as they occurred.

Effective January 1, 2006, the Company adopted the fair value recognition provisions of Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment* (SFAS 123(R)) using the modified prospective transition method. Under that transition method, compensation cost recognized on or after January 1, 2006 includes: (a) compensation cost for all share-based payments granted prior to, but not yet vested as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123, and (b) compensation cost for all share-based payments granted on or after January 1, 2006, based on the grant date fair value estimated in accordance with SFAS 123(R). Results for prior periods have not been restated. Under SFAS 123(R), compensation is recorded over the vesting period directly to paid-in capital. Thus, upon adoption, the Company eliminated the deferred compensation balance relating to employee stock options with an offsetting reduction to additional paid-in capital.

The following pro forma information shows the effect on the Company's statement of operations as if the Company had accounted for its employee stock options under the fair value method of SFAS 123 in these earlier periods. The Company's pro forma expense calculations under FAS 123 considered estimated forfeitures as of

CBEYOND, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

the date of grant and, accordingly, are considered to reasonably approximate the expense that would have been recorded had the expense been calculated under FAS 123(R).

	Year Ended December 31,	
	2004	2005
Net loss attributable to common stockholders	$ (18,539)	$ (4,814)
Add: Share-based compensation expense determined under the intrinsic value based method	362	286
Deduct: Share-based compensation expense determined under the fair value based method	(1,880)	(2,716)
Pro forma net loss attributable to common stockholders	$ (20,057)	$ (7,244)
Net loss attributable to common stockholders per common share:		
Basic and diluted—as reported	$ (143.71)	$ (1.16)
Basic and diluted—pro forma	$ (155.48)	$ (1.74)

Basic and Diluted Net Income (Loss) Attributable to Common Stockholders per Common Share

Basic net income (loss) attributable to common stockholders per common share excludes dilution for potential common stock issuances and is computed by dividing net income (loss) attributable to common stockholders by the weighted-average common shares outstanding for the period. As the Company reported a net loss attributable to common stockholders for the years ended 2004 and 2005, the conversion of Preferred Stock and the exercise of stock options and warrants were not considered in the computation of diluted net loss attributable to common stockholders per common share because their effect is anti-dilutive.

For the year ended December 31, 2006, the Company reported net income, and accordingly considered the dilutive effect of stock options outstanding during the period. For purposes of the calculation of diluted earnings per share for the year ended December 31, 2006, an additional 2,020 shares were added to the denominator because they were dilutive for the period. Weighted average shares issuable upon the exercise of stock options that were not included in the calculation of diluted earnings per share were 203 for the year ended December 31, 2006. Such shares were not included because they were anti-dilutive.

Reclassifications

Reclassifications have been made to the December 31, 2005 balance sheet to provide further breakout of accrued liabilities and to aggregate certain non-current assets and liabilities on the face of the balance sheet. In addition, certain amounts have been reclassified among the accrued liability accounts disclosed in Note 4.

Recent Accounting Pronouncements

In May 2005, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standard No. 154, *Accounting Changes and Error Corrections—A Replacement of APB Opinion No. 20 and FASB Statement No. 3* (SFAS 154). The FASB issued SFAS 154 to provide guidance on the accounting for and reporting of error corrections. Unless otherwise impracticable, it establishes retrospective application as the required method for reporting a change in accounting principle in the absence of explicit transition requirements specific to the newly adopted accounting principle. SFAS 154 also provides guidance for determining whether retrospective application is impracticable and for reporting an accounting change when retrospective application is impracticable. Furthermore, this statement addresses the reporting of a correction of an error in previously issued financial statements by restating previously issued financial statements. SFAS 154 is effective for financial statements for fiscal years beginning after December 15, 2005. The Company has adopted SFAS 154 effective January 1, 2006, and the adoption of this statement did not have an impact on its consolidated financial statements.

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CBEYOND, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

In July 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes—An Interpretation of FASB Statement No. 109* (FIN 48). FIN 48 prescribes a recognition threshold and measurement attribute for financial statement recognition and measurement of a tax positions taken or expected to be taken in a tax return. In addition, it provides guidance on the measurement, derecognition, classification and disclosure of tax positions, as well as the accounting for related interest and penalties. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company is evaluating the effect of FIN 48 on its Financial Statements and has not determined the impact that the adoption will have on its results of operations, cash flows and financial position.

In June 2006, the Emerging Issues Task Force issued EITF Issue No. 06-03, *How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation)* (EITF 06-03). EITF 06-03 provides guidance regarding accounting for certain taxes assessed by a governmental authority that are imposed on and concurrent with specific revenue-producing transactions between a seller and a customer. These taxes and surcharges include, among others, universal service fund charges, sales, use, value added, and some excise taxes. The Company is currently evaluating the requirements of EITF 06-03 but does not believe the adoption will have a material effect on its consolidated financial statements.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, *Fair Value Measurement* (SFAS 157). This standard defines fair value, establishes a framework for measuring fair value in accounting principles generally accepted in the United States of America and expands disclosure about fair value measurements. This pronouncement applies to other accounting standards that require or permit fair value measurements. Accordingly, this statement does not require any new fair value measurement, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. This statement is effective for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company is currently evaluating the requirements of SFAS 157 and has not yet determined the impact that the adoption will have on its consolidated financial statements.

3. Property and Equipment

Property and equipment consist of:

		Year Ended December 31,	
	Useful Lives (In years)	2005	2006
Network and lab equipment	2–7	$101,172	$ 127,842
Leasehold improvements	3–10	4,461	7,057
Computers and software	2–5	32,119	39,448
Furniture and fixtures	7	2,382	2,915
Construction-in progress		2,839	4,676
		142,973	181,938
Less accumulated depreciation and amortization		(85,905)	(109,148)
Property and equipment, net		$ 57,068	$ 72,790

The amount depreciated under the capital lease was $326 during both 2005 and 2006.

Any future debt outstanding under the Company's line of credit with Bank of America will be collateralized by a pledge of substantially all of the assets of the Company.

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CBEYOND, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

4. Accrued Liabilities

	December 31	
	2005	2006
Accrued bonus	$ 4,058	$ 4,907
Accrued other compensation and benefits	874	1,159
Accrued sales taxes	2,595	3,722
Accrued other taxes	3,570	4,329
Accrued professional fees	1,204	1,168
Deferred rent	2,135	4,916
Deferred installation revenue	654	750
Other accrued expenses	2,007	2,134
Total Other Accrued Liabilities	$17,097	$23,085

5. Capitalization

Common Stock

In conjunction with the initial public offering, Cbeyond's certificate of incorporation was amended to authorize 50,000 shares of common stock. In November 2005, Cbeyond issued 6,132 shares of common stock in an initial public offering for $12.00 a share, and as more fully described below, issued 19,546 shares of common stock as a result of the conversion of preferred shares, including accumulated dividends. The proceeds from the offering were $65,006, net of underwriter commissions of $4,941 and expenses of $3,641. As of December 31, 2005, no shares were reserved for issuance under the Company's 2002 Stock Incentive Plan, and 2,110 shares were reserved for issuance under the Company's 2005 Stock Incentive Plan. Subsequent to the initial public offering and prior to December 31, 2005 all outstanding warrants were exercised in a cashless transaction resulting in the issuance of 716 common shares (see Note 6). Also in conjunction with the initial public offering, the Company effected a 1 for 3.88 reverse stock split. All share and per share amounts included in these financial statements and footnotes have been adjusted to reflect this split as if it were in effect for all periods presented. As of December 31, 2006, no shares were reserved for issuance under the Company's 2002 Stock Incentive Plan, and 1,259 shares were reserved for issuance under the Company's 2005 Stock Incentive Plan.

Preferred Stock

In November 2002, in connection with a corporate reorganization and pursuant to a stock purchase agreement, Cbeyond issued 12,398 shares of Series B preferred stock (Series B) for $3.88 per share; including 753 shares issued in conjunction with the cancellation of debt (see Note 6). In December 2004, Cbeyond amended its certificate of incorporation to authorize 15,206 shares of Series B and 1,546 shares of Series C preferred stock (Series C) and, pursuant to a stock purchase agreement with substantially all of the existing Series B preferred stockholders and certain other investors, Cbeyond issued 1,437 shares of Series C for $11.83 per share. Additionally, the Company issued 9 shares of Series B to an existing Series B preferred stockholder at $3.88 per share under the stockholders' prior stock purchase agreement.

Each share of the Series B and Series C (collectively, the "Preferred Stock") was convertible initially into one share of the Company's common stock. The conversion price per share of common stock was equal to the original price paid per share of Preferred Stock. All of the shares of Preferred Stock would automatically convert to common stock in the event of a public offering of the Company's common stock meeting certain conditions, subject to adjustment for dilutive events. In November 2005, The Company completed such a public offering. Accordingly, 12,407 and 1,570 issued and outstanding shares of Series B and Series C, respectively, were converted into common stock at the time of the transaction. The cumulative unpaid dividends of Series B and Series C were converted into 5,413 and 156 shares of common stock, respectively.

CBEYOND, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

The Preferred Stock was redeemable through the exercise of a put option upon the vote of a majority of the holders of the Preferred Stock beginning November 1, 2007 if there had not been either a sale of the Company or a qualified initial public offering of its common stock. If the put option was exercised, the repurchase price would have been the greater of (a) the Liquidation Value or (b) the fair market value per share of the Company as determined by provisions outlined in the Second Amended and Restated Shareholder Agreement. The Company classified its Preferred Stock outside of equity in accordance with EITF Topic D-98, *Classification and Measurement of Redeemable Securities* (Topic D-98), because the redemption provisions of the put option were not solely within the control of the Company, without regard to the probability of whether the redemption requirements would ever be triggered.

Topic D-98 establishes that the initial carrying value of the Preferred Stock should be the fair value at the date of issuance. Topic D-98 further provides that if the Preferred Stock is not redeemable currently and that it is not probable that the security will become redeemable, then subsequent adjustments to redemption value are not necessary until it is probable that the Preferred Stock will become redeemable. Accordingly, since inception, the Company determined that it is not probable that a qualified initial public offering of its stock would not be achieved before November 1, 2007. In making this determination, the Company assessed the likelihood of redemption based on the Preferred Stock redemption provisions and the specific facts and circumstances at each reporting period. The Company's business plan since inception was to expand into numerous major metropolitan markets replicating a similar operating model. Successful execution of this business model was predicated on obtaining significant funds through a public offering of its common stock within a reasonable period of time after inception.

The Preferred Stock accumulated dividends at an annual rate of 12% compounded daily on the Preferred Stock's liquidation value. The liquidation value of the Preferred Stock was equal to the original price paid per share of Preferred Stock plus cumulative unpaid dividends. As provided for in the Company's amended and restated certificate of incorporation, accumulated dividends of $22,845 accrued through the date of the public offering were paid in common stock in lieu of cash upon conversion of the Preferred Stock.

The holders of the Company's common stock and Preferred Stock voted as one class, with each share of Preferred Stock entitled to one vote for each share of common stock issuable upon conversion.

As of December 31, 2006, Cbeyond was authorized to issue up to 15,000 shares of Preferred Stock, of which there were no shares issued or outstanding.

The following table summarizes the Preferred Stock transactions during the period covered by these financial statements:

	Series B	Series C
Balance at December 31, 2003	$ 54,835	$ —
Issuance of preferred stock	35	16,882
Accretion of preferred dividends	7,072	11
Accretion of issuance costs	126	2
Balance at December 31, 2004	62,068	16,895
Adjustments to issuance costs	—	(24)
Accretion of preferred dividends	6,719	1,831
Accretion of issuance costs	107	42
Conversion to common stock	(68,894)	(18,744)
Balance at December 31, 2005 and 2006	$ —	$ —

CBEYOND, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

6. Debt

At December 31, 2005 and 2006, there was no long-term debt outstanding, as a result of the Company using proceeds from its initial public offering of common stock to pay off and cancel its credit facility with Cisco Capital (the "Credit Facility").

On February 8, 2006, the Company entered into a credit agreement with Bank of America that provides for a secured revolving line of credit for up to $25,000. The interest rates applicable to loans under the revolving line of credit are floating interest rates that, at the Company's option, will equal a LIBO rate or an alternate base rate plus, in each case, and applicable margin. The base rate is a fluctuating interest rate equal to the higher of (a) the prime rate of interest per annum publicly announced from time to time by Bank of America, as administrative agent, as its prime rate in effect at its principal office in New York City and (b) the overnight federal funds rate plus 0.50%. The interest periods of the Eurodollar loans shall be 1, 2, 3 or 6 months, at the Company's option. The applicable margins for LIBO rate loans are 2.25%, 2.50%, and 2.75% for loans drawn in aggregate up to $8,300, between $8,300 and $16,600, and between $16,600 and $25,000, respectively. The applicable margins for alternate base rate loans are 0.75%, 1.00%, and 1.25% for loans drawn in aggregate up to $8,300, between $8,300 and $16,600, and between $16,600 and $25,000, respectively. In addition, the Company is required to pay to Bank of America under the revolving line of credit a commitment fee for unused commitments at a per annum rate of 0.50%. The term of the facility is five years. In addition, the facility contains certain restrictive covenants, including restrictions on the payment of dividends.

The Company entered into the Credit Facility in 2001 to support the Company's entry into its first five markets. The Credit Facility was amended five times through March 2005 to accommodate new market expansions and changing economic conditions. After all amendments, the Credit Facility provided for borrowings of up to $105,400 through December 31, 2005, payable in quarterly installments through March 31, 2010. The Credit Facility was secured by substantially all of the assets and equity of the Company and restricted the payment of dividends. Borrowings under the facility bore interest at either a variable rate of LIBOR plus a margin of between 3.5% and 5.5%, depending on the Company's leverage ratio, or at a fixed rate that ranged from 6.85% to 8.85% during the time the loan was outstanding. The majority of borrowings available under the Credit Facility were restricted to purchases of network equipment and services.

In connection with amendments to the Credit Facility in November 2002, the Company issued warrants to Cisco Capital to acquire up to 720 shares of the Company's common stock at an exercise price of approximately $0.04 per share. The Company calculated a fair value for the warrants of $2,215 using a binomial valuation model with the following assumptions: volatility factor of 97.9%, fair value of common stock of $3.10, estimated life of the warrants of 7.4 years, and risk-free interest rate of 3.64%. These warrants, which were subject to vesting upon the occurrence of certain triggering events, became fully vested during 2005 and were exercised in 2005 subsequent to the initial public offering.

In addition, the Company amended the Credit Facility as part of a corporate reorganization in November 2002. In conjunction with this amendment, Cisco Capital cancelled $25,000 of the amount outstanding in exchange for 753 shares of Series B (Debt Exchange). As a result of the significant discount on the value of the Company's debt cancelled in the Debt Exchange, the Company accounted for the exchange as a troubled debt restructuring in accordance with SFAS No. 15 and EITF Issue No. 02-4, *Determining whether Debtor's Modification or Exchange of Debt Instruments is within the Scope of FASB Statement No. 15.* Under SFAS No. 15, a gain is recognized to the extent that the carrying amount of the debt before the restructuring, net of unamortized discounts and loan costs and other consideration exchanged as partial settlement, exceeds future contractual payments (principal and interest combined) of the restructured debt. Based on this calculation, the Company recorded a gain of $4,338 at the date of the restructuring. Projected future interest payments estimated

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

based on the interest rate in effect at the date of the restructuring, approximately 7.3%, were considered carrying value in excess of principal. As interest was paid in subsequent periods, payments were applied against the carrying value, resulting in no interest expense after the date of restructuring, except to the extent actual interest rates exceeded the interest rate in effect at the date of restructuring, which occurred during 2004 and totaled approximately $259 as an increase to interest expense. The effects of such fluctuations were recognized in the period the applicable interest rate changed, except that no gain was recorded until it could no longer be offset by future payments.

The table below illustrates the activity recognized from the date of the troubled debt restructuring through the final pay-off of the debt after the initial public offering.

Debt cancelled	$25,000
Less:	
Value of preferred stock exchanged	(2,902)
Warrants issued with restructure	(2,215)
Unamortized debt discount	(3,636)
Unamortized deferred financing costs written off	(393)
Restructuring transaction costs	(264)
Carrying value in excess of principal at restructure	15,590
Gain on restructuring of debt	(4,338)
Interest payments recorded as a reduction of carrying value in 2002	(449)
Carrying value in excess of principal as of December 31, 2002	10,803
Interest payments recorded as a reduction of carrying value in 2003	(2,578)
Carrying value in excess of principal as of December 31, 2003	8,225
Interest payments recorded as a reduction of carrying value in 2004	(2,281)
Carrying value in excess of principal as of December 31, 2004	5,944
Interest payments recorded as a reduction of carrying value in 2005	(1,618)
Write-off of net remaining carrying value in excess of principal upon early repayment of debt	(4,326)
Carrying value in excess of principal as of December 31, 2005	$ —

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

7. Income Taxes

The Company recorded income tax expense during the year ended December 31, 2006 due to being subject to federal alternative minimum tax (AMT) requirements.

The current and deferred income tax provisions were as follows for the years ended December 31, 2004, 2005 and 2006:

	2004	2005	2006
Current			
Federal	$ —	$ —	$ 430
State	—	—	—
Total current	—	—	430
Deferred			
Federal	(4,002)	6,097	5,064
State	(286)	436	207
Change in valuation allowance	4,288	(6,533)	(5,271)
Total deferred	$ —	$ —	$ —
Income tax provision	$ —	$ —	$ 430

The following table summarizes the significant differences between the U.S. federal statutory tax rate and the Company's effective tax rate for financial statement purposes for the years ended December 31, 2004, 2005 and 2006:

	2004	2005	2006
Federal income tax (benefit) provision at statutory rate	$(4,010)	$ 1,308	$ 2,874
State income taxes, net of federal benefit	(286)	93	117
Nondeductible expenses	8	147	123
Alternative minimum tax (AMT)	—	—	430
Adjustments to net operating loss carryforward	—	4,985	2,157
Change in valuation allowance	4,288	(6,533)	(5,271)
	$ —	$ —	$ 430

CBEYOND, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

The income tax effects of temporary differences between the carrying amounts of assets and liabilities in the financial statements and their respective income tax bases, which give rise to deferred tax assets and liabilities, as of December 31, 2005 and 2006 are as follows:

	2005	2006
Deferred tax assets:		
Net operating loss	$ 38,068	$ 29,641
Carrying value in excess of principal	831	—
Allowance for doubtful accounts	679	942
Impairment of investments	176	—
Accrued liabilities	2,421	5,327
Share-based compensation expense	—	1,848
Other	(118)	55
Gross deferred tax assets	42,057	37,813
Deferred tax liabilities:		
Property and equipment	3,284	2,822
Other	—	1,489
Gross deferred tax liabilities	3,284	4,311
Net deferred tax assets	38,773	33,502
Valuation allowance	(38,773)	(33,502)
Net deferred taxes	$ —	$ —

At December 31, 2006, the Company has federal net operating loss carryforwards of approximately $96,326 state net operating less carryforwards of $70,117, which begin expiring in 2020. The federal net operating loss carryforward consists of both regular net operating losses of $81,830 (with a corresponding deferred tax asset of $29,641) and net operating losses related to share-based compensation of $14,496. Utilization of existing net operating loss carryforwards may be limited in future years if significant ownership changes were to occur. The Company has recorded a valuation allowance equal to the net deferred tax assets at December 31, 2005 and 2006, due to the uncertainty of future taxable income.

The provision for income taxes during the year ended December 31, 2006 consisted of $430 of estimated alternative minimum tax (AMT) expected to be due at year-end, based on current annual book and taxable income. The AMT tax results from the ability to offset only 90% of AMT net operating losses against AMT taxable income. The AMT results in a credit that will be used to offset income taxes due in future periods, when and if the Company pays regular income tax.

Under FAS 123(R), the Company continues to follow the with-and-without approach and considers the impact of excess stock option deductions last when computing its income tax provision. The excess tax benefits are credited to additional paid-in-capital to the extent they are used to offset the AMT tax payable.

As of December 31, 2006, net operating loss carryforwards include tax deductions of approximately $14,496 resulting from the exercise of stock options. In accordance with FAS 123(R), any income tax benefit derived from these tax deductions is reflected as additional paid-in capital at the time we recognize any such income tax benefit. During 2006, the Company also recognized as tax expense approximately $290 of alternative minimum tax (AMT) that would have been payable had there been no stock option deductions. Actual stock option deductions incurred for income tax purposes results in an actual payment of AMT in the amount of $140. A "hypothetical" deferred income tax asset is created by the AMT expense incurred.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

8. Share-Based Compensation Plans

In November 2005, in connection with the Company's initial public offering, the Company adopted the Cbeyond Communications, Inc. 2005 Equity Incentive Plan (Incentive Plan). The Incentive Plan permits the grant of nonqualified stock options, incentive stock options, restricted stock and stock purchase rights. At December 31, 2006, the number of shares of common stock that may be issued pursuant to the Incentive Plan is 5,806, including 3,615 shares rolled over into the Incentive Plan from the 2002 Plan and the 2000 Plan. Substantially all of the options granted under the Incentive Plan following the 2005 initial public offering vest at a rate of 25% per year over four years, although the Board of Directors may occasionally approve a different vesting period. Options are granted at exercise prices not less than fair market value of the Company's common stock on the date of grant. The fair market value of the Company's common stock will be determined by the closing price of the Company's common stock on the NASDAQ Global Market on the grant date. Options expire 10 years after the grant date.

In November 2002, in connection with the Company's recapitalization, the Company adopted the Cbeyond Communications, Inc. 2002 Equity Incentive Plan (2002 Plan) and issued 1,621 and 295 options thereunder with respective vesting periods of two and three years. The 2002 Plan permits the grant of nonqualified stock options, incentive stock options and stock purchase rights. The number of shares of common stock that may be issued pursuant to the 2002 Plan is 3,608. Substantially all of the options granted under the 2002 Plan following the 2002 recapitalization vest at a rate of 25% per year over four years, although the Board of Directors may occasionally approve a different vesting period. Options issued under the 2002 Plan were generally granted at exercise prices equal to the estimated fair value of the Company's common stock on the date of grant. For each fiscal year since the 2002 recapitalization and prior to the Company's initial public offering in November 2005, the Company had determined the fair value of its common stock by using independent external valuation events such as arms-length transactions in the Company's shares, significant business milestones that may have affected the value of our business, and internal valuation estimates based on discounted cash flow analysis of the Company's financial results or other metrics, such as multiples of revenue and adjusted EBITDA. Options expire 10 years after the grant date.

In addition to the 2002 Plan, the Company also maintains a 2000 Stock Incentive Plan (2000 Plan), of which the number of shares of common stock that may be issued pursuant to the 2000 Plan is 7. All of the shares remaining for issuance under the 2002 Plan and the 2000 Plan were rolled into the Incentive Plan and no additional awards will be granted under either the 2002 Plan or the 2000 Plan. All awards granted under the 2002 Plan or 2000 Plan that expire without having been exercised or are cancelled, forfeited or repurchased will become available for grant under the Incentive Plan.

CBEYOND, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

A summary of the status of the Incentive Plan, the 2002 Plan and the 2000 Plan is presented in the table below:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (years)	Aggregate Intrinsic Value
Outstanding, December 31, 2003	2,664	3.90		
Granted	344	11.35		
Exercised	(8)	3.88		
Forfeited	(118)	4.11		
Outstanding, December 31, 2004	2,882	4.78		
Granted	971	11.87		
Exercised	(33)	3.92		
Forfeited	(177)	6.64		
Outstanding, December 31, 2005	3,643	$ 6.60		
Granted	1,072	15.27		
Exercised	(854)	4.79		
Forfeited and expired	(226)	12.52		
Outstanding, December 31, 2006	3,635	$ 9.20	7.51	$77,737
Vested and expected to vest, December 31,2006	3,498	$ 8.94	7.48	$75,719
Options exercisable, December 31, 2006	1,847	$ 5.39	6.37	$46,547

The weighted-average fair value of all options at grant date for options granted in 2004, 2005 and 2006 was $5.57, $11.87 and $9.45 per share, respectively. During 2006, the weighted average fair value of the 487 options that vested during the period was $5.55 per share, representing a total fair value of options vesting during the period of $2,703. The amount by which fair value of the stock exceeds an option's exercise price at the applicable grant date is amortized over the vesting period and recognized as non-cash stock option compensation in the consolidated statement of operations. The Company has 1,259 options available for future grant as of December 31, 2006.

The following table provides additional information based on the exercise prices of options outstanding at December 31, 2006:

Option Price	Options Outstanding	Options Exercisable	Contractual Life
$3.88	1,632	1,512	6.1
$11.00	593	20	9.1
$11.71	53	11	8.9
$11.83	575	144	8.1
$12.00	223	48	8.8
$12.03	184	96	7.6
$13.43	3	3	4.4
$18.28	72	0	9.6
$20.30	217	13	9.3
$30.36	83	0	9.8
Total	3,635	1,847	7.5

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Prior to January 1, 2006, the Company followed APB No. 25 and related Interpretations in accounting for its stock options. Under APB No. 25, if the exercise price of the Company's employee stock options equaled or exceeded the market value of the underlying stock on the date of the grant, no compensation expense was recognized. Effective January 1, 2006, the Company adopted the fair value recognition provisions of SFAS 123(R), under which the Company recognizes, as expense over the applicable service period the fair value of the options granted. Total share-based compensation expense recognized in 2006 totaled $4,355 under the new method, a reduction of $0.16 and $0.15, respectively, in basic and diluted earnings per share. Additionally, the adoption increased cash flows from financing activities and decreased cash flows from operating activities by $290 relating to excess tax benefits from the exercise of stock options.

The fair value of options was estimated at the date of grant using a binomial option-pricing model with the following weighted-average assumptions:

	Year ended December 31,		
	2004	2005	2006
Risk-free interest rate	3.4%	3.9%	4.6%
Expected dividend yield	0.0%	0.0%	0.0%
Expected volatility	53.7%	55.3%	63.0%
Suboptimal exercise barrier	2.31	2.44	2.96

The Company accounts for equity instruments issued to non-employees in accordance with the provisions of SFAS No. 123 and EITF Issue No. 96-18, *Accounting for Equity Instruments that are Issued to Other Than Employees for Acquiring, or in Conjunction with, Selling Goods or Services.* All transactions in which goods or services are the consideration received for the issuance of equity instruments are accounted for based on the fair value of the equity instrument issued, which the Company deems more reliably measurable than the fair value of the consideration received. The measurement date of the fair value of the equity instrument issued is the earlier of the date on which the counterparty's performance, or obligation to perform, is complete or the date on which it is probable that performance will occur. During 2004 and 2005, respectively, the Company issued 13 and 3 common stock options to vendors for services. In 2004 and 2005, respectively, these options were valued at $78 and $16. The Company recognized $13, $38 and $22 in selling, general and administrative expenses for the years ended December 31, 2004, 2005 and 2006, respectively.

Management evaluates the appropriateness of its underlying assumptions each time it estimates the fair value of equity instruments requiring measurement under SFAS 123(R). To assist management in validating its assumptions, the Company periodically engages consultants, as it did in 2006, with relevant experience to assess and evaluate its assumptions.

The risk-free interest rate used in estimating the fair value of options is based on the U.S. Treasury zero-coupon securities using the contractual term of the option. The Company also uses historical data, stratified into employee groups that exhibit similar behavior, to estimate the term that options are expected to be outstanding and the forfeiture rate of options granted. Through the first quarter of 2006, the Company stratified employees into four groups for these purposes. Beginning in the second quarter of 2006, the Company reduced its stratification to two employee groups because three of the previously stratified employee groups did not exhibit substantially different behavior over time and, accordingly, yield similar valuations. Because Cbeyond is a recently public company and does not have its own volatility history to rely upon, expected volatility is based on historical volatilities experienced by companies considered representative of Cbeyond based on four primary categories: size, stage of lifecycle, capital structure and industry. This approach to estimating volatility has remained consistent over time, although the mix and weighting of representative volatilities has been refined periodically to ensure that the four primary categories are appropriately considered. Through the first quarter of

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

2006, the Company included certain indices, including a small cap index and a telecom index, as part of the representative group. Effective in the second quarter of 2006, the Company refined its representative group and included only individual stocks in its volatility analysis. In reviewing the modifications to the development of its underlying valuation assumptions, the Company considered whether applying the refined assumptions would have had a material impact on recent valuations performed using the previous assumptions, noting that the effect on compensation expenses would not have resulted in a materially different amount.

Options with graded vesting are valued as multiple awards and expensed on a straight line basis over the vesting period. The amount of compensation cost recognized at any date is at least equal to the portion of the grant date value of the award that is vested at that date. During the twelve months ended December 31, 2005 and 2006, the Company issued 34 and 854 shares of common stock, respectively, resulting from the exercise of stock options. The total intrinsic value of options exercised during the twelve months ended December 31, 2005 and 2006 based on market value at the exercise dates is set forth in the table below. As of December 31, 2006, unrecognized compensation cost related to unvested stock option awards totals approximately $11,622 and is expected to be recognized over a weighted-average period of 1.87 years. Additional information pertaining to option exercises in 2004, 2005 and 2006 is as follows:

	December 31		
	2004	2005	2006
Total intrinsic value of options exercised	$ 47	$ 337	$14,594
Total cash received for option exercises	$ 30	$ 130	$ 4,093

9. Commitments

The Company has entered into various operating and capital leases, with expirations through 2016, for network facilities, office space, equipment, and software used in its operations. Future minimum lease obligations under non-cancelable operating leases and maturities of capital lease obligations as of December 31, 2006 are as follows:

	Operating	Capital
2007	$ 4,375	$ 100
2008	4,933	—
2009	5,015	—
2010	5,037	—
2011	4,962	—
Thereafter		—
	16,903	
	$41,225	100
Less amounts representing interest		(2)
Present value of minimum lease payments		98
Less current portion		98
Obligations under capital leases—net of current portion		$ —

Total rent expense for the years ended December 31, 2004, 2005 and 2006 was $2,218, $2,766 and $3,360, respectively. Certain real estate leases have fixed escalation clauses, holidays, and leasehold improvement allowances. Such allowances were $887 and $1,775 in 2005 and 2006, respectively, and are depreciated over the shorter of their useful lives or the lease term. Expense under such operating leases is recorded on a straight-line

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CBEYOND, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

basis over the life of the lease. Our lease agreements also generally have lease renewal options that are at our discretion and range in terms.

The net book value of the software under capital leases at December 31, 2004, 2005 and 2006 was $870, $544 and $218, respectively. The Company applies its incremental borrowing rate in effect at the time a capital lease is initiated to determine the present value of the future minimum lease payments.

At December 31, 2006, the Company had outstanding letters of credit of $1,020. These letters of credit expire at various times through August 2007 and collateralize the Company's obligations to third parties for leased space. The fair value of these letters of credit approximates contract values.

10. Employee Benefit Plan

The Company has a 401(k) Profit Sharing Plan (the Plan) for the benefit of eligible employees and their beneficiaries. All employees are eligible to participate in the Plan on the first day of the following quarter of the Plan year following the date of hire provided they have reached the age of 18. The Plan provides for an employee deferral up to the dollar limit that is set by law. As of the year ended December 31, 2006, the Plan did not provide for a matching contribution by the employer.

Effective January 1, 2007, for all 401(k) plan participants, there will be a Company match of 50% of up to 3% of eligible compensation as well as a company discretionary contribution of 1.5% of eligible compensation. Eligible compensation includes base salary and any commissions. Both the match and discretionary contribution will be made in Cbeyond stock.

11. Selected Quarterly Financial Data (unaudited)

Unaudited Interim Results

The accompanying unaudited interim condensed consolidated financial statements and information have been prepared in accordance with accounting principles generally accepted in the United States and in accordance with the instructions for Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and disclosures required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, these financial statements contain all normal and recurring adjustments considered necessary to present fairly the financial position, results of operations and cash flows for the periods presented.

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
2005				
Revenue	$35,176	$38,182	$41,403	$44,336
Gross profit (exclusive of depreciation and amortization)	24,732	26,802	29,408	30,994
Operating income (loss)	(1,117)	(289)	1,380	1,349
Depreciation and amortization expense	5,674	5,978	6,097	6,411
Gain from write-off of carrying value in excess of principal	—	—	—	4,060
Income (loss) before income taxes	$(1,576)	$ (932)	$ 928	$ 5,316
Net income (loss)	$(1,576)	$ (932)	$ 928	$ 5,316
Net income (loss) attributable to common stockholders	$(3,961)	$(3,417)	$(1,660)	$ 4,224
Net loss attributable to common stockholders per common share—basic	$(28.63)	$(21.96)	$(10.06)	$ 0.26
Net loss attributable to common stockholders per common share—diluted	$(28.63)	$(21.96)	$(10.06)	$ 0.20

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CBEYOND, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
2006				
Revenue	$47,578	$52,534	$54,907	$58,867
Gross profit (exclusive of depreciation and amortization)	32,580	36,281	38,447	42,284
Operating income (loss)	(174)	1,265	1,931	4,021
Depreciation and amortization expense	6,577	6,864	6,937	6,818
Income before income taxes	$ 51	$ 1,500	$ 2,143	$ 4,516
Net income	$ 20	$ 1,406	$ 2,005	$ 4,349
Net income attributable to common stockholders	$ 20	$ 1,406	$ 2,005	$ 4,349
Net income attributable to common stockholders per common share—basic	$ —	$ 0.05	$ 0.07	$ 0.16
Net income attributable to common stockholders per common share—diluted	$ —	$ 0.05	$ 0.07	$ 0.15

12. Segment Information

The Company's management monitors and analyzes financial results on a segment basis for reporting and management purposes. Specifically, the Company's chief operating decision maker allocates resources to and evaluates the performance of its segments based, depending on which segment, on revenue, direct operating expenses, and certain non-GAAP financial measures. The accounting policies of the Company's reportable segments are the same as those described in the summary of significant accounting policies.

At December 31, 2006, the operating segments were geographic and included Atlanta, Dallas, Denver, Houston, Chicago and Los Angeles. The newest market, San Diego, was launched in January 2007 and incurred costs in 2006 related to this launch. Although San Diego is not operating as of December 31, 2006, the costs incurred in preparing for its launch are disclosed as a separate segment. The balance of the Company's operations is in its Corporate group, for which the operations consist of corporate executive, administrative and support functions and centralized operations, which includes network operations, customer care and provisioning. The Corporate group is treated as a separate segment consistent with the manner in which management monitors and analyzes financial results.

Corporate costs are not allocated to the other segments because such costs are managed and controlled on a centralized, functional basis that spans all markets, with centralized, functional management held accountable for Corporate results. Management also believes that the decision not to allocate these centralized costs provides a better evaluation of each revenue-producing geographic segment. Management does not report assets by segment sine it manages assets and makes decisions on technology deployment and other investments on a company-wide rather than on a local market basis. The chief operating decision maker does not use segment assets in evaluating the performance of operating segments. As a result, management does not believe that segment asset disclosure is meaningful information to investors. In addition to segment results, the Company uses total adjusted EBITDA to assess the operating performance of the overall business. Because the chief operating decision maker primarily evaluates the performance of each segment on the basis of adjusted EBITDA, management believes that segment adjusted EBITDA data should be available to investors so that investors have the same data that management employs in assessing the Company's overall operations. The chief operating decision maker also uses revenue to measure operating results and assess performance, and both revenue and adjusted EBITDA are presented herein in accordance with SFAS NO. 131, *Disclosures about Segments of an Enterprise and Related Information.*

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CBEYOND, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

The table below presents information about the Company's reportable segments:

	Year Ended December 31,		
	2004	2005	2006
Revenue:			
Atlanta	$ 42,236	$ 53,719	$ 63,529
Dallas	33,129	42,277	51,335
Denver	35,051	47,916	58,531
Houston	2,895	13,051	26,382
Chicago	—	2,134	12,281
Los Angeles	—	—	1,828
Total revenue	$113,311	$159,097	$213,886
Adjusted EBITDA:			
Atlanta	$ 24,986	$ 30,174	$ 37,881
Dallas	12,353	18,561	24,008
Denver	17,750	24,954	31,835
Houston	(3,954)	1,377	8,676
Chicago	(565)	(5,470)	(1,411)
Los Angeles	—	(382)	(5,624)
San Diego	—	—	(630)
Corporate	(33,768)	(43,407)	(55,196)
Total Adjusted EBITDA	$ 16,802	$ 25,807	$ 39,539
Operating income (loss):			
Atlanta	$ 18,922	$ 24,255	$ 32,808
Dallas	7,281	13,374	18,934
Denver	13,404	19,773	26,985
Houston	(4,658)	(285)	5,974
Chicago	(568)	(6,090)	(2,913)
Los Angeles	—	(382)	(6,254)
San Diego	—	—	(631)
Corporate	(41,704)	(49,322)	(67,860)
Total operating income (loss)	$ (7,323)	$ 1,323	$ 7,043

CBEYOND, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

	Year Ended December 31,		
	2004	2005	2006
Depreciation and amortization expense:			
Atlanta	$ 6,064	$ 5,919	$ 5,073
Dallas	5,072	5,187	5,074
Denver	4,346	5,181	4,850
Houston	703	1,662	2,702
Chicago	3	620	1,502
Los Angeles	—	—	630
San Diego	—	—	1
Corporate	6,459	5,591	7,364
Total depreciation and amortization	$ 22,647	$ 24,160	$ 27,196
Capital expenditures:			
Atlanta	$ 2,742	$ 4,946	$ 5,669
Dallas	2,870	3,976	6,923
Denver	3,903	3,838	4,961
Houston	4,041	4,039	3,587
Chicago	2,325	3,256	2,843
Los Angeles	—	2,131	3,444
San Diego	—	—	1,561
Corporate	7,860	7,580	14,879
Total capital expenditures	$ 23,741	$ 29,766	$ 43,867
Reconciliation of Adjusted EBITDA to Net income (loss):			
Total Adjusted EBITDA for reportable segments	$ 16,802	$ 25,807	$ 39,539
Depreciation and amortization	(22,647)	(24,160)	(27,196)
Non-cash share-based compensation	(375)	(324)	(4,355)
Public offering expenses	(1,103)	—	(945)
Interest income	637	1,325	1,919
Interest expense	(2,788)	(2,424)	(163)
Gain from write-off of carrying value of debt in excess of principal	—	4,060	—
Loss on disposal of property and equipment	(1,746)	(539)	(601)
Other income (expense), net	(236)	(9)	12
Income (loss) before income taxes	(11,456)	3,736	8,210
Income tax expense	—	—	(430)
Net income (loss)	$(11,456)	$ 3,736	$ 7,780

13. Public Offering Costs

In 2004, the Company began work in connection with an initial public offering of common stock. In connection with the proposed offering, the Company incurred legal and accounting fees of approximately $1,103. Although such transaction costs are typically deferred and deducted from the proceeds of the offering as a charge against additional paid-in capital, due to the length of time that transpired after these costs were incurred and other considerations, management determined it was appropriate to expense such costs. In early 2005, the Company began incurring additional costs associated with its initial public offering which was completed in November 2005. The costs associated with the November 2005 public offering, excluding the underwriting discount, totaled $3,641 and were offset against the proceeds of the offering.

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CBEYOND, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

In October 2006, the Company completed a secondary public offering of 4,907 shares of common stock, including 201 shares that were issued by the Company in connection with option exercises executed at the time of the offering. All offered shares were from existing stockholders with no proceeds to the Company. All direct costs of this offering, which were primarily legal and accounting fees with outside service firms related to the preparation of the registration statement, were expensed as incurred and totaled $945.

14. Contingencies

Triennial Review Remand Order

In February 2005, the Federal Communications Commission (the "FCC") issued its Triennial Review Remand Order (the "TRRO") and adopted new rules, effective March 11, 2005, governing the obligations of incumbent local exchange carriers (ILECs) to afford access to certain of their network elements, if at all, and the cost of such facilities. The TRRO reduces the ILECs' obligations to provide high-capacity loops within, and dedicated transport facilities between, certain ILEC wire centers that are deemed to be sufficiently competitive, based upon various factors such as the number of fiber-based colocators and/or the number of business access lines within such wire centers. In addition, certain caps are imposed regarding the number of UNE facilities that the ILECs are required to make available on a single route or into a single building. Where the wire center conditions or the caps are exceeded, the TRRO eliminated the ILECs' obligations to provide these high-capacity circuits to competitors at the discounted rates historically received under the 1996 Telecommunications Act.

The rates charged by ILECs for the Company's high-capacity circuits in place on March 11, 2005 that were affected by the FCC's new rules were increased 15% effective for one year until March 2006. In addition, by March 10, 2006, the Company was required to transition those existing facilities to alternative arrangements, such as other competitive facilities or the higher-priced "special access services" offered by the ILECs, unless another rate had been negotiated. Subject to any contractual protections under the Company's existing interconnection agreements with ILECs, beginning March 11, 2005, the Company was also potentially subject to the ILECs' higher "special access" pricing for any new installations of DS-1 loops and/or DS-1 and DS-3 transport facilities in the affected ILEC wire centers, on the affected transport routes or that exceeded the caps.

The Company estimated the probable liability for implementation of certain provisions of the TRRO and accrued approximately $1,892 as of December 31, 2005 for these liabilities, which were charged to cost of service in the year ended December 31, 2005. The estimate includes $1,553 for the total cost impact related to wire centers and transport routes deemed sufficiently competitive. For costs associated with the caps imposed on the number of circuits that the Company may have on a single route or into a single building, approximately $339 is reflected in the results of operations through December 31, 2005.

The Company estimated the probable liability for implementation of certain provisions of the TRRO and has accrued approximately $4,400 as of December 31, 2006 for these increased costs, $2,507 of which was charged to cost of service in the year ended December 31, 2006. This cumulative estimate includes $3,701 for the total cost impact related to wire centers and transport routes determined to be sufficiently competitive to be subject to the FCC's new rules, of which $2,148 is reflected in cost of service through December 31, 2006. This cumulative estimate also includes $699 for costs associated with the caps imposed on the number of circuits that the Company may have on a single route or into a single building, of which approximately $360 is reflected in cost of service through December 31, 2006. This estimate is for all markets and, where alternate pricing agreements have not been reached, is based on special access rates available under volume and/or term pricing plans. The Company believes volume and/or term pricing plans are the most probable pricing regime to which we are subject to based on our experience and our intent to enter into volume and/or term commitments where more attractively priced alternatives do not exist.

During October 2006, the Company amended its interconnection agreement for the Atlanta market. This agreement established the pricing in effect from March 11, 2005 through March 10, 2006 for certain circuits

CBEYOND, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

added subsequent to March 11, 2005. The agreed upon pricing was lower than the special access rates previously accrued, resulting in a reduction of the accrual and expense of $304, $216 of which relates to 2005. This change in estimate is reflected in the results of operations for year ended December 31, 2006.

Georgia Regulatory Ruling

In February 2006, the Georgia Public Service Commission (the "PSC") ordered a rate increase for the lease of unbundled network elements provided by BellSouth. The increased rates are applicable both prospectively and retroactively to June 2003. The Company estimated and accrued approximately $1,471 through December 31, 2005 for the cumulative impact of this action, which was charged to cost of service in the fourth quarter of 2005. Prior to the PSC staff recommendation, there was insufficient information as to whether the outcome of this matter would result in a change in pricing and whether such change in pricing, if any, would be applied retroactively or prospectively.

During the year ended December 31, 2006, the Company accrued an additional $982 relating to the new pricing, resulting in a total accrual of $2,453 as of December 31, 2006. Although the Company continues to negotiate the final settlement of the retroactive payment due, the recorded accrual represents management's best estimate of the ultimate settlement of this matter.

General Regulatory Contingencies

The Company operates in a highly regulated industry and is subject to regulation and oversight by telecommunications authorities at the federal, state and local levels. Decisions made by these agencies, including the various rulings made to date regarding interpretation and implementation of the TRRO, compliance with various federal and state rules and regulations and other administrative decisions are frequently challenged through both the regulatory process and through the court system. Challenges of this nature often are not resolved for long periods of time and occasionally include retroactive impacts, such as the PSC ruling discussed above. At any point in time, there are a number of similar matters before the various regulatory agencies that could be either beneficial or adverse to the Company's results of operations. In addition, the Company is always at risk of non-compliance, which can result in fines and assessments. The Company regularly evaluates the potential impact of matters undergoing challenges and matters involving compliance with regulations to determine whether sufficient information exists to require either disclosure and/or accrual in accordance with Statement of Financial Accounting Standard No. 5, *Accounting for Contingencies*. However, due to the nature of the regulatory environment, reasonably estimating the range of possible outcomes and the probabilities of the possible outcomes is difficult since many matters could range from a gain contingency to a loss contingency.

Dissolution of Captive Leasing Entities

Effective December 31, 2006, the Company dissolved and collapsed its captive leasing companies. These entities, historically, purchased assets tax-free and leased the assets to the operating companies as a means of preserving cash flow in the Company's start-up phase of operations. During 2006, management determined that the nature of the Company's operations and experience with asset duration did not justify the administrative cost and effort of maintaining these entities. In connection with the collapse, a final accounting of all activity under the leasing entities was performed and reconciled back to historical sales tax filings. Certain underpayments were identified that resulted in the recognition of approximately $128 in penalties and interest in selling, general and administrative costs during the fourth quarter of 2006. This amount represents management's best estimate of what it believes it will have to pay in connection with finalizing all sales tax returns for the leasing entities. There are certain scenarios that are reasonably possible where a taxing authority could calculate penalties and interest in excess of the amounts accrued by the Company. In accordance with FAS 5, the additional interest and penalties could range from zero to $392.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

15. Related Party Transactions

Cbeyond has had a close relationship with Cisco Systems, Inc. and its financing subsidiary, Cisco Systems Capital (collectively, Cisco). Cisco has been and continues to be one of the Company's major equipment suppliers. In addition, one of its executives is on the Company's Board of Directors and Audit Committee. All transactions with Cisco are carried out on an arm's-length basis.

Cisco was also the Company's principal lender until shortly after the Company's initial public offering when Cbeyond repaid all outstanding borrowings and cancelled its credit facility. In connection with transactions under the credit arrangement, Cisco became a significant shareholder of the Company.

During the year ended December 31, 2006, the Company purchased approximately $18,700 of equipment and services from Cisco. As of December 31, 2006, the Company's outstanding accounts payable to Cisco totaled approximately $1,300.

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Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosures

None.

Item 9A. Controls and Procedures

Disclosure Controls and Procedures

Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we have evaluated the effectiveness of our disclosure controls and procedures pursuant to Exchange Act Rule 13a-15(b) as of the end of the period covered by this report. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that these disclosure controls and procedures are effective.

Management's Annual Report On Internal Control Over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting for the Company. With the participation of our Chief Executive Officer and Chief Financial Officer, management conducted an evaluation of the effectiveness of our internal control over financial reporting as of December 31, 2006 based on the Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this evaluation, management concluded that our internal control over financial reporting was effective as of December 31, 2006. There were no changes in our internal control over financial reporting during the quarter ended December 31, 2006 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Our independent registered public accounting firm, Ernst & Young LLP, has issued an audit report on management's assessment of our internal control over financial reporting, which appears in Item 8 of this report.

Item 9B. Other Information

None.