NEUSTAR INC
Form 10-Q
October 30, 2009

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

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

For the quarterly period ended September 30, 2009

OR

o **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 001-32548

NeuStar, Inc.

(Exact name of registrant as specified in its charter)

Delaware	**52-2141938**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

46000 Center Oak Plaza
Sterling, Virginia 20166
(Address of principal executive offices) (zip code)
(571) 434-5400
(Registrant s telephone number, including area code)

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 þ No o

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

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

Large accelerated filer þ	Accelerated filer o	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

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

There were 74,363,152 shares of Class A common stock, $0.001 par value, and 4,538 shares of Class B common stock, $0.001 par value, outstanding at October 27, 2009.

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PART I FINANCIAL INFORMATION
Item 1. Financial Statements

NEUSTAR, INC.
CONSOLIDATED BALANCE SHEETS
(in thousands, except share and per share data)

	December 31, 2008	September 30, 2009 (unaudited)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 150,829	$ 262,614
Restricted cash	496	498
Short-term investments	10,824	40,614
Accounts receivable, net of allowance for doubtful accounts of $1,209 and $1,402 respectively	71,805	63,016
Unbilled receivables	830	1,310
Notes receivable	759	
Prepaid expenses and other current assets	8,928	10,657
Deferred costs	8,518	7,467
Income taxes receivable	4,621	3,445
Deferred tax assets	11,079	8,542
Total current assets	268,689	398,163
Investments, long-term	40,506	
Property and equipment, net	64,160	67,203
Goodwill	118,067	118,417
Intangible assets, net	16,594	10,523
Deferred costs, long-term	3,333	1,672
Deferred tax assets, long-term	4,244	3,556
Other assets	3,573	4,390
Total assets	$ 519,166	$ 603,924

See accompanying notes.

NEUSTAR, INC.
CONSOLIDATED BALANCE SHEETS
(in thousands, except share and per share data)

	December 31, 2008	September 30, 2009 (unaudited)
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 6,901	$ 5,960
Accrued expenses	52,202	51,039
Deferred revenue	32,530	35,659
Notes payable	2,587	1,777
Capital lease obligations	7,536	9,470
Accrued restructuring reserve	1,867	2,300
Other liabilities	430	3,891
Total current liabilities	104,053	110,096
Deferred revenue, long-term	11,657	9,036
Notes payable, long-term	1,777	
Capital lease obligations, long-term	10,156	6,959
Accrued restructuring reserve, long-term	1,589	1,099
Other liabilities, long-term	3,281	4,215
Total liabilities	132,513	131,405
Commitments and contingencies		
Stockholders equity:		
Preferred stock, $0.001 par value; 100,000,000 shares authorized; no shares issued and outstanding as of December 31, 2008 and September 30, 2009		
Class A common stock, par value $0.001; 200,000,000 shares authorized; 78,925,222 and 79,319,294 shares issued and outstanding at December 31, 2008 and September 30, 2009, respectively	79	79
Class B common stock, par value $0.001; 100,000,000 shares authorized; 4,538 shares issued and outstanding at December 31, 2008 and September 30, 2009, respectively		
Additional paid-in capital	321,528	333,601
Treasury stock, 4,949,771 and 4,961,249 shares at December 31, 2008 and September 30, 2009, respectively, at cost	(128,403)	(128,598)
Accumulated other comprehensive loss	(879)	(229)
Retained earnings	194,328	267,666
Total stockholders equity	386,653	472,519
Total liabilities and stockholders equity	$ 519,166	$ 603,924

See accompanying notes.

NEUSTAR, INC.
UNAUDITED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)

	Three Months Ended September 30, 2008	Three Months Ended September 30, 2009	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2009
Revenue:				
Addressing	$ 32,470	$ 32,139	$ 94,899	$ 96,157
Interoperability	16,237	13,926	49,228	42,122
Infrastructure and other	75,103	71,138	217,305	207,876
Total revenue	123,810	117,203	361,432	346,155
Operating expense:				
Cost of revenue (excluding depreciation and amortization shown separately below)	27,683	26,629	78,983	82,808
Sales and marketing	17,865	20,447	56,808	59,193
Research and development	7,140	3,948	22,442	12,775
General and administrative	15,407	13,472	47,040	41,274
Depreciation and amortization	10,552	9,538	30,958	28,115
Restructuring charges		2,733		2,733
Impairment of goodwill			29,021	
	78,647	76,767	265,252	226,898
Income from operations	45,163	40,436	96,180	119,257
Other (expense) income:				
Interest and other expense	(1,110)	(2,596)	(4,434)	(4,669)
Interest and other income	359	2,747	3,200	6,352
Income before income taxes	44,412	40,587	94,946	120,940
Provision for income taxes	16,038	16,068	48,176	47,602
Net income	$ 28,374	$ 24,519	$ 46,770	$ 73,338
Net income per common share:				
Basic	$ 0.38	$ 0.33	$ 0.63	$ 0.99
Diluted	$ 0.38	$ 0.32	$ 0.61	$ 0.97
Weighted average common shares outstanding:				
Basic	73,859	74,356	74,509	74,269
Diluted	75,259	75,594	76,548	75,409

See accompanying notes.

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NEUSTAR, INC.
UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2009
Operating activities:		
Net income	$ 46,770	$ 73,338
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	30,958	28,115
Stock-based compensation	13,339	10,123
Amortization of deferred financing costs	129	127
Excess tax benefits from stock-based compensation	(2,291)	(492)
Deferred income taxes	(560)	3,191
Impairment of goodwill	29,021	
Provision for doubtful accounts	1,906	1,965
Other-than-temporary loss on available-for-sale investments	2,637	
Gain on available-for-sale investments and trading securities		(3,055)
Loss on auction rate securities rights		1,771
Changes in operating assets and liabilities, net of acquisitions:		
Accounts receivable	9,242	5,884
Unbilled receivables	(1,531)	(480)
Notes receivable	1,603	759
Prepaid expenses and other current assets	(1,653)	(1,729)
Deferred costs	(377)	2,712
Income taxes receivable		1,668
Other assets	919	(633)
Other liabilities	(864)	4,395
Accounts payable and accrued expenses	(4,156)	(1,164)
Income taxes payable	(774)	
Accrued restructuring reserve	(308)	(57)
Deferred revenue	(5,674)	508
Net cash provided by operating activities	118,336	126,946
Investing activities:		
Purchases of property and equipment	(18,528)	(18,921)
Sales of investments, net	40,380	12,154
Business acquired, net of cash	(13,762)	(350)
Net cash provided by (used in) investing activities	8,090	(7,117)
Financing activities:		
Disbursement of restricted cash	(55)	(2)
Principal repayments on notes payable	(2,501)	(2,587)
Principal repayments on capital lease obligations	(3,670)	(7,429)
Proceeds from exercise of common stock options	6,018	1,458
Excess tax benefits from stock-based compensation	2,291	492

Repurchase of restricted stock awards	(192)	(195)
Repurchase of common stock	(124,855)	
Net cash used in financing activities	(122,964)	(8,263)
Effect of foreign exchange rates on cash and cash equivalents	533	219
Net increase in cash and cash equivalents	3,995	111,785
Cash and cash equivalents at beginning of period	98,630	150,829
Cash and cash equivalents at end of period	$ 102,625	$ 262,614

See accompanying notes.

NEUSTAR, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2008 AND 2009

1. DESCRIPTION OF BUSINESS AND ORGANIZATION

NeuStar, Inc. (the Company or Neustar) was incorporated as a Delaware corporation in 1998. The Company provides essential clearinghouse services to the communications industry and enterprise customers. Its customers use the databases the Company contractually maintains in its clearinghouse to obtain data required to successfully route telephone calls in North America, to exchange information with other communications service providers (CSPs) and to manage technological changes in their own networks. The Company operates the authoritative directories that manage virtually all telephone area codes and numbers, and it enables the dynamic routing of calls among thousands of competing CSPs, in the United States and Canada. All CSPs that offer telecommunications services to the public at large, or telecommunications service providers, must access the Company s clearinghouse to properly route virtually all of their customers calls. The Company also provides clearinghouse services to emerging CSPs, including Internet service providers, mobile network operators, cable television operators, and voice over Internet protocol, or VoIP, service providers. In addition, the Company provides domain name services, including internal and external managed DNS solutions that play a key role in directing and managing traffic on the Internet, and it also manages the authoritative directories for the .us and ..biz Internet domains. The Company operates the authoritative directory for U.S. Common Short Codes, which is part of the short messaging service relied upon by the U.S. wireless industry, and provides solutions used by mobile network operators throughout Europe and Asia to enable mobile instant messaging for their end users.

The Company was founded to meet the technical and operational challenges of the communications industry when the U.S. government mandated local number portability in 1996. While the Company remains the provider of the authoritative solution that the communications industry relies upon to meet this mandate, the Company has developed a broad range of innovative services to meet an expanded range of customer needs. The Company provides critical technology services that solve the addressing, interoperability and infrastructure needs of CSPs and enterprises. These services are now used by CSPs and enterprises to manage a range of their technical and operating requirements, including:

Addressing. The Company enables CSPs and enterprises to use critical, shared addressing resources, such as telephone numbers, Internet top-level domain names, and U.S. Common Short Codes.

Interoperability. The Company enables CSPs to exchange and share critical operating data so that communications originating on one provider s network can be delivered and received on the network of another CSP. The Company also facilitates order management and work flow processing among CSPs.

Infrastructure and Other. The Company enables CSPs to more efficiently manage their networks by centrally managing certain critical data they use to route communications over their own networks.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Unaudited Interim Financial Information

The accompanying unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required by U.S. generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included. The results of operations for the nine months ended September 30, 2009 are not necessarily indicative of the results that may be expected for the full fiscal year. The consolidated balance sheet as of December 31, 2008 has been derived from the audited consolidated financial statements at that date, but does not include all of the information and notes required by U.S. generally accepted accounting principles for complete financial statements. These consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes included in the Company s Annual Report on Form 10-K for the year ended December 31, 2008 filed with the

Securities and Exchange Commission (SEC).

In connection with preparation of the consolidated financial statements and in accordance with the Subsequent Events Topic of the Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC), the Company evaluated subsequent events after the balance sheet date of September 30, 2009 through October 30, 2009, the issuance date of these unaudited interim financial statements.

NEUSTAR, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Reclassification

Certain prior period amounts have been reclassified to conform to current period presentation.

Use of Estimates

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expense during the reporting periods. Significant estimates and assumptions are inherent in the analysis and the measurement of deferred tax assets; the identification and quantification of income tax liabilities due to uncertain tax positions; restructuring liabilities; valuation of investments; recoverability of intangible assets, other long-lived assets and goodwill; and the determination of the allowance for doubtful accounts. The Company bases its estimates on historical experience and assumptions that it believes are reasonable. Actual results could differ from those estimates.

Fair Value of Financial Instruments

The FASB ASC Topic Financial Instruments requires disclosures of fair value information about financial instruments, whether or not recognized in the balance sheet, for which it is practicable to estimate that value. Due to their short-term nature, the carrying amounts reported in the consolidated financial statements approximate the fair value for cash and cash equivalents, accounts receivable, accounts payable and accrued expenses. As of December 31, 2008, the Company believes the carrying amount of its long-term debt approximates its fair value because the fixed and variable interest rates of the debt approximate a market rate. The Company s long-term debt balance as of September 30, 2009 is zero. The fair value of the Company s cash reserve fund included in short-term investments was primarily determined using pricing models that utilized recent trades for securities in active markets, dealer quotes for those securities considered to be inactive, and assumptions surrounding contractual terms, maturity and liquidity (see Note 4). The Company determined the fair value of its auction rate securities using an average of discounted cash flow models (see Note 4). The Company has rights to sell its auction rate securities at par beginning June 30, 2010, to the investment firm that brokered the original purchases (the auction rate securities rights). The fair value of the Company s auction rate securities rights is based on the estimated discounted cash flow of the associated auction rate securities (see Note 4). As permitted under the FASB ASC Topic Financial Instruments, the Company elected fair value measurement for the auction rate securities rights.

The estimated fair values of the Company s financial instruments are as follows (in thousands):

	December 31, 2008		September 30, 2009 (unaudited)	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Cash and cash equivalents	$150,829	$150,829	$262,614	$262,614
Restricted cash (current assets)	$ 496	$ 496	$ 498	$ 498
Short-term investments	$ 10,824	$ 10,824	$ 40,614	$ 40,614
Investments, long-term	$ 40,506	$ 40,506	$	$
Marketable securities (long-term other assets)	$ 268	$ 268	$ 1,435	$ 1,435
Deferred compensation (long-term other liabilities)	$ 284	$ 284	$ 1,448	$ 1,448
Notes payable, long-term	$ 1,777	$ 1,777	$	$

NEUSTAR, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Investments

The Company s investments classified as available-for-sale are carried at estimated fair value, as determined by quoted market prices or other valuation methods, with unrealized gains and losses reported as a separate component of accumulated other comprehensive income. Realized gains and losses and declines in value judged to be other-than-temporary, if any, on available-for-sale securities are included in other (expense) income. The cost of available-for-sale short-term investments sold is based on the specific identification method for the three months ended March 31, 2008. Because of other-than-temporary charges related to short-term investments recognized in earnings subsequent to the first quarter of 2008, the cost of securities sold during the six months ended September 30, 2008, and the three and nine months ended September 30, 2009, is reduced by a pro-rata allocation of other-than-temporary losses previously recognized as a charge to earnings. Interest and dividends on these securities is included in interest and other income.

The Company periodically evaluates whether any declines in the fair value of its investments are other-than-temporary. This evaluation consists of a review of several factors, including but not limited to: the length of time and extent that a security has been in an unrealized loss position; the existence of an event that would impair the issuer s future earnings potential; the near-term prospects for recovery of the market value of a security; the Company s intent to sell an impaired security; and the probability that the Company will be required to sell the security before the market value recovers. Prior to April 1, 2009, declines in value below cost for investments which the Company had the ability and intent to hold the investment for a period of time sufficient to allow for a market recovery, were not recognized as an other-than temporary charge in earnings. Beginning April 1, 2009, if an investment which the Company does not intend to sell prior to recovery declines in value below the amortized cost basis and it is not more likely than not the Company will be required to sell the related security before the recovery of its amortized cost basis, the Company recognizes the difference between the present value of the cash flows expected to be collected and the amortized cost basis, or credit loss, as an other-than temporary charge in interest and other expense. The difference between the estimated fair value and the security s amortized cost basis at the measurement date related to all other factors is reported as a separate component of accumulated other comprehensive loss. As of September 30, 2009, there were no unrealized losses recorded for the Company s available-for-sale investments.

The Company s investments classified as trading are carried at estimated fair value with unrealized gains and losses reported in other (expense) income. At September 30, 2009, the Company classified its auction rate securities as trading pursuant to the Investments Debt and Equity Securities Topic of the FASB ASC, with changes in the fair value of these securities recorded in interest and other income (see Note 3). Interest and dividends on these securities are included in interest and other income.

Goodwill

Goodwill represents the excess of the purchase price over the fair value of assets acquired, as well as other definite-lived intangible assets. In accordance with the Intangibles Goodwill and Other Topic of the FASB ASC, goodwill and indefinite-lived intangible assets are not amortized, but are reviewed for impairment upon the occurrence of events or changes in circumstances that would reduce the fair value of such assets below their carrying amount. The Company is required to test goodwill for impairment at least annually, or on an interim basis if circumstances change that would indicate the possibility of impairment. For purposes of the Company s annual impairment test, the Company has identified and assigned goodwill to two reporting units, Clearinghouse and NGM.

In the nine months ended September 30, 2008, the Company recorded a goodwill impairment charge of $29.0 million related to its NGM reporting unit (see Note 5). There was no impairment charge related to the Company s Clearinghouse reporting unit in the nine months ended September 30, 2008. There were no impairment charges related to the Company s Clearinghouse or NGM reporting units during the nine months ended September 30, 2009.

Impairment of Long-Lived Assets

In accordance with the Property, Plant and Equipment Topic of the FASB ASC, the Company reviews long-lived assets and certain identifiable intangible assets for impairment whenever events or changes in circumstances indicate the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of the assets to future undiscounted net cash flows expected to be generated by the

NEUSTAR, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

assets. Recoverability measurement and estimates of undiscounted cash flows are done at the lowest possible level for which there are identifiable cash flows. If such assets are considered impaired, the amount of impairment recognized is equal to the amount by which the carrying amount of assets exceeds the fair value of the assets. Assets to be disposed of are recorded at the lower of the carrying amount or the fair value less costs to sell.

Revenue Recognition

The Company provides the North American communications industry with essential clearinghouse services that address the industry s addressing, interoperability, and infrastructure needs. The Company s revenue recognition policies are in accordance with the Revenue Recognition Topic of the FASB ASC. Pursuant to various private commercial and government contracts, the Company provides addressing, interoperability and infrastructure services.

Significant Contracts

The Company provides wireline and wireless number portability, implements the allocation of pooled blocks of telephone numbers and provides network management services pursuant to seven contracts with North American Portability Management LLC (NAPM), an industry group that represents all telecommunications service providers in the United States. In 2008, the Company recognized revenue under its contracts with NAPM primarily on a per-transaction basis. The aggregate fees for transactions processed under these contracts were determined by the total number of transactions, and these fees were billed to telecommunications service providers based on their allocable share of the total transaction charges. This allocable share was based on each respective telecommunications service provider s share of the aggregate end-user services revenues of all U.S. telecommunications service providers, as determined by the Federal Communications Commission. In January 2009, the Company amended its seven regional contracts with NAPM under which it provides telephone portability and other clearinghouse services to CSPs in the United States. These amendments provide for an annual fixed-fee pricing model under which the annual fixed-fee (Base Fee) is set at $340.0 million in 2009 and is subject to an annual price escalator of 6.5% in subsequent years. The amendments also provide for a fixed credit of $40.0 million in 2009, $25.0 million in 2010 and $5.0 million in 2011, which will be applied to reduce the Base Fee for the applicable year. Additional credits of up to $15.0 million annually in 2009, 2010 and 2011 may be triggered if the customer reaches certain levels of aggregate telephone number inventories and adopts and implements certain Internet Protocol (IP) fields and functionality. Moreover, the amendments provide for credits in the event that the volume of transactions in a given year is above or below the contractually established volume range for that year. The determination of whether any volume credits have been earned is done annually at the end of the year and such credits, if any, are applied to the following year s invoices. The Company determines the fixed and determinable fee under the amendments on an annual basis and recognizes such fee on a straight-line basis over twelve months. For 2009, the Company has concluded that the fixed and determinable fee equals $285.0 million, which is the Base Fee of $340.0 million reduced by the $40.0 million fixed credit and $15.0 million of available additional credits. To the extent any available additional credits expire unused, they will be recognized in revenue at that time. The Company records the fixed and determinable fee amongst addressing, interoperability and infrastructure based on the relative volume of transactions in each of these service offerings processed during the applicable period.

Under the Company s contracts with NAPM, the Company also bills a Revenue Recovery Collections fee equal to a percentage of monthly billings to its customers, which is available to the Company if any telecommunications service provider fails to pay its allocable share of total transactions charges.

During 2008, per transaction pricing under the contracts with NAPM was derived on a straight-line basis using an effective rate calculation formula based on annualized transaction volume between 200 million and 587.5 million. For annualized transaction volumes less than or equal to 200 million, the price per transaction was equal to a flat rate of $0.95 per transaction. For annualized volumes greater than or equal to 587.5 million, the price per transaction was equal to a flat rate of $0.75 per transaction. For the three and nine months ended September 30, 2008, the average price per transaction was $0.86 and $0.87, respectively.

NEUSTAR, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

For the three and nine months ended September 30, 2009, the effective price per transaction under the contracts with NAPM was $0.72 and $0.73, respectively. The effective price per transaction is calculated by dividing the straight-line portion of the fixed and determinable fee by the number of transactions during the corresponding period.

Addressing

The Company s addressing services include telephone number administration, implementing the allocation of pooled blocks of telephone numbers, directory services for Internet domain names and U.S. Common Short Codes, and internal and external managed domain name services. The Company generates revenue from its telephone number administration services under two government contracts. Under its contract to serve as the North American Numbering Plan Administrator, the Company earns a fixed annual fee and recognizes this fee as revenue on a straight-line basis as services are provided. Under the Company s contract to serve as the National Pooling Administrator, the Company earns a fixed price associated with administration of the pooling system. The Company recognizes revenue for this contract on a straight-line basis over the term of the contract. In the event the Company estimates losses on its fixed price contracts, the Company recognizes these losses in the period in which a loss becomes apparent.

In addition to the administrative functions associated with its role as the National Pooling Administrator, the Company also generates revenue from implementing the allocation of pooled blocks of telephone numbers under its long-term contracts with NAPM. In 2008, the Company recognized revenue on a per-transaction fee basis as the services were performed. As discussed above under the heading Revenue Recognition Significant Contracts, beginning January 1, 2009, the Company determines the fixed and determinable fee on an annual basis and recognizes such fee on a straight-line basis over twelve months. For its Internet domain name services, the Company generates revenue for Internet domain registrations, which generally have contract terms between one and ten years. The Company recognizes revenue on a straight-line basis over the term of the related customer contracts.

The Company generates revenue through internal and external managed domain name services. The Company s revenue consists of customer set-up fees, monthly recurring fees and per-transaction fees for transactions in excess of pre-established monthly minimums under contracts with terms ranging from one to three years. Customer set-up fees are not considered a separate deliverable and are deferred and recognized on a straight-line basis over the term of the contract. Under the Company s contracts to provide its managed domain name services, customers have contractually established monthly transaction volumes for which they are charged a recurring monthly fee. Transactions processed in excess of the pre-established monthly volume are billed at a contractual per-transaction rate. Each month, the Company recognizes the recurring monthly fee and usage in excess of the established monthly volume on a per-transaction basis as services are provided. The Company generates revenue from its U.S. Common Short Code services under short-term contracts ranging from three to twelve months, and the Company recognizes revenue on a straight-line basis over the term of the customer contracts.

Interoperability

The Company s interoperability services consist primarily of wireline and wireless number portability and order management services. The Company generates revenue from providing telephone number portability services under its long-term contracts with NAPM. In 2008, the Company recognized revenue on a per-transaction fee basis as the services were performed. As discussed above under the heading Revenue Recognition Significant Contracts, beginning January 1, 2009, the Company determines the fixed and determinable fee on an annual basis and recognizes such fee on a straight-line basis over twelve months.

Under its long-term contract with Canadian LNP Consortium, Inc., the Company recognizes revenue on a per-transaction fee basis as the services are performed. The Company provides order management services (OMS), consisting of customer set-up and implementation followed by transaction processing, under contracts with terms ranging from one to three years. Customer set-up and implementation is not considered a separate deliverable; accordingly, the fees for these services are deferred and recognized as revenue on a straight-line basis over the term of the contract. Per-transaction fees are recognized as the transactions are processed. The Company generates revenue from its inter-carrier mobile instant messaging services under contracts with mobile operators that range from one to three years. These contracts consist of user subscription fees based on the number of subscribers that use mobile instant messaging services, as well as fees for set-

NEUSTAR, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

up and implementation. The Company recognizes user subscription fee revenue on a monthly basis over the term of the contract after completion of customer set-up and implementation. Customer set-up and implementation is not considered a separate deliverable; accordingly, the fees for these services are deferred and recognized as revenue on a straight-line basis over the remaining term of the contract following delivery of the set-up and implementation services.

Infrastructure and Other

The Company s infrastructure services consist primarily of network management and connection services. The Company generates revenue from network management services under its long-term contracts with NAPM. In 2008, the Company recognized revenue on a per-transaction fee basis as the services were performed. As discussed above under the heading Revenue Recognition Significant Contracts, beginning January 1, 2009, the Company determines the fixed and determinable fee on an annual basis and recognizes such fee on a straight-line basis over twelve months. In addition, the Company generates revenue from connection fees and system enhancements under its contracts with NAPM. The Company recognizes connection fee revenue as the service is performed. System enhancements are provided under contracts in which the Company is reimbursed for costs incurred plus a fixed fee, and revenue is recognized based on costs incurred plus a pro rata amount of the fee. The Company generates revenue from its intra-carrier mobile instant messaging services under contracts with mobile operators that range from one to three years. These contracts consist of license fees based on the number of subscribers that use mobile instant messaging services, as well as fees for set-up and implementation. The Company recognizes license fee revenue on a straight-line basis over the term of the contract after completion of customer set-up and implementation. Customer set-up and implementation is not considered a separate deliverable; accordingly, the fees for these services are deferred and recognized as revenue on a straight-line basis over the remaining term of the contract following delivery of the set-up and implementation services.

Service Level Standards

Pursuant to certain of the Company s private commercial contracts, the Company is subject to service level standards and to corresponding penalties for failure to meet those standards. The Company records a provision for these performance-related penalties when it becomes aware that required service levels have not been met, triggering the requirement to pay a penalty, which results in a corresponding reduction to revenue.

Cost of Revenue and Deferred Costs

Cost of revenue includes all direct materials, direct labor, and those indirect costs related to generation of revenue such as indirect labor, materials and supplies and facilities cost. The Company s primary cost of revenue is related to personnel costs associated with service implementation, product maintenance, customer deployment and customer care, including salaries, stock-based compensation and other personnel-related expense. In addition, cost of revenue includes costs relating to maintaining the Company s existing technology and services, as well as royalties paid related to the Company s U.S. Common Short Code services. Cost of revenue also includes the costs incurred by the Company s information technology and systems department, including network costs, data center maintenance, database management, data processing costs, and facilities costs.

Deferred costs represent direct labor related to professional services incurred for the setup and implementation of contracts. These costs are recognized in cost of revenue on a straight-line basis over the contract term. Deferred costs also include royalties paid related to the Company s U.S. Common Short Code services, which are recognized in cost of revenue on a straight-line basis over the contract term. Deferred costs are classified as such on the consolidated balance sheets.

Stock-Based Compensation

The Company accounts for its stock-based compensation plans under the recognition and measurement provisions of the Compensation Stock Compensation Topic of the FASB ASC. The Company estimates the value of stock-based awards on the date of grant using the Black-Scholes option-pricing models. For stock-based awards subject to graded vesting, the Company has utilized the straight-line method for allocating compensation cost by period.

NEUSTAR, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Basic and Diluted Net Income per Common Share

In 2009, the Company adopted and retrospectively applied the FASB standard which updated the Earnings Per Share Topic of the FASB ASC for determining whether instruments granted in share-based payment transactions are participating. The authoritative literature effective in 2009 clarifies that unvested share-based payment awards that contain non-forfeitable rights to divide