

CYANOTECH CORP  
Form 10-Q  
August 13, 2018

Table of Contents

---

---

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-Q**

**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

**For Quarterly Period Ended June 30, 2018**

**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 0-14602**

**CYANOTECH CORPORATION**

(Exact name of registrant as specified in its charter)

**NEVADA**

(State or other jurisdiction of incorporation or organization)

**91-1206026**

(IRS Employer Identification Number)

**73-4460 Queen Kaahumanu Hwy. #102, Kailua-Kona, HI 96740**

(Address of principal executive offices)

**(808) 326-1353**

(Registrant's telephone number)

**Not Applicable**

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act of 1934 during the past 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 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 No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Edgar Filing: CYANOTECH CORP - Form 10-Q

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

Number of common shares outstanding as of August 10, 2018:

<b>Title of Class</b>	<b>Shares Outstanding</b>
Common stock - \$0.02 par value	5,788,887

---

---

---

Table of Contents

CYANOTECH CORPORATION

FORM 10-Q

INDEX

**PART I. FINANCIAL INFORMATION**

Item 1. <u>Financial Statements</u>	3
<u>Condensed Consolidated Balance Sheets as of June 30, 2018 and March 31, 2018 (unaudited)</u>	3
<u>Condensed Consolidated Statements of Operations for the three months ended June 30, 2018 and 2017 (unaudited)</u>	4
<u>Condensed Consolidated Statements of Cash Flows for the three months ended June 30, 2018 and 2017 (unaudited)</u>	5
<u>Notes to Condensed Consolidated Financial Statements (unaudited)</u>	6
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	15
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	19
Item 4. <u>Controls and Procedures</u>	19

**PART II. OTHER INFORMATION**

Item 1. <u>Legal Proceedings</u>	21
Item 1A <u>Risk Factors</u>	21
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	21
Item 3. <u>Defaults upon Senior Securities</u>	21
Item 5. <u>Other Information</u>	21
Item 6. <u>Exhibits</u>	22
<u>SIGNATURES</u>	23

Table of Contents

## PART 1. FINANCIAL INFORMATION

## Item 1. Financial Statements (Unaudited)

## CYANOTECH CORPORATION

## CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except per share amounts)

(Unaudited)

	<b>June 30, 2018</b>	<b>March 31, 2018</b>
<b>ASSETS</b>		
Current assets:		
Cash	\$935	\$1,329
Accounts receivable, net of allowance for doubtful accounts of \$27 at June 30, 2018 and \$27 at March 31, 2018	2,804	2,664
Inventories, net	9,487	9,034
Prepaid expenses and other current assets	593	590
Total current assets	13,819	13,617
Equipment and leasehold improvements, net	15,432	15,734
Restricted cash	—	65
Other assets	280	291
Total assets	\$29,531	\$29,707
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Line of credit	\$1,250	\$500
Current maturities of long-term debt	660	655
Customer deposits	300	133
Accounts payable	3,735	3,527
Accrued expenses	1,000	892
Total current liabilities	6,945	5,707
Long-term debt, less current maturities	5,636	5,790
Other long-term liabilities	98	103
Total liabilities	12,679	11,600

Commitments and contingencies

Stockholders' equity:

Preferred stock of \$0.01 par value, authorized 10,000,000 shares; no shares issued and outstanding	—	—
Common stock of \$0.02 par value, authorized 50,000,000 shares; 5,788,887 shares issued and outstanding at June 30, 2018 and 5,772,032 at March 31, 2018	116	115
Additional paid-in capital	32,070	32,051
Accumulated deficit	(15,334)	(14,059)
Total stockholders' equity	16,852	18,107
Total liabilities and stockholders' equity	\$29,531	\$29,707

See accompanying Notes to Condensed Consolidated Financial Statements.

Table of Contents

## CYANOTECH CORPORATION

## CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share amounts)

(Unaudited)

	<b>Three Months Ended June 30, 2018      2017</b>	
NET SALES	\$7,145	\$8,809
COST OF SALES	5,309	5,206
Gross Profit	1,836	3,603
<b>OPERATING EXPENSES:</b>		
General and administrative	1,372	1,352
Sales and marketing	1,423	1,489
Research and development	208	142
Total operating expenses	3,003	2,983
(Loss) income from operations	(1,167)	620
Interest expense, net	130	108
(Loss) income before income tax	(1,297)	512
INCOME TAX (BENEFIT) EXPENSE	(22 )	11
NET (LOSS) INCOME	\$(1,275)	\$501
<b>NET (LOSS) INCOME PER SHARE:</b>		
Basic	\$(0.22 )	\$0.09
Diluted	\$(0.22 )	\$0.09
<b>SHARES USED IN CALCULATION OF NET (LOSS) INCOME PER SHARE:</b>		
Basic	5,785	5,685
Diluted	5,785	5,719

See accompanying Notes to Condensed Consolidated Financial Statements.





Table of Contents

## CYANOTECH CORPORATION

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Dollars in thousands)

(Unaudited)

	<b>Three Months Ended June 30, 2018      2017</b>	
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net (loss) income	\$(1,275)	\$501
Adjustments to reconcile net (loss) income to net cash (used in) provided by operating activities:		
Depreciation and amortization	475	479
Amortization of debt issue costs and other assets	19	15
Share-based compensation expense	34	31
Net (increase) decrease in assets:		
Accounts receivable	(140 )	(484 )
Inventories	(453 )	(9 )
Prepaid expenses and other assets	(3 )	138
Net increase (decrease) in liabilities:		
Customer deposits	167	(40 )
Accounts payable	208	(534 )
Accrued expenses	108	130
Deferred rent and other liabilities	(5 )	(17 )
Net cash (used in) provided by operating activities	(865 )	210
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Investment in equipment and leasehold improvements	(173 )	(56 )
Net cash used in investing activities	(173 )	(56 )
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Net draws (payments) on line of credit	750	(111 )
Principal payments on long-term debt	(141 )	(130 )
Payments on capitalized leases	(16 )	(21 )
Withholding on restricted stock unit vesting	(32 )	—
Proceeds from stock options exercised	18	—
Net cash provided by (used in) financing activities	579	(262 )
Net decrease in cash and restricted cash	(459 )	(108 )
Cash and restricted cash at beginning of period	1,394	1,407

Cash at end of period	\$935	\$1,299
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid during the period for:		
Interest	\$103	\$104
Income taxes	\$—	\$—
RECONCILIATION OF CASH AND RESTRICTED CASH AT BEGINNING OF PERIOD:		
Cash	\$1,329	\$1,407
Restricted cash	65	—
Total cash and restricted cash at beginning of period	\$1,394	\$1,407

See accompanying Notes to Condensed Consolidated Financial Statements.

Table of Contents

CYANOTECH CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2018  
(Unaudited)

**1. SIGNIFICANT ACCOUNTING POLICIES**

**Basis of Presentation**

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) for interim financial information pursuant to the instructions to Form 10-Q and Regulation S-X of the Securities and Exchange Commission (SEC). These interim condensed consolidated financial statements are unaudited and, in the opinion of management, include all adjustments (consisting of normal recurring adjustments and accruals) necessary to present fairly the Condensed Consolidated Balance Sheets, Condensed Consolidated Statements of Operations, and Condensed Consolidated Statements of Cash Flows for the periods presented in accordance with GAAP. Accordingly, they do not include all of the information and notes required by GAAP for complete financial statements. The results of operations for the interim periods are not necessarily indicative of the results to be expected for the full fiscal year. The Condensed Consolidated Balance Sheet as of March 31, 2018 was derived from the audited consolidated financial statements. These condensed consolidated financial statements and notes should be read in conjunction with the Company’s audited consolidated financial statements for the year ended March 31, 2018, contained in the Company’s annual report on Form 10-K as filed with the SEC on June 15, 2018.

The accompanying condensed consolidated financial statements include the accounts of Cyanotech Corporation and its wholly owned subsidiary, Nutrex Hawaii, Inc. (“Nutrex Hawaii” or “Nutrex”, collectively the “Company”). All significant intercompany balances and transactions have been eliminated in consolidation.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosures of any contingent assets and liabilities as of the date of the financial statements and the reported amounts of revenues and expenses during the periods reported. Management reviews these estimates and assumptions periodically and reflects the effect of revisions in the period that they are determined to be necessary. Actual results could differ from those estimates and assumptions.

## Liquidity

As of June 30, 2018, the Company had cash of \$0.9 million and working capital of \$6.9 million compared to \$1.3 million and \$7.9 million, respectively, at March 31, 2018. On August 30, 2016, the Credit Agreement, which the Company and First Foundation Bank (the Bank) entered into on June 3, 2016, became effective. The Credit Agreement allows the Company to borrow up to \$2.0 million on a revolving basis. At June 30, 2018, the Company had borrowed \$1.25 million and had \$0.75 million available on the line. The line of credit was renewed on August 30, 2017 and will expire on August 30, 2018. The Company intends to renew or replace it with another line of credit on or before the expiration date.

As of June 30, 2018, the Company had \$6.2 million of term loans payable to the Bank that require the payment of principal and interest monthly through August 2032. Pursuant to the term loans, the Company is subject to annual financial covenants, customary affirmative and negative covenants and certain subjective acceleration clauses. As of March 31, 2018, the Company was in compliance with these financial covenants.

Funds generated by operating activities and available cash continue to be the Company's most significant sources of liquidity for working capital requirements, debt service and funding of maintenance levels of capital expenditures. Based upon the Company's fiscal year 2019 operating plan and related cash flow projections and the Company's projected consolidated financial position as of March 31, 2019, cash flows expected to be generated by operating activities and available financing are expected to be sufficient to fund the Company's operations for at least the next twelve months, and the Company's current ratio is expected to be in compliance with the annual term loan covenant requirement as of March 31, 2019. However, no assurances can be provided that the Company will achieve its operating plan and cash flow objectives for the next fiscal year or its projected consolidated financial position as of March 31, 2019. Such estimates are subject to change based on future results and such change could cause future results to vary significantly from expected results.

## Revenue Recognition

The Company records revenue based on the five-step model which includes: (1) identifying the contract with the customer; (2) identifying the performance obligations in the contract; (3) determining the transaction price; (4) allocating the transaction price to the performance obligations; and (5) recognizing revenue when the performance obligations are satisfied. Substantially all of the Company's revenue is generated by fulfilling orders for the purchase of our micro algal nutritional supplements to retailers, wholesalers, or direct to consumers via online channels, with each order considered to be a distinct performance obligation. These orders may be formal purchase orders, verbal phone orders, e-mail orders or orders received online. Shipping and handling activities for which the Company is responsible under the terms and conditions of the order are not accounted for as performance obligations but as fulfillment costs. These activities are required to fulfill the Company's promise to transfer the goods and are expensed when revenue is recognized. The impact of this policy election is insignificant as it aligns with our current practice.

Revenue is measured as the net amount of consideration expected to be received in exchange for fulfilling a performance obligation. The Company has elected to exclude sales, use and similar taxes from the measurement of the transaction price. The impact of this policy election is insignificant, as it aligns with our current practice. The amount of consideration expected to be received and revenue recognized includes estimates of variable consideration, which includes costs for trade promotion programs, coupons, returns and early payment discounts. Such estimates are calculated using historical averages adjusted for any expected changes due to current business conditions and experience. The Company reviews and updates these estimates at the end of each reporting period and the impact of any adjustments are recognized in the period the adjustments are identified. In assessing whether collection of consideration from a customer is probable, the Company considers the customer's ability and intent to pay that amount of consideration when it is due. Payment of invoices is due as specified in the underlying customer agreement, typically 30 days from the invoice date, which occurs on the date of transfer of control of the products to the customer.

Revenue is recognized at the point in time that the control of the ordered products is transferred to the customer. Generally, this occurs when the product is delivered, or in some cases, picked up from one of our distribution centers by the customer.

Customer contract liabilities consist of customer deposits received in advance of fulfilling an order and are shown separately on the consolidated balance sheets. During the three-month periods ended June 30, 2018 and June 30, 2017, the Company recognized \$112,000 and \$45,000, respectively, of revenue from deposits that were included in contract liabilities as of March 31, 2018 and March 31, 2017, respectively. The Company's contracts have a duration of one year or less and therefore, the Company has elected the practical expedient of not disclosing revenues allocated to partially unsatisfied performance obligations.

The following table represents revenue disaggregated by product in the three months ended June 30, 2018 and June 30, 2017 (in thousands):

	Three months ended June 30, 2018		
	Astaxant	Spirulina	Total
Packaged products	\$5,095	\$ 1,068	\$6,163
Bulk products	263	719	982
Total	\$5,358	\$ 1,787	\$7,145

	Three months ended June 30, 2017		
	Astaxant	Spirulina	Total
Packaged products	\$5,505	\$ 1,927	\$7,432
Bulk products	221	1,156	1,377

Total	\$5,726	\$ 3,083	\$8,809
-------	---------	----------	---------

6

---

Table of Contents

**Recently Adopted Accounting Pronouncements**

In May 2017, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2017-09, *Compensation-Stock Compensation (Topic 718) Scope of Modification Accounting* ("ASU No. 2017-09"). ASU No. 2017-09 will clarify and reduce both (i) diversity in practice and (ii) cost and complexity when applying the guidance in Topic 718, to a change to the terms and conditions of a share-based payment award. This guidance became effective for fiscal years beginning after December 15, 2017 and interim periods within those fiscal years. The amendments in this ASU are applied prospectively to awards modified on or after the adoption date. The Company adopted this standard as of April 1, 2018 with no impact on its consolidated financial statements.

In November 2016, the FASB issued ASU 2016-18, "*Statement of Cash Flows (Topic 230): Restricted Cash*" ("ASU No. 2016-18"). This update addresses the fact that diversity exists in the classification and presentation of changes in restricted cash on the statement of cash flows under Topic 230, *Statement of Cash Flows*. ASU No. 2016-18 became effective for public companies for the fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. The Company adopted this standard as of April 1, 2018 by using the retrospective method, which required reclassification of restricted cash in the accompanying consolidated statement of cash flows as of the beginning of the period for the three months ended June 30, 2018.

In August 2016, FASB issued ASU 2016-15, "*Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments*" ("ASU No. 2016-15"). This ASU clarifies and provides specific guidance on eight cash flow classification issues that are not currently addressed by current GAAP and thereby reduces the current diversity in practice. ASU No. 2016-15 is effective for public business entities for annual periods, including interim periods within those annual periods, beginning after December 15, 2017. The Company adopted this standard as of April 1, 2018 with no impact on its consolidated financial statements and related disclosures.

In May 2014, the FASB issued their converged standard on revenue recognition, Accounting Standards Update No. 2014-09, "*Revenue from Contracts with Customers (Topic 606)*" ("ASU No. 2014-09"), updated in December 2016 with the release of ASU 2016-20. This standard outlines a single comprehensive model for companies to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including industry-specific guidance. The core principle of the revenue model is that an entity recognizes revenue to depict the transfer of promised goods and services in an amount that reflects the consideration to which the entity expects to be entitled to in exchange for those goods and services. In addition, the new standard requires that reporting companies disclose the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. In August 2015, the FASB issued ASU No 2015-14 "*Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date,*" which deferred the effective date of ASU No. 2014-09 to annual reporting periods beginning after December 15, 2017.

The new revenue standard is required to be applied either retrospectively to each prior reporting period presented or prospectively with the cumulative effect of initially applying the standard recognized at the date of the initial application, supplemented with certain disclosures related to the effect of adoption on previously reported amounts, if any (the modified retrospective method). The Company adopted the standard on April 1, 2018 for contracts that were not completed before the adoption date, using the modified retrospective method. The Company has evaluated the effect of the standard and concluded it is not material to the timing or amount of revenues or expenses recognized in the Company's historical consolidated financial statements. As a result, the Company has concluded that the application of the standard does not have a material effect that requires a retrospective adjustment to any previously reported amounts in the Company's historical consolidated financial statements for reporting disclosure purposes.



Table of Contents

**Recently Issued Accounting Pronouncements**

In July 2018, the FASB issued ASU 2018-10 “*Codification Improvements to Topic 842, Leases*” (“ASU No. 2018-02”). This ASU affects narrow aspects of the guidance issued in the amendments in ASU No. 2016-02 including those regarding residual value guarantees, rate implicit in the lease, lessee reassessment of lease classification, lessor reassessment of lease term and purchase option, variable lease payments that depend on an index or a rate, investment tax credits, lease term and purchase option, transition guidance for amounts previously recognized in business combinations, certain transition adjustments, transition guidance for leases previously classified as capital leases under Topic 840, transition guidance for modifications to leases previously classified as direct financing or sales-type leases under Topic 840, transition guidance for sale and leaseback transactions, impairment of net investment in the lease, unguaranteed residual asset, effect of initial direct costs on rate implicit in the lease, and failed sale and leaseback transactions. The Company is currently evaluating the impact this ASU will have on its implementation of ASU No. 2016-02.

In June 2018, the FASB issued ASU 2018-07 “*Compensation - Stock Compensation (Topic 718)*” (“ASU No. 2018-07”): Improvements to Nonemployee Share-Based Payment Accounting. This ASU expands the scope of Topic 718 to include share-based payment transactions for acquiring goods and services from non-employees, and as a result, the accounting for share-based payments to non-employees will be substantially aligned. ASU No. 2018-07 is effective for fiscal years beginning after December 15, 2018, including interim periods within that fiscal year. Early adoption is permitted but no earlier than an entity’s adoption date of Topic 606. The Company is currently evaluating the impact this new guidance will have on its financial statements and related disclosures.

In February 2016, the FASB issued ASU 2016-02, “*Leases (Topic 842)*” (“ASU No. 2016-02”). The principle objective of ASU No. 2016-02 is to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet. ASU No. 2016-02 continues to retain a distinction between finance and operating leases but requires lessees to recognize a right-of-use asset representing its right to use the underlying asset for the lease term and a corresponding lease liability on the balance sheet for all leases with terms greater than twelve months. ASU No. 2016-02 is effective for fiscal years and interim periods beginning after December 15, 2018. Early adoption of ASU No. 2016-02 is permitted. Entities are required to apply the amendments at the beginning of the earliest period presented using a modified retrospective approach. This guidance is applicable to the Company’s fiscal year beginning April 1, 2019. In July 2018, the FASB issued ASU No. 2018-11, “*Leases (Topic 842): Targeted Improvements*,” which provides an additional transition method that permits changes to be applied by means of a cumulative-effect adjustment recorded in retained earnings as of the beginning of the fiscal year of adoption. The Company has started the assessment process by evaluating the population of leases under the revised definition of what qualifies as a leased asset, and expects to have the assessment completed by March 2019. The Company is the lessee under various agreements for facilities and equipment that are currently accounted for as operating and capital leases. The Company expects this guidance will have a material impact on its consolidated balance sheets due to the recognition of lease rights and obligations as assets and liabilities, respectively. The Company does not expect this guidance to have a material effect on its consolidated results of operations and cash flows.

**2. INVENTORIES**

Inventories are stated at the lower of cost or net realizable value. Cost is determined by the first-in, first-out method. Inventories consist of the following:

	<b>June 30, 2018</b>	<b>March 31, 2018</b>
	<b>(in thousands)</b>	
Raw materials	\$371	\$410
Work in process	3,301	2,602
Finished goods	5,663	5,878
Supplies	152	144
Inventories, net	\$9,487	\$9,034

The Company recognizes abnormal production costs, including fixed cost variances from normal production capacity, as an expense in the period incurred. Abnormal costs related to spirulina production of \$250,000 were charged to cost of sales for the quarter ended June 30, 2018. There were no abnormal production costs for the quarter ended June 30, 2017. Non-inventoriable fixed costs related to spirulina production of \$125,000 were charged to cost of sales for the quarter ended June 30, 2018. Non-inventoriable fixed costs related to spirulina production of \$9,000 were charged to cost of sales for the quarter ended June 30, 2017.

Table of Contents**3.EQUIPMENT AND LEASEHOLD IMPROVEMENTS, NET**

Equipment and leasehold improvements are stated at cost. Depreciation and amortization are provided using the straight-line method over the estimated useful lives for equipment and furniture and fixtures, or the shorter of the land lease term or estimated useful lives for leasehold improvements as follows:

	Years
Equipment	3 to 10
Furniture and fixtures	3 to 7
Leasehold improvements	10 to 25

Equipment and leasehold improvements consist of the following:

	<b>June 30, 2018</b>	<b>March 31, 2018</b>
	<b>(in thousands)</b>	
Equipment	\$18,114	\$17,935
Leasehold improvements	14,287	14,248
Furniture and fixtures	348	348
	32,749	32,531
Less accumulated depreciation and amortization	(17,821)	(17,346)
Construction-in-progress	504	549
Equipment and leasehold improvements, net	\$15,432	\$15,734

The Company reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying value of such assets may not be recoverable. Recoverability of these assets is measured by a comparison of the carrying amount to forecasted undiscounted future cash flows expected to be generated by the asset. If the carrying amount exceeds its estimated future cash flows, then an impairment charge is recognized to the extent that the carrying amount exceeds the asset's fair value. Management has determined no asset impairment existed as of June 30, 2018 and March 31, 2018, respectively.

**4.LINE OF CREDIT**

On August 30, 2016, the Revolving Credit Agreement (the "Credit Agreement"), which the Company and First Foundation Bank ("the Bank") entered into on June 3, 2016, became effective after the Company and the Bank received the necessary approvals from the State of Hawaii to secure the lien on the Company's leasehold property in Kona,

Hawaii. The Credit Agreement allows the Company to borrow up to \$2,000,000 on a revolving basis. Borrowings under the Credit Agreement bear interest at the Wall Street Journal prime rate (5.00% at June 30, 2018) + 2%, floating. The Credit Agreement includes various covenants as defined in the Credit Agreement. The Credit Agreement also contains standard acceleration provisions in the event of a default by the Company. At June 30, 2018, the Company had borrowed \$1,250,000 under the Credit Agreement and had \$750,000 available on the line. The line of credit will be subject to renewal upon expiration on August 30, 2018.

## 5. ACCRUED EXPENSES

Accrued expenses consist of the following:

	<b>June 30, 2018</b>	<b>March 31, 2018</b>
	<b>(in thousands)</b>	
Wages, commissions, bonus and profit sharing	\$807	\$ 707
Rent and utilities	69	69
Other accrued expenses	124	116
Total accrued expenses	\$1,000	\$ 892

## 6. LONG-TERM DEBT

Long-term debt consists of the following:

	<b>June 30, 2018</b>	<b>March 31, 2018</b>
	<b>(in thousands)</b>	
Long-term debt	\$6,520	\$6,678
Less current maturities	(660 )	(655 )
Long-term debt, excluding current maturities	5,860	6,023
Less unamortized debt issuance costs	(224 )	(233 )
Total long-term debt, net of current maturities and unamortized debt issuance costs	\$5,636	\$5,790

Table of Contents

*Term Loans*

The Company executed a loan agreement with a lender providing for \$2,500,000 in aggregate credit facilities (the “2015 Loan”) secured by substantially all the Company’s assets, pursuant to a Term Loan Agreement dated July 30, 2015 (the “2015 Loan Agreement”). The 2015 Loan Agreement is evidenced by a promissory note in the amount of \$2,500,000, the repayment of which is partially guaranteed under the provisions of a United States Department of Agriculture (“USDA”) Rural Development Guarantee program. The proceeds of the 2015 Loan were used to pay off a \$500,000 short term note payable that matured on September 18, 2015, and to acquire new processing equipment and leasehold improvements at the Company’s Kona, Hawaii facility.

The provisions of the 2015 Loan Agreement require the payment of principal and interest until its maturity on September 1, 2022, the obligation fully amortizes over seven (7) years. Interest on the 2015 Loan accrues on the outstanding principal balance at an annual variable rate equal to the published Wall Street Journal prime rate (5.00% at June 30, 2018) plus 2.0% and is adjustable on the first day of each calendar quarter and fixed for that quarter. At no time shall the annual interest rate be less than 6.00%. The 2015 Loan has a prepayment penalty of 5% for any prepayment made prior to the first anniversary of the date of the 2015 Loan Agreement, which penalty is reduced by 1% each year thereafter until the fifth anniversary of such date, after which there is no prepayment penalty. The balance under the 2015 Loan was \$1,644,000 and \$1,726,000 at June 30, 2018 and March 31, 2018, respectively.

The 2015 Loan includes a one-time origination and guaranty fee totaling \$113,900 and an annual renewal fee payable in the amount of 0.50% of the USDA guaranteed portion of the outstanding principal balance as of December 31 of each year, beginning December 31, 2015. The USDA has guaranteed 80% of all amounts owing under the 2015 Loan. The Company is subject to financial covenants and customary affirmative and negative covenants.

The Company executed a loan agreement with a lender providing for \$5,500,000 in aggregate credit facilities (the “Loan”) secured by substantially all the Company’s assets, including a mortgage on the Company's interest in its lease at the National Energy Laboratory of Hawaii Authority, pursuant to a Term Loan Agreement dated August 14, 2012 (the “Loan Agreement”). The Loan Agreement is evidenced by promissory notes in the amounts of \$2,250,000 and \$3,250,000, the repayment of which is partially guaranteed under the provisions of a USDA Rural Development Guarantee. The proceeds of the Loan have been used to acquire new processing equipment and leasehold improvements at the Company’s Kona, Hawaii facility.

The provisions of the Loan required the payment of interest only for the first 12 months of the term; thereafter, and until its maturity on August 14, 2032, the obligation fully amortizes over nineteen (19) years. Interest on the Loan accrues on the outstanding principal balance at an annual variable rate equal to the published Wall Street Journal prime rate (5.00% at June 30, 2018) plus 1.0% and is adjustable on the first day of each calendar quarter and fixed for that quarter. At no time shall the annual interest rate be less than 5.50%. The balance under this Loan was \$4,596,000 and \$4,648,000 at June 30, 2018 and March 31, 2018, respectively.

The Loan includes a one-time origination and guaranty fees totaling \$214,500 and an annual renewal fee payable in the amount of 0.25% of the USDA guaranteed portion of the outstanding principal balance as of December 31 of each year, beginning December 31, 2012. The USDA has guaranteed 80% of all amounts owing under the Loan. The Company is subject to financial covenants and customary affirmative and negative covenants.

On October 6, 2017, the Company entered into an Equipment Finance Agreement (the “Equipment Agreement”) with a lender, which provides up to \$175,000 of financing for equipment. The interest rate on this loan is 4.75%. The provisions of the Equipment Agreement require the payment of principal and interest until its maturity on October 31, 2022, the obligation fully amortizes over five (5) years. The balance under this loan was \$149,000 and \$156,000 at June 30, 2018 and March 31, 2018, respectively.

### *Capital Leases*

The Company has three capital leases providing for \$278,000 in equipment, secured by the equipment financed. The capital leases mature at various dates between May 2019 and March 2021 and are payable in 60 equal monthly payments, except for one which is payable in 36 equal monthly payments. The interest rates under these capital leases range from 4.18% to 12.90%. The aggregate balance under these leases was \$131,000 and \$148,000 at June 30, 2018 and March 31, 2018, respectively.

Future principal payments under the term loan and capital lease agreements as of June 30, 2018 are as follows:

<b>Payments Due</b>	<b>(in thousands)</b>
Next 12 Months	\$ 660
Year 2	684
Year 3	685
Year 4	716
Year 5	398
Thereafter	3,377
Total principal payments	\$ 6,520

Table of Contents**7. OPERATING LEASES**

The Company leases facilities, equipment and land under operating leases expiring through 2035. The land lease provides for contingent rentals in excess of minimum rental commitments based on a percentage of the Company's sales. Management has accrued for the estimated contingent rent as of June 30, 2018.

Future minimum lease payments under all non-cancelable operating leases at June 30, 2018 are as follows:

<b>Payments Due</b>	<b>(in thousands)</b>
Next 12 Months	\$ 628
Year 2	611
Year 3	537
Year 4	533
Year 5	397
Thereafter	3,741
Total minimum lease payments	\$ 6,447

**8. OTHER COMMITMENTS AND CONTINGENCIES**

From time to time, the Company may be involved in litigation and investigations relating to claims and matters arising out of its operations in the normal course of business. The Company believes that it currently is not a party to any legal proceedings or claims which, individually or in aggregate, would have a material effect on its consolidated financial position, results of operations or cash flows.

**9. SHARE-BASED COMPENSATION**

The Company accounts for share-based payment arrangements using fair value. If an award vests or becomes exercisable based on the achievement of a condition other than service, such as for meeting certain performance or market conditions, the award is classified as a liability. Liability-classified awards are remeasured to fair value at each balance sheet date until the award is settled. The Company currently has no liability-classified awards.

Equity-classified awards, including grants of employee stock options, are measured at the grant-date fair value of the award and are not subsequently remeasured unless an award is modified. The cost of equity-classified awards is recognized in the statement of operations over the period during which an employee is required to provide the service in exchange for the award, or the vesting period. All of the Company's stock options are service-based awards, and

because the Company's stock options are "plain vanilla," as defined by the U.S. Securities and Exchange Commission in Staff Accounting Bulletin No. 107, they are reflected only in equity and compensation expense accounts.

As of June 30, 2018, the Company had two equity-based compensation plans: the 2016 Equity Incentive Plan (the 2016 Plan) and the 2014 Independent Director Stock Option and Restricted Stock Grant Plan (the "2014 Directors Plan"). The Company has also issued stock options, which remain outstanding as of June 30, 2018, under two equity-based compensation plans which have expired according to their terms: the 2005 Stock Option Plan (the "2005 Plan") and the 2004 Independent Director Stock Option and Stock Grant Plan (the "2004 Directors Plan"). These plans allowed the Company to award stock options and shares of restricted common stock to eligible employees, certain outside consultants and independent directors. No additional awards will be issued under the 2005 Plan or the 2004 Directors Plan.

On August 25, 2016, the Company's shareholders approved the 2016 Plan as a successor to the 2005 Plan, authorizing the Board of Directors to provide incentive to the Company's officers, employees and certain independent consultants through equity based compensation in the form of stock options, restricted stock, restricted stock units, stock appreciation rights and other stock based awards (together, "Stock Awards") and performance shares and performance units (together "Performance Awards"). Awards under the 2016 Plan are limited to the authorized amount of 1,300,000 shares, up to 600,000 of which are available for issuance in connection with Performance Awards and Stock Awards. As of June 30, 2018, there were 1,131,483 shares available for grant under the 2016 Plan.

On August 28, 2014, the Company's shareholders approved the 2014 Directors Plan authorizing the Board of Directors to provide incentive to the Company's independent directors through equity based compensation in the form of stock options and restricted stock. Awards under the 2014 Directors Plan are limited to the authorized amount of 350,000 shares. As of June 30, 2018, there were 231,623 shares available for grant under the 2014 Directors Plan.



Table of Contents

The following table presents shares authorized, available for future grant and outstanding under each of the Company's plans:

	<b>As of June 30, 2018</b>		
	<b>Authorized</b>	<b>Available</b>	<b>Outstanding</b>
2016 Plan	1,300,000	1,131,483	152,514
2014 Directors Plan	350,000	231,623	12,000
2005 Plan	—	—	437,400
2004 Directors Plan	—	—	12,000
Total	1,650,000	1,363,106	613,914

**Stock Options**

All stock option grants made under the equity-based compensation plans were issued at exercise prices no less than the Company's closing stock price on the date of grant. Options under the 2005 Plan and 2014 Directors Plan were determined by the Board of Directors or the Compensation Committee of the Board of Directors in accordance with the provisions of the respective plans. The terms of each option grant include vesting, exercise, and other conditions are set forth in a Stock Option Agreement evidencing each grant. No option can have a life in excess of ten (10) years. The Company records compensation expense for employee stock options based on the estimated fair value of the options on the date of grant using the Black-Scholes option-pricing model. The model requires various assumptions, including a risk-free interest rate, the expected term of the options, the expected stock price volatility over the expected term of the options, and the expected dividend yield. Compensation expense for employee stock options is recognized ratably over the vesting term. Compensation expense recognized for options issued under all Plans was \$18,000 and \$15,000 for the three months ended June 30, 2018 and 2017, respectively. All stock-based compensation has been classified as general and administrative expense in the condensed consolidated statement of operations.

A summary of option activity under the Company's stock plans for the three months ended June 30, 2018 is presented below:

<b>Option Activity</b>	<b>Shares</b>	<b>Weighted Average Exercise Price</b>	<b>Weighted Average Remaining Contractual Term (in years)</b>	<b>Aggregate Intrinsic Value</b>
Outstanding at March 31, 2018	589,400	\$ 4.06	4.9	\$ 675,300

Granted	—	—		
Exercised	(6,000 )	\$ 2.85		
Forfeited	(2,000 )	\$ 5.61		
Outstanding at June 30, 2018	581,400	\$ 4.07	4.7	\$ 158,724
Exercisable at June 30, 2018	461,400	\$ 4.21	3.6	\$ 114,324

The aggregate intrinsic value in the table above is before applicable income taxes and represents the excess amount over the exercise price optionees would have received if all options had been exercised on the last business day of the period indicated, based on the Company's closing stock price of \$3.90 for such day.

A summary of the Company's non-vested options for the three months ended June 30, 2018 is presented below:

<b>Nonvested Options</b>	<b>Shares</b>	<b>Weighted Average Grant-Date Fair Value</b>
Nonvested at March 31, 2018	120,000	\$ 1.81
Granted	—	—
Vested	—	—
Forfeited	—	—
Nonvested at June 30, 2018	120,000	\$ 1.81

Table of Contents

The following table summarizes the weighted average characteristics of outstanding stock options as of June 30, 2018:

Range of Exercise Prices	Outstanding Options			Exercisable Options		
	Number of Shares	Remaining Life (Years)	Weighted Average Price	Number of Shares	Weighted Average Price	
\$1.60 - \$3.70	166,800	5.1	\$ 3.06	91,800	\$2.82	
\$3.71 - \$4.42	239,100	4.5	3.83	194,100	3.83	
\$4.43 - \$5.40	95,000	4.9	5.00	95,000	5.00	
\$5.41 - \$7.08	80,500	4.4	5.77	76,704	73,408	73,714
Gross margin	90,052	102,753	116,101	139,020	135,945	
Operating expenses	82,710	88,672	98,249	99,232	104,110	
Income from operations	7,342	14,081	17,852	39,788	31,835	
Interest and other income, net	3,455	6,845	8,045	4,914	1,253	
Income before income taxes	10,797	20,926	25,897	44,702	33,088	
Income tax expense, net	4,340	8,516	9,946	20,079	14,395	
Net income	\$ 6,457	\$12,410	\$15,951	\$24,623	\$18,693	
Net income per share - basic	\$ 0.35	\$0.66	\$0.84	\$1.27	\$0.95	
Net income per share - diluted	\$ 0.34	\$0.65	\$0.82	\$1.26	\$0.94	
Weighted average shares outstanding - basic	18,453	18,751	19,044	19,372	19,780	
Weighted average shares outstanding - diluted	19,007	19,165	19,404	19,550	19,925	

As of December 31,

Consolidated Balance Sheet Data:	2005	2006	2007	2008	2009
Cash, cash equivalents, short-term and long-term investments	\$ 134,185	\$ 158,148	\$ 187,426	\$ 224,590	\$ 255,698
Working capital	124,501	154,606	167,441	183,347	203,660

Edgar Filing: CYANOTECH CORP - Form 10-Q

Total assets	248,059	275,437	321,843	334,384	404,579
Total liabilities	23,263	25,327	40,038	30,963	45,573
Stockholders' equity	224,796	250,110	281,805	303,421	359,006

Other Operating Data	2005	2006	As of December 31, 2007	2008	2009
Number of subscription client sites	11,464	13,257	14,467	15,920	16,020
Millions of properties in database	1.8	2.1	2.7	3.2	3.6

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following Management's Discussion and Analysis of Financial Condition and Results of Operations contains "forward-looking statements," including statements about our beliefs and expectations. There are many risks and uncertainties that could cause actual results to differ materially from those discussed in the forward-looking statements. Potential factors that could cause actual results to differ materially from those discussed in any forward-looking statements include, but are not limited to, those stated above in Item 1A. under the headings "Risk Factors — Cautionary Statement Concerning Forward-Looking Statements" and "—Risk Factors," as well as those described from time to time in our filings with the Securities and Exchange Commission.

All forward-looking statements are based on information available to us on the date of this filing and we assume no obligation to update such statements. The following discussion should be read in conjunction with our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and other filings with the Securities and Exchange Commission and the consolidated financial statements and related notes in this Annual Report on Form 10-K.

Overview

CoStar Group, Inc. ("CoStar") is the number one provider of information, marketing and analytic services to the commercial real estate industry in the U.S. and the U.K. based on the fact that we offer the most comprehensive commercial real estate database available, have the largest research department in the industry, provide more information, marketing and analytic services than any of our competitors and believe we generate more revenues than any of our competitors. We have created a standardized information, marketing and analytic platform where members of the commercial real estate and related business community can continuously interact and facilitate transactions by efficiently exchanging accurate and standardized commercial real estate information. Our integrated suite of online service offerings includes information about space available for lease, comparable sales information, tenant information, information about properties for sale, internet marketing services, information for clients' websites, information about industry professionals and their business relationships, data integration, and industry news. We also provide market research and analysis for commercial real estate investors and lenders via our PPR service offerings. Our service offerings span all commercial property types, including office, industrial, retail, land, mixed-use, hospitality and multifamily.

Since 1994, we have expanded the geographical coverage of our existing information and marketing services and developed new information, marketing and analytic services. In addition to internal growth, this expansion included the acquisitions of Chicago ReSource, Inc. in Chicago in 1996 and New Market Systems, Inc. in San Francisco in 1997. In August 1998, we expanded into the Houston region through the acquisition of Houston-based real estate information provider C Data Services, Inc. In January 1999, we expanded further into the Midwest and Florida by acquiring LeaseTrend, Inc. and into Atlanta and Dallas/Fort Worth by acquiring Jamison Research, Inc. In February 2000, we acquired COMPS.COM, Inc., a San Diego-based provider of commercial real estate information. In November 2000, we acquired First Image Technologies, Inc., a California-based provider of commercial real estate software. In September 2002, we expanded further into Portland, Oregon through the acquisition of certain assets of Napier Realty Advisors (doing business as REAL-NET). In January 2003, we established a base in the U.K. with our acquisition of London-based FOCUS Information Limited. In May 2004, we expanded into Tennessee through the acquisition of Peer Market Research, Inc., and in September 2004, we extended our coverage of the U.K. through the acquisition of Scottish Property Network. In September 2004, we strengthened our position in Denver, Colorado through the acquisition of substantially all of the assets of RealComp, Inc., a local comparable sales information provider.

In January 2005, we acquired National Research Bureau, a Connecticut-based provider of U.S. shopping center information. In December 2006, our U.K. subsidiary, CoStar Limited, acquired Grecam S.A.S. ("Grecam"), a provider

of commercial property information and market-level surveys, studies and consulting services located in Paris, France. In February 2007, CoStar Limited also acquired Property Investment Exchange Limited (“Propex”), a provider of commercial property information and operator of an electronic platform that facilitates the exchange of investment property located in London, England. In April 2008, we acquired the assets of First CLS, Inc. (doing business as the Dorey Companies and DoreyPRO), an Atlanta-based provider of local commercial real estate information. Most recently, in July 2009, we acquired Massachusetts-based Property and Portfolio Research, Inc. (“PPR”), a provider of real

estate analysis, market forecasts and credit risk analytics to the commercial real estate industry, and its wholly owned U.K. subsidiary Property and Portfolio Research Ltd., and in October 2009, we acquired Massachusetts-based Resolve Technology, Inc. (“Resolve Technology”), a provider of business intelligence and portfolio management software serving the institutional real estate investment industry. The First CLS, Inc., PPR and Resolve Technology acquisitions are discussed later in this section under the heading “Recent Acquisitions.”

In 2004, we began our expansion into 21 new metropolitan markets throughout the U.S. and began expanding the geographical coverage of many of our existing U.S. and U.K. markets. We completed our expansion into the 21 new markets in the first quarter of 2006. In early 2005, in conjunction with the acquisition of National Research Bureau, we launched a major effort to expand our coverage of retail real estate information. The retail component of our flagship product, CoStar Property Professional, was unveiled in May 2006 at the International Council of Shopping Centers’ convention in Las Vegas.

During the second half of 2006, in order to expand the geographical coverage of our service offerings, we began actively researching commercial properties in 81 new Core Based Statistical Areas (“CBSAs”) in the U.S., we increased our U.S. field research fleet by adding 89 vehicles and we hired researchers to staff these vehicles. We released our CoStar Property Professional service in the 81 new CBSAs across the U.S. in the fourth quarter of 2007. Throughout our recent expansion efforts, we have remained focused on ensuring that CoStar continues to provide the quality of information our customers expect. As such, in 2009 we expanded our research operations, and we plan to continue to grow our research operations slightly in 2010, in order to continue to meet customer expectations.

During the second half of 2009, as a part of our strategy to provide subscribers with tools for conducting primary research and analysis on commercial real estate, we expanded subscribers’ capabilities to use CoStar’s database of research-verified commercial property information to conduct in-depth analysis and generate reports on trends in sales and leasing activity online. Further, in July 2009, we acquired PPR and its wholly owned subsidiary, providers of real estate investment analysis and market forecasting services.

In connection with our acquisitions of Propex, Grecam and PPR’s wholly owned subsidiary Property and Portfolio Research Ltd., we intend to expand the coverage of our service offerings within the U.K. and to integrate our international operations more fully with those in the U.S. We have gained operational efficiencies as a result of consolidating a majority of our U.K. research operations in one location in Glasgow and combining the majority of our remaining U.K. operations in one central location in London.

We intend to eventually introduce a consistent international platform of service offerings. In 2007, we introduced the “CoStar Group” as the brand encompassing our international operations. We believe that our recent U.S. and international expansion and integration efforts have created a platform for long-term growth.

We expect to continue to develop and distribute new services, expand existing services within our current platform, consider strategic acquisitions and expand and develop our sales and marketing organization. For instance, in May 2008, we released CoStar Showcase®, an internet marketing service that provides commercial real estate professionals the opportunity to make their listings accessible to all visitors to our public website, [www.CoStar.com](http://www.CoStar.com). More recently, in July 2009, we expanded subscribers’ analytic capabilities to use our online database to conduct in-depth analysis and generate reports on sales and leasing activity through our acquisition of PPR and in October 2009, we acquired Resolve Technology, which enabled us to provide our customers with additional tools for analyzing commercial real estate markets. Any future expansion could reduce our profitability and increase our capital expenditures. Therefore, while we expect current service offerings to remain profitable, driving overall earnings throughout 2010 and providing substantial cash flow for our business, it is possible that any new investments could cause us to generate losses and negative cash flow from operations in the future.

Current general economic conditions in the U.S. and the world are negatively affecting business operations for our clients and are resulting in more business consolidations and, in certain circumstances, failures. As a result of these economic conditions, we continue to see customer cancellations, reductions of services and failures to pay amounts due to us, although at a slower pace than in previous quarters. If cancellations, reductions of services and failures to pay continue at the current rate or increase, and we are unable to offset the resulting decrease in revenue by increasing sales to new or existing customers, our revenues may decline or grow at reduced rates. Additionally,



current economic conditions may cause customers to reduce expenses, and customers may be forced to purchase fewer services from us or cancel all services. We compete against many other commercial real estate information, marketing and analytic service providers for business. If customers choose to cancel our services for cost-cutting or other reasons, our revenue could decline. The extent and duration of any future continued weakening of the economy is unknown. The extent and duration of any benefits resulting from any of the governmental or private sector initiatives designed to strengthen the economy are currently unknown and there can be no assurance that those initiatives will be successful in the future. Because of these uncertainties, we may not be able to accurately forecast our revenue or earnings. However, we continue to believe that the Company is positioned to generate continued, sustained earnings in 2010.

Our financial reporting currency is the U.S. dollar. Changes in exchange rates can significantly affect our reported results and consolidated trends. We believe that our increasing diversification beyond the U.S. economy through our international businesses benefits our stockholders over the long term. We also believe it is important to evaluate our operating results before and after the effect of currency changes, as it may provide a more accurate comparison of our results of operations over historical periods. Currency volatility may continue, which may impact (either positively or negatively) our reported financial results and consolidated trends and comparisons.

We currently issue stock options and/or restricted stock to our officers, directors and employees, and as a result we record additional compensation expense in our consolidated statements of operations. We plan to continue the use of stock-based compensation for our officers, directors and employees, which may include, among other things, restricted stock or stock option grants that typically will require us to record additional compensation expense in our consolidated statements of operations and reduce our net income.

Our subscription-based information services, consisting primarily of CoStar Property Professional, CoStar Tenant, CoStar COMPS Professional, and FOCUS services currently generate more than 95% of our total revenues. CoStar Property Professional, CoStar Tenant, and CoStar COMPS Professional are generally sold as a suite of similar services and comprise our primary service offering in our U.S. operating segment. FOCUS is our primary service offering in our International operating segment. The majority of our contracts for our subscription-based information services typically have a minimum term of one year and renew automatically. Upon renewal, many of the subscription contract rates may change in accordance with contract provisions or as a result of contract renegotiations. To encourage clients to use our services regularly, we generally charge a fixed monthly amount for our subscription-based information services rather than fees based on actual system usage. Contract rates are generally based on the number of sites, number of users, organization size, the client's business focus, geography and the number of services to which a client subscribes. Our subscription clients generally pay contract fees on a monthly basis, but in some cases may pay us on a quarterly or annual basis. We recognize this revenue on a straight-line basis over the life of the contract. Annual and quarterly advance payments result in deferred revenue, substantially reducing the working capital requirements generated by accounts receivable.

For the twelve months ended December 31, 2009 and 2008, our contract renewal rate was approximately 85% and 89%, respectively. As discussed above, our trailing twelve-month contract renewal rate may continue to decline if continuing negative economic conditions lead to greater business failures and/or consolidations, further reductions in customer spending or decreases in the customer base.

#### Application of Critical Accounting Policies and Estimates

The preparation of financial statements and related disclosures in conformity with generally accepted accounting principles ("GAAP") in the United States of America 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 revenues and expenses during the period reported. The following accounting policies involve a "critical accounting estimate" because they are particularly dependent on estimates and assumptions made by

management about matters that are highly uncertain at the time the accounting estimates are made. In addition, while we have used our best estimates based on facts and circumstances available to us at the time, different estimates reasonably could have been used in the current period. Changes in the accounting estimates we use are reasonably likely to occur from period to period, which may have a material impact on the presentation of our financial condition and results of operations. We review these estimates and assumptions periodically and reflect the effects of revisions in the period that they are determined to be necessary.

## Valuation of Long-Lived and Intangible Assets and Goodwill

We assess the impairment of long-lived assets, identifiable intangibles and goodwill whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Judgments made by management relate to the expected useful lives of long-lived assets and our ability to realize any undiscounted cash flows of the carrying amounts of such assets. The accuracy of these judgments may be adversely affected by several factors, including the factors listed below:

- Significant underperformance relative to historical or projected future operating results;
- Significant changes in the manner of our use of the acquired assets or the strategy for our overall business;
  - Significant negative industry or economic trends; or
- Significant decline in our market capitalization relative to net book value for a sustained period.

When we determine that the carrying value of long-lived and identifiable intangible assets may not be recovered based upon the existence of one or more of the above indicators, we test for impairment.

Goodwill and identifiable intangible assets not subject to amortization are tested annually by each reporting unit on October 1 of each year for impairment and are tested for impairment more frequently based upon the existence of one or more of the above indicators. We consider our operating segments, U.S. and International, as our reporting units under FASB authoritative guidance for consideration of potential impairment of goodwill.

The goodwill impairment test is a two-step process. The first step is to determine the fair value of each reporting unit. We estimate the fair value of each reporting unit based on a projected discounted cash flow model that includes significant assumptions and estimates including our future financial performance and a weighted average cost of capital. The fair value of each reporting unit is compared to the carrying amount of the reporting unit. If the carrying value of the reporting unit exceeds the fair value, then the second step of the process is performed to measure the impairment loss. We measure impairment loss based on a projected discounted cash flow method using a discount rate determined by our management to be commensurate with the risk in our current business model. A 50% decrease in the fair value of our International reporting unit as of December 31, 2009 would have no impact on the carrying value of our goodwill.

## Accounting for Income Taxes

As part of the process of preparing our consolidated financial statements, we are required to estimate our income taxes in each of the jurisdictions in which we operate. This process requires us to estimate our actual current tax exposure and assess the temporary differences resulting from differing treatment of items, such as deferred revenue or deductibility of certain intangible assets, for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included within our consolidated balance sheets. We must then also assess the likelihood that our deferred tax assets will be recovered from future taxable income, and, to the extent we believe that it is more-likely-than not that some portion or all of our deferred tax assets will not be realized, we must establish a valuation allowance. To the extent we establish a valuation allowance or change the allowance in a period, we must reflect the corresponding increase or decrease within the tax provision in the statements of operations.

## Non-GAAP Financial Measures

We prepare and publicly release quarterly unaudited financial statements prepared in accordance with GAAP. We also disclose and discuss certain non-GAAP financial measures in our public releases. Currently, the non-GAAP financial measure that we disclose is EBITDA, which is our net income (loss) before interest, income taxes, depreciation and amortization. We disclose EBITDA on a consolidated and an operating segment basis in our earnings releases, investor conference calls and filings with the Securities and Exchange Commission. The non-GAAP financial

measures that we use may not be comparable to similarly titled measures reported by other companies. Also, in the future, we may disclose different non-GAAP financial measures in order to help our investors more meaningfully evaluate and compare our future results of operations to our previously reported results of operations.

We view EBITDA as an operating performance measure and as such we believe that the GAAP financial measure most directly comparable to it is net income (loss). In calculating EBITDA, we exclude from net income (loss) the financial items that we believe should be separately identified to provide additional analysis of the financial components of the day-to-day operation of our business. We have outlined below the type and scope of these exclusions and the material limitations on the use of this non-GAAP financial measure as a result of these exclusions. EBITDA is not a measurement of financial performance under GAAP and should not be considered as a measure of liquidity, as an alternative to net income (loss) or as an indicator of any other measure of performance derived in accordance with GAAP. Investors and potential investors in our securities should not rely on EBITDA as a substitute for any GAAP financial measure, including net income (loss). In addition, we urge investors and potential investors in our securities to carefully review the reconciliation of EBITDA to net income (loss) set forth below, in our earnings releases and in other filings with the Securities and Exchange Commission and to carefully review the GAAP financial information included as part of our Quarterly Reports on Form 10-Q and our Annual Reports on Form 10-K that are filed with the Securities and Exchange Commission, as well as our quarterly earnings releases, and compare the GAAP financial information with our EBITDA.

EBITDA is used by management to internally measure our operating and management performance and by investors as a supplemental financial measure to evaluate the performance of our business that, when viewed with our GAAP results and the accompanying reconciliation, we believe provides additional information that is useful to gain an understanding of the factors and trends affecting our business. We have spent more than 22 years building our database of commercial real estate information and expanding our markets and services partially through acquisitions of complementary businesses. Due to the expansion of our information, marketing and analytic services, which included acquisitions, our net income (loss) has included significant charges for purchase amortization, depreciation and other amortization. EBITDA excludes these charges and provides meaningful information about the operating performance of our business, apart from charges for purchase amortization, depreciation and other amortization. We believe the disclosure of EBITDA helps investors meaningfully evaluate and compare our performance from quarter to quarter and from year to year. We also believe EBITDA is a measure of our ongoing operating performance because the isolation of non-cash charges, such as amortization and depreciation, and non-operating items, such as interest and income taxes, provides additional information about our cost structure, and, over time, helps track our operating progress. In addition, investors, securities analysts and others have regularly relied on EBITDA to provide a financial measure by which to compare our operating performance against that of other companies in our industry.

Set forth below are descriptions of the financial items that have been excluded from our net income (loss) to calculate EBITDA and the material limitations associated with using this non-GAAP financial measure as compared to net income (loss):

- Purchase amortization in cost of revenues may be useful for investors to consider because it represents the use of our acquired database technology, which is one of the sources of information for our database of commercial real estate information. We do not believe these charges necessarily reflect the current and ongoing cash charges related to our operating cost structure.
- Purchase amortization in operating expenses may be useful for investors to consider because it represents the estimated attrition of our acquired customer base and the diminishing value of any acquired trade names. We do not believe these charges necessarily reflect the current and ongoing cash charges related to our operating cost structure.
- Depreciation and other amortization may be useful for investors to consider because they generally represent the wear and tear on our property and equipment used in our operations. We do not believe these charges necessarily reflect the current and ongoing cash charges related to our operating cost structure.
- The amount of net interest income we generate may be useful for investors to consider and may result in current cash inflows or outflows. However, we do not consider the amount of net interest income to be a representative

component of the day-to-day operating performance of our business.

31

---

- Income tax expense (benefit) may be useful for investors to consider because it generally represents the taxes which may be payable for the period and the change in deferred income taxes during the period and may reduce the amount of funds otherwise available for use in our business. However, we do not consider the amount of income tax expense (benefit) to be a representative component of the day-to-day operating performance of our business.

Management compensates for the above-described limitations of using non-GAAP measures by using a non-GAAP measure only to supplement our GAAP results and to provide additional information that is useful to gain an understanding of the factors and trends affecting our business.

The following table shows our EBITDA reconciled to our net income and our cash flows from operating, investing and financing activities for the indicated periods (in thousands):

	Year Ended December 31,		
	2007	2008	2009
Net income	\$ 15,951	\$ 24,623	\$ 18,693
Purchase amortization in cost of revenues	2,170	2,284	2,389
Purchase amortization in operating expenses	5,063	4,880	3,412
Depreciation and other amortization	8,914	9,637	8,875
Interest income, net	(8,045 )	(4,914 )	(1,253 )
Income tax expense, net	9,946	20,079	14,395
EBITDA	\$ 33,999	\$ 56,589	\$ 46,511
Cash flows provided by (used in)			
Operating activities	\$ 51,732	\$ 40,908	\$ 39,569
Investing activities	\$(40,331 )	\$ 52,430	\$ 3,408
Financing activities	\$ 8,161	\$ 11,475	\$ 2,172

#### Consolidated Results of Operations

The following table provides our selected consolidated results of operations for the indicated periods (in thousands of dollars and as a percentage of total revenue):

	Year Ended December 31,								
	2007			2008			2009		
Revenues	\$ 192,805	100.0	%	\$ 212,428	100.0	%	\$ 209,659	100.0	%
Cost of revenues	76,704	39.8		73,408	34.6		73,714	35.2	
Gross margin	116,101	60.2		139,020	65.4		135,945	64.8	
Operating expenses:									
Selling and marketing	51,777	26.9		41,705	19.6		42,508	20.3	
Software development	12,453	6.5		12,759	6.0		13,942	6.6	
General and administrative	36,569	19.0		39,888	18.8		44,248	21.1	
Gain on lease settlement, net	(7,613 )	(3.9 )	¾	0.0	¾		0.0		
Purchase amortization	5,063	2.6		4,880	2.3		3,412	1.6	

Edgar Filing: CYANOTECH CORP - Form 10-Q

Total operating expenses	98,249	51.0	99,232	46.7	104,110	49.7	
Income from operations	17,852	9.3	39,788	18.7	31,835	15.2	
Interest and other income, net	8,045	4.2	4,914	2.3	1,253	0.6	
Income before income taxes	25,897	13.4	44,702	21.0	33,088	15.8	
Income tax expense, net	9,946	5.2	20,079	9.5	14,395	6.9	
Net income	\$15,951	8.3	% \$24,623	11.6	% \$18,693	8.9	%

32

---



Comparison of Year Ended December 31, 2009 and Year Ended December 31, 2008

**Revenues.** Revenues decreased to \$209.7 million in 2009, from \$212.4 million in 2008. Revenues from customers in our International operations decreased \$4.3 million primarily due to foreign currency fluctuations. The decrease in International revenues was partially offset by an increase in U.S. revenues of approximately \$1.5 million. The increase in U.S. revenues is primarily due to additional revenue of approximately \$8.5 million from our July 2009 acquisition of PPR partially offset by decreased sales resulting from a difficult commercial real estate and economic environment. Our subscription-based information services consist primarily of CoStar Property Professional, CoStar Tenant, CoStar COMPS Professional, FOCUS services and Propex services. As of December 31, 2009, our subscription-based information services represented more than 95% of our total revenues.

**Gross Margin.** Gross margin decreased to \$135.9 million in 2009, from \$139.0 million in 2008. The gross margin percentage decreased to 64.8% in 2009, from 65.4% in 2008. The decrease in the amount and percentage of gross margin was principally due to a \$2.8 million decrease in revenue in 2009.

**Selling and Marketing Expenses.** Selling and marketing expenses increased to \$42.5 million in 2009, from \$41.7 million in 2008, and increased as a percentage of revenues to 20.3% in 2009, from 19.6% in 2008. The increase in the amount and percentage of selling and marketing expenses was primarily due to additional selling and marketing expenses of approximately \$1.7 million incurred by PPR and included as a result of our July 2009 acquisition of PPR. The increase was offset by an approximately \$900,000 decrease due to foreign currency fluctuations.

**Software Development Expenses.** Software development expenses increased to \$13.9 million in 2009, from \$12.8 million in 2008, and increased as a percentage of revenues to 6.6% in 2009, from 6.0% in 2008. The increase in the amount and percentage of software development expenses was due to additional software development expenses of approximately \$600,000 incurred by PPR and included as a result of our July 2009 acquisition of PPR as well as additional development expenses of approximately \$400,000 incurred by Resolve Technology, and included as a result of our October 2009 acquisition of Resolve Technology.

**General and Administrative Expenses.** General and administrative expenses increased to \$44.2 million in 2009, from \$39.9 million in 2008, and increased as a percentage of revenues to 21.1% in 2009, from 18.8% in 2008. The increase in the amount and percentage of general and administrative expenses was principally a result of an increase of acquisition and deal related costs of approximately \$700,000, an increase in legal fees of \$2.0 million and additional general and administrative expenses of approximately \$1.1 million incurred by PPR and included as a result of our July 2009 acquisition of PPR.

**Purchase Amortization.** Purchase amortization decreased to \$3.4 million in 2009, from \$4.9 million in 2008, and decreased as a percentage of revenues to 1.6% in 2009, from 2.3% in 2008. The decrease in purchase amortization expense is due to the completion of amortization for certain identifiable intangible assets in 2009.

**Interest and Other Income, Net.** Interest and other income, net decreased to \$1.3 million in 2009, from \$4.9 million in 2008. Interest and other income, net decreased due to lower average interest rates in 2009 compared to 2008.

**Income Tax Expense, Net.** Income tax expense, net decreased to \$14.4 million in 2009, from \$20.1 million in 2008. This decrease was due to lower income before income taxes as a result of our decreased profitability.

Comparison of Business Segment Results for Year Ended December 31, 2009 and Year Ended December 31, 2008

We manage our business geographically in two operating segments, with our primary areas of measurement and decision-making being the U.S. and International, which includes the U.K. and France. Management relies on an internal management reporting process that provides segment revenue and EBITDA, which is our net income before

interest, income taxes, depreciation and amortization. Management believes that segment EBITDA is an appropriate measure for evaluating the operational performance of our segments. EBITDA is used by management to internally measure our operating and management performance and to evaluate the performance of our business. However, this measure should be considered in addition to, not as a substitute for or superior to, income from operations or other measures of financial performance prepared in accordance with GAAP.

**Segment Revenues.** CoStar Property Professional, CoStar Tenant, and CoStar COMPS Professional are generally sold as a suite of similar services and comprise our primary service offering in our U.S. operating segment. U.S. revenues increased to \$191.6 million from \$190.1 million for the years ended December 31, 2009 and 2008, respectively. This increase in U.S. revenue is due to additional revenues of approximately \$8.5 million included as a result of our July 2009 acquisition of PPR, partially offset by a decrease of approximately \$7.0 million in U.S. revenues due to decreased sales resulting from a difficult commercial real estate and economic environment. FOCUS is our primary service offering in our International operating segment. International revenues decreased approximately \$4.3 million primarily due to foreign currency fluctuations, partially offset by intersegment revenues of approximately \$900,000 attributable to services performed by Property and Portfolio Research Ltd. for PPR. Intersegment revenues are eliminated from total revenues.

**Segment EBITDA.** U.S. EBITDA decreased to \$47.7 million from \$58.8 million for the years ended December 31, 2009 and 2008, respectively. The decrease in U.S. EBITDA was due primarily to additional costs incurred by PPR, which we acquired in July of 2009 and increased legal fees. International EBITDA decreased to a loss of \$1.2 million for the year ended December 31, 2009 from a \$2.2 million loss for the year ended December 31, 2008. This decreased loss is primarily due to a lower corporate allocation in 2009 as compared to 2008. International EBITDA includes a corporate allocation of approximately \$500,000 and \$1.1 million for the years ended December 31, 2009 and 2008, respectively. The corporate allocation represents costs incurred for U.S. employees involved in international management and expansion activities.

#### Comparison of Year Ended December 31, 2008 and Year Ended December 31, 2007

**Revenues.** Revenues grew to \$212.4 million in 2008, from \$192.8 million in 2007. This increase in revenue was due to further penetration of our subscription-based information and marketing services, and successful cross-selling of our services to our customers in existing markets, combined with continued high renewal rates. Our subscription-based information services consist primarily of CoStar Property Professional, CoStar Tenant, CoStar COMPS Professional, FOCUS services and Propex services. As of December 31, 2008, our subscription-based information and marketing services represented more than 90% of our total revenues.

**Gross Margin.** Gross margin increased to \$139.0 million in 2008, from \$116.1 million in 2007. The gross margin percentage increased to 65.4% in 2008, from 60.2% in 2007. The increase in the gross margin resulted principally from revenue growth from our subscription-based information and marketing services and a decrease in cost of revenues. Cost of revenues decreased to \$73.4 million for the year ended December 31, 2008, from \$76.7 million for the year ended December 31, 2007 principally due to expansion costs that were incurred in 2007 that were not incurred in 2008.

**Selling and Marketing Expenses.** Selling and marketing expenses decreased to \$41.7 million in 2008, from \$51.8 million in 2007, and decreased as a percentage of revenues to 19.6% in 2008, from 26.9% in 2007. The decrease was principally due to a reduction in personnel costs of approximately \$5.4 million primarily due to the fact that the sales force sold services with a smaller average price point in 2008, which resulted in lower average contract values compared to 2007. Additionally, there was a decrease in marketing initiatives of approximately \$2.3 million in 2008.

**Software Development Expenses.** Software development expenses slightly increased to \$12.8 million in 2008, from \$12.5 million in 2007, and slightly decreased as a percentage of revenues to 6.0% in 2008, from 6.5% in 2007. The decrease in the percentage was primarily due to increased revenues in 2008.

**General and Administrative Expenses.** General and administrative expenses increased to \$39.9 million in 2008, from \$36.6 million in 2007, and decreased slightly as a percentage of revenues to 18.8% in 2008, from 19.0% in 2007. The increase in the amount of general and administrative expenses was principally a result of an increase of approximately \$2.5 million in legal fees and an increase of \$1.6 million in bad debt expense.



Gain on Lease Settlement, Net. On September 14, 2007, CoStar U.K Limited, a wholly owned U.K. subsidiary of CoStar, entered into an agreement with Trafigura Limited to assign to Trafigura our leasehold interest in our office space located in London. The lease assignment was effective on December 19, 2007. As a result, CoStar U.K. Limited was paid \$7.6 million, net of expenses, for the assignment of the lease. There were no gains on lease settlements in 2008.

Purchase Amortization. Purchase amortization slightly decreased to \$4.9 million in 2008, from \$5.1 million in 2007, and slightly decreased as a percentage of revenues to 2.3% in 2008, from 2.6% in 2007.

Interest and Other Income, Net. Interest and other income, net decreased to \$4.9 million in 2008, from \$8.0 million in 2007. Although, cash and cash equivalents, short-term and long-term investments were higher in 2008 than in 2007, our interest and other income decreased due to lower average interest rates in 2008 compared to 2007.

Income Tax Expense, Net. Income tax expense, net increased to \$20.1 million in 2008, from \$9.9 million in 2007. This increase was primarily due to higher income before income taxes for 2008 due to our growth and profitability, in addition to a higher effective tax rate in 2008. The effective tax rate was lower in 2007 due to the gain on lease settlement in the U.K. that was completed in December 2007. The lease settlement resulted in income in the U.K., which reduced the overall effective tax rate.

#### Comparison of Business Segment Results for Year Ended December 31, 2008 and Year Ended December 31, 2007

Due to the increased size, complexity and funding requirements associated with our international expansion, in 2007 we began to manage our business geographically in two operating segments, with our primary areas of measurement and decision-making being the U.S. and International, which includes the U.K. and France. Management relies on an internal management reporting process that provides segment revenue and EBITDA, which is our net income before interest, income taxes, depreciation and amortization. Management believes that segment EBITDA is an appropriate measure for evaluating the operational performance of our segments. EBITDA is used by management to internally measure our operating and management performance and to evaluate the performance of our business. However, this measure should be considered in addition to, not as a substitute for or superior to, income from operations or other measures of financial performance prepared in accordance with GAAP.

Segment Revenues. CoStar Property Professional, CoStar Tenant, and CoStar COMPS Professional are generally sold as a suite of similar services and comprise our primary service offering in our U.S. operating segment. U.S. revenues increased to \$190.1 million from \$170.3 million for the years ended December 31, 2008 and 2007, respectively. This increase in U.S. revenue is due to further penetration of our U.S. subscription-based information and marketing services and the successful cross-selling of our service to our customers, combined with a continued high renewal rate. FOCUS is our primary service offering in our International operating segment. International revenues slightly decreased to \$22.4 million from \$22.5 million for the years ended December 31, 2008 and 2007, respectively. This decrease is due to foreign currency fluctuations. In their functional currency, International revenues increased 7.2% for the year ended December 31, 2008 compared to the year ended December 31, 2007.

Segment EBITDA. U.S. EBITDA increased to \$58.8 million from \$32.9 million for the years ended December 31, 2008 and 2007, respectively. The increase in U.S. EBITDA was due to increased revenues, and lower sales and marketing personnel costs, partially offset by an increase in legal fees and bad debt expense. International EBITDA decreased to a loss of \$2.2 million from \$1.1 million earnings for the years ended December 31, 2008 and 2007, respectively. This decrease is primarily due to gain on lease settlement of \$7.6 million in 2007 that did not occur in 2008. International EBITDA also includes a corporate allocation of approximately \$1.1 million and \$2.6 million for the years ended December 31, 2008 and 2007, respectively. The corporate allocation represents costs incurred for U.S. employees involved in international management and expansion activities.



## Consolidated Quarterly Results of Operations

The following tables summarize our consolidated results of operations on a quarterly basis for the indicated periods (in thousands, except per share amounts, and as a percentage of total revenues):

	2008				2009			
	Mar. 31	Jun. 30	Sep. 30	Dec. 31	Mar. 31	Jun. 30	Sep. 30	Dec. 31
Revenues	\$ 52,264	\$ 53,478	\$ 53,757	\$ 52,929	\$ 51,370	\$ 50,064	\$ 53,590	\$ 54,635
Cost of revenues	19,721	18,341	17,613	17,733	16,894	16,744	19,149	20,927
Gross margin	32,543	35,137	36,144	35,196	34,476	33,320	34,441	33,708
Operating expenses	25,313	26,627	24,864	22,428	23,735	25,129	27,490	27,756
Income from operations	7,230	8,510	11,280	12,768	10,741	8,191	6,951	5,952
Interest and other income, net	1,938	1,243	951	782	442	322	263	226
Income before income taxes	9,168	9,753	12,231	13,550	11,183	8,513	7,214	6,178
Income tax expense, net	4,126	4,318	5,586	6,049	5,077	3,897	2,889	2,532
Net income	\$ 5,042	\$ 5,435	\$ 6,645	\$ 7,501	\$ 6,106	\$ 4,616	\$ 4,325	\$ 3,646
Net income per share - basic	\$ 0.26	\$ 0.28	\$ 0.34	\$ 0.39	\$ 0.31	\$ 0.24	\$ 0.22	\$ 0.18
Net income per share - diluted	\$ 0.26	\$ 0.28	\$ 0.34	\$ 0.38	\$ 0.31	\$ 0.24	\$ 0.22	\$ 0.18

	2008								2009							
	Mar. 31	Jun. 30	Sep. 30	Dec. 31	Mar. 31	Jun. 30	Sep. 30	Dec. 31	Mar. 31	Jun. 30	Sep. 30	Dec. 31	Mar. 31	Jun. 30	Sep. 30	Dec. 31
Revenues	100.0 %	100.0 %	100.0 %	100.0 %	100.0 %	100.0 %	100.0 %	100.0 %	100.0 %	100.0 %	100.0 %	100.0 %	100.0 %	100.0 %	100.0 %	100.0 %
Cost of revenues	37.7	34.3	32.8	33.5	32.9	33.4	35.7	38.3	32.9	33.4	35.7	38.3	32.9	33.4	35.7	38.3
Gross margin	62.3	65.7	67.2	66.5	67.1	66.6	64.3	61.7	67.1	66.6	64.3	61.7	67.1	66.6	64.3	61.7
Operating expenses	48.5	49.8	46.2	42.4	46.2	50.2	51.3	50.8	46.2	50.2	51.3	50.8	46.2	50.2	51.3	50.8
Income from operations	13.8	15.9	21.0	24.1	20.9	16.4	13.0	10.9	20.9	16.4	13.0	10.9	20.9	16.4	13.0	10.9
Interest and other income, net	3.7	2.3	1.8	1.5	0.9	0.6	0.5	0.4	0.9	0.6	0.5	0.4	0.9	0.6	0.5	0.4
Income before income taxes	17.5	18.2	22.8	25.6	21.8	17.0	13.5	11.3	21.8	17.0	13.5	11.3	21.8	17.0	13.5	11.3
Income tax expense, net	7.9	8.0	10.4	11.4	9.9	7.8	5.4	4.6	9.9	7.8	5.4	4.6	9.9	7.8	5.4	4.6
Net income	9.6 %	10.2 %	12.4 %	14.2 %	11.9 %	9.2 %	8.1 %	6.7 %	11.9 %	9.2 %	8.1 %	6.7 %	11.9 %	9.2 %	8.1 %	6.7 %

## Recent Acquisitions

First CLS, Inc. On April 1, 2008, we acquired certain assets of First CLS, Inc. (doing business as the Dorey Companies and DoreyPRO), an Atlanta-based provider of local commercial real estate information for \$3.0 million in initial cash consideration and deferred consideration of \$1.7 million paid during the third quarter of 2009.

PPR. On July 17, 2009, we acquired all of the issued and outstanding equity securities of PPR, and its wholly owned subsidiary Property and Portfolio Research Ltd., providers of real estate analysis, market forecasts and credit risk analytics to the commercial real estate industry. We acquired PPR from DMG Information, Inc. ("DMGI") in exchange for 572,999 shares of CoStar common stock, which had an aggregate value of approximately \$20.9 million as of the closing date. On July 17, 2009, 433,667 shares of our common stock were issued to DMGI, and the remaining 139,332 shares were issued to DMGI on September 28, 2009 after taking into account post-closing purchase price adjustments.

Resolve Technology. On October 19, 2009, we acquired all of the outstanding capital stock of Resolve Technology, a Delaware corporation, for approximately \$4.5 million, consisting of approximately \$3.4 million in cash and 25,886 shares, or approximately \$1.1 million, of CoStar restricted common stock, which shares are subject to a three-year lockup. The purchase price is subject to certain post-closing adjustments. Additionally, the seller may be entitled to receive (i) a potential deferred cash payout two years after closing based on the incremental growth of Resolve Technology's revenue, and (ii) other potential deferred cash payouts for successful completion of operational and sales milestones during the period from closing through June 30, 2013, which period may be subject to extension to a date no later than December 31, 2014.



**Accounting Treatment.** These acquisitions were accounted for using purchase accounting. The purchase price for the First CLS, Inc. acquisition was primarily allocated to acquired customer base and goodwill. For each of the PPR and Resolve Technology acquisitions, the purchase price was allocated to various working capital accounts, developed technology, customer base, trademarks, non-competition agreements and goodwill. The acquired customer base for the acquisitions, which consists of one distinct intangible asset for each acquisition and is composed of acquired customer contracts and the related customer relationships, is being amortized on a 125% declining balance method over ten years. The identified intangibles will be amortized over their estimated useful lives. Goodwill for these acquisitions will not be amortized, but is subject to annual impairment tests. The results of operations of First CLS, Inc., PPR, and Resolve Technology have been consolidated with those of the Company since the respective dates of the acquisitions and are not considered material to our consolidated financial statements. Accordingly, pro forma financial information has not been presented for any of the acquisitions.

### Liquidity and Capital Resources

Our principal sources of liquidity are cash, cash equivalents and short-term investments. Total cash, cash equivalents and short-term investments were \$226.0 million at December 31, 2009 compared to \$195.3 million at December 31, 2008. The increase in cash, cash equivalents and short-term investments for the year ended December 31, 2009 was primarily due to net cash from operating activities of approximately \$39.6 million, net cash provided from financing activities of approximately \$2.2 million, partially offset by purchases of property and equipment and other assets of approximately \$10.5 million, and net cash paid for acquisitions of approximately \$3.2 million.

Net cash provided by operating activities for the year ended December 31, 2009 was \$39.6 million compared to \$40.9 million for the year ended December 31, 2008. The \$1.3 million decrease in net cash provided by operating activities is primarily due to a decrease of approximately \$5.5 million from net income plus non-cash items, a decrease of approximately \$4.7 million due to changes in prepaid expenses and deposits, and decreased cash receipts for deferred revenue of \$1.1 million, partially offset by decreased payments for accounts payable and other liabilities of approximately \$5.7 million and \$4.3 million in increased cash receipts on receivables.

Net cash provided by investing activities was \$3.4 million for the year ended December 31, 2009, compared to net cash provided by investing activities of \$52.4 million for the year ended December 31, 2008. This \$49.0 million decrease in net cash provided by investing activities was primarily due to the decision in 2008 to invest in money market funds and U.S. treasuries instead of short-term investment instruments, which resulted in a net sale of investments of approximately \$59.1 million for the year ended December 31, 2008 compared to sales of investments of approximately \$17.2 million for the year ended December 31, 2009.

Net cash provided by financing activities was \$2.2 million for the year ended December 31, 2009 compared to \$11.5 million for the year ended December 31, 2008. The change is due to decreased proceeds from exercise of stock options.

**Contractual Obligations.** The following table summarizes our principal contractual obligations at December 31, 2009 and the effect such obligations are expected to have on our liquidity and cash flows in future periods (in thousands):

	Total	2010	2011-2012	2013-2014	2015 and thereafter
Operating leases	\$26,225	\$10,530	\$11,751	\$3,061	\$883
Purchase obligations(1)	7,036	2,927	2,746	763	600
Total contractual principal cash obligations	\$33,261	\$13,457	\$14,497	\$3,824	\$1,483

(1) Amounts do not include (i) contracts with initial terms of twelve months or less, or (ii) multi-year contracts that may be terminated by a third party or us. Amounts do not include unrecognized tax benefits of \$1.9 million due to uncertainty regarding the timing of future cash payments.

In February 2010, we purchased a 169,429 square-foot LEED Gold certified office building located at 1331 L Street, NW in downtown Washington, D.C. for a purchase price of \$41.25 million in cash.

During 2009, we incurred capital expenditures of approximately \$10.5 million. We expect to make capital expenditures in 2010 of approximately \$20.0 million to \$25.0 million.

To date, we have grown in part by acquiring other companies and we may continue to make acquisitions. Our acquisitions may vary in size and could be material to our current operations. We may use cash, stock, debt or other means of funding to make these acquisitions. We paid \$3.0 million in initial cash consideration in April 2008 and \$1.7 million in deferred consideration in August 2009 for the online commercial real estate information assets of First CLS, Inc., an Atlanta-based provider of local commercial real estate information. In the third quarter of 2009, we issued 572,999 shares of common stock to DMGI, Inc. for all of the issued and outstanding capital stock of PPR and its wholly owned subsidiary. In October 2009, we acquired Resolve Technology for approximately \$3.4 million (\$2.9 million was paid upon acquisition and \$450,000 was deferred until February 2010) in cash and 25,886 shares of CoStar common stock. Additionally, the seller may be entitled to receive (i) a potential deferred cash payout two years after closing based on the incremental growth of Resolve Technology's revenue, and (ii) other potential deferred cash payouts for successful completion of additional operational and sales milestones during the period from closing through June 30, 2013, which period may be subject to extension to a date no later than December 31, 2014.

Based on current plans, we believe that our available cash combined with positive cash flow provided by operating activities should be sufficient to fund our operations for at least the next 12 months.

As of December 31, 2009, we had \$32.8 million par value of long-term investments in student loan auction rate securities ("ARS"), which failed to settle at auctions. The majority of these investments are of high credit quality with AAA credit ratings and are primarily securities supported by guarantees from the Federal Family Education Loan Program ("FFELP") of the U.S. Department of Education. While we continue to earn interest on these investments, the investments are not liquid in the short term. In the event we need to immediately access these funds, we may have to sell these securities at an amount below par value. Based on our ability to access our cash, cash equivalents and other short-term investments and our expected operating cash flows, we do not anticipate having to sell these investments below par value in order to operate our business in the foreseeable future.

On December 23, 2008, the Company initiated a Financial Industry Regulatory Authority ("FINRA") arbitration against Credit Suisse First Boston ("CSFB") related to CSFB's purchase of ARS for the Company's account. Our complaint asserts breach of contract, fraud, breach of fiduciary duty and other causes of action. An arbitration hearing was originally scheduled to begin during the week beginning December 7, 2009, but was rescheduled at the request of CSFB and is now set to begin on March 8, 2010. We expect to receive a ruling on its claim during the second quarter of 2010. Since the outcome of this legal proceeding is uncertain at this time, we cannot estimate the amount of gain or loss, if any, that could result from the resolution of this matter.

#### Recent Accounting Pronouncements

In February 2007, the FASB issued authoritative guidance on the fair value option for financial assets and financial liabilities, which permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. This guidance is effective for fiscal years beginning on or after December 31, 2007. We adopted this guidance on January 1, 2008 and have not elected to apply the fair value option to any of our financial instruments. The adoption of this guidance did not have a material impact on our results of operations or financial position.

In December 2007, the FASB issued authoritative guidance on business combinations, which changes the accounting for any business combination we enter into with an acquisition date after December 31, 2008. Under this guidance, an

acquiring entity is required to recognize all the assets acquired and liabilities assumed in a transaction at the acquisition date fair value with limited exceptions. This guidance changes the accounting treatment and disclosure for certain specific items in a business combination. We adopted this guidance on January 1, 2009 and have recorded assets acquired and liabilities assumed at fair value.

In December 2007, the FASB issued authoritative guidance on non-controlling interest, which establishes new accounting and reporting standards for the non-controlling interest in a subsidiary and for the deconsolidation of a subsidiary. This guidance is effective for fiscal years beginning on or after December 15, 2008. We adopted this guidance on January 1, 2009. The adoption of this guidance did not have a material impact on our results of operations or financial position.

In April 2008, the FASB issued authoritative guidance on existing intangibles or expected future cash flows from those intangibles, which is effective for all fiscal years and interim periods beginning after December 15, 2008. Early adoption of this guidance is not permitted. This guidance requires additional footnote disclosures about the impact of our ability or intent to renew or extend agreements related to existing intangibles or expected future cash flows from those intangibles, how we account for costs incurred to renew or extend such agreements, the time until the next renewal or extension period by asset class, and the amount of renewal or extension costs capitalized, if any. For any intangibles acquired after December 31, 2008, this guidance requires that we consider our experience regarding renewal and extensions of similar arrangements in determining the useful life of such intangibles. If we do not have experience with similar arrangements, this guidance requires that we use the assumptions of a market participant putting the intangible to its highest and best use in determining the useful life. We adopted this guidance on January 1, 2009. The adoption of this guidance did not have a material impact on our results of operations or financial position.

In June 2008, the FASB issued authoritative guidance related to determining whether instruments granted in share-based payment transactions are participating securities. This guidance clarifies that unvested share-based payment awards with a right to receive non-forfeitable dividends are participating securities. This guidance is effective for all annual and interim periods beginning after December 15, 2008. Adoption of this standard will require the two-class method of calculating basic earnings per share to the extent that unvested share-based payments have the right to receive non-forfeitable dividends. We adopted this guidance on January 1, 2009. The adoption of this guidance did not have a material impact on our results of operations or financial position.

In April 2009, the FASB issued authoritative guidance related to the initial recognition, measurement and subsequent accounting for assets and liabilities arising from pre-acquisition contingencies in a business combination. It requires that such assets acquired or liabilities assumed be initially recognized at fair value at the acquisition date if fair value can be determined during the measurement period. When fair value cannot be determined, companies should typically account for the acquired contingencies using existing guidance. This guidance requires that companies expense acquisition and deal-related costs that were previously allowed to be capitalized. This guidance also requires that a systematic and rational basis for subsequently measuring and accounting for the assets or liabilities be developed depending on their nature. This guidance was effective for contingent assets or liabilities arising from business combinations with an acquisition date on or after January 1, 2009. The adoption of this guidance changes the accounting treatment and disclosure for certain specific items in a business combination with an acquisition date subsequent to December 31, 2008. We adopted this guidance on January 1, 2009, and expensed acquisition and deal-related costs associated primarily with the acquisitions of PPR and Resolve Technology.

In April 2009, the FASB issued authoritative guidance for determining whether a market is active or inactive, and whether a transaction is distressed. This guidance is applicable to all assets and liabilities (financial and non-financial) and will require enhanced disclosures. We adopted this guidance for our interim period ending June 30, 2009. The adoption of this guidance did not have a material impact on our results of operations or financial position, but did require additional disclosures in our financial statements.

In April 2009, the FASB issued authoritative guidance requiring disclosures in interim reporting periods concerning the fair value of financial instruments that were previously only required in the annual financial statements. We adopted the provisions of this guidance for our interim period ending June 30, 2009. The adoption of this guidance did not have a material impact on our results of operations or financial position, but did require additional disclosures in our financial statements.

In April 2009, the FASB issued authoritative guidance that redefines what constitutes an other-than-temporary impairment, defines credit and non-credit components of an other-than-temporary impairment, prescribes their financial statement treatment, and requires enhanced disclosures relating to such impairments. We adopted this guidance for our interim period ending June 30, 2009. The adoption of this guidance did not have a material impact on our results of operations or financial position, but did require additional disclosures in our financial statements.

In May 2009, the FASB issued authoritative guidance which establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued. This guidance was effective for all interim and annual reporting periods ending after June 15, 2009. This guidance has not and is not expected to result in significant changes in the subsequent events that we report, either through recognition or disclosure, in our financial statements.

In June 2009, the FASB issued authoritative guidance to amend the manner in which entities evaluate whether consolidation is required for variable interest entities (VIE). Previously, variable interest holders were required to determine whether they had a controlling financial interest in a VIE based on a quantitative analysis of the expected gains and/or losses of the entity. The new guidance requires an enterprise with a variable interest in a VIE to qualitatively assess whether it has a controlling financial interest in the entity, and if so, whether it is the primary beneficiary. This guidance also requires that companies continually evaluate VIEs for consolidation, rather than assessing whether consolidation is required based upon the occurrence of triggering events. This guidance enhances disclosures to provide financial statement users with greater transparency about transfers of financial assets and a transferor's continuing involvement with transferred financial assets. This guidance will be effective for the first annual reporting period beginning after November 15, 2009. This guidance is not expected to materially impact our results of operations, financial position or related disclosures.

In June 2009, the FASB issued authoritative guidance which replaced the previous hierarchy of U.S. GAAP and establishes the FASB Codification as the single source of authoritative U.S. GAAP recognized by the FASB to be applied by nongovernmental entities. This guidance is effective for financial statements issued for interim and annual periods ending after September 15, 2009. This guidance did not materially impact our results of operations or financial position, but did require changes to our disclosures in our financial statements.

In July 2009, the FASB issued authoritative guidance to improve the consistency with which companies apply fair value measurements guidance to liabilities. This guidance is effective for interim and annual periods beginning after September 30, 2009. This guidance is not expected to materially impact our results of operations, financial position or related disclosures.

In October 2009, the FASB issued authoritative guidance that amends existing guidance for identifying separate deliverables in a revenue-generating transaction where multiple deliverables exist, and provides guidance for measuring and allocating revenue to one or more units of accounting. In addition, the FASB issued authoritative guidance on arrangements that include software elements. Under this guidance, tangible products containing software components and non-software components that are essential to the functionality of the tangible product will no longer be within the scope of the software revenue recognition guidance. This guidance is effective using the prospective application or the retrospective application for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010 with earlier application permitted. We are currently assessing the impacts adoption of this guidance may have on our financial statements.

In January 2010, the FASB issued authoritative guidance that amends the disclosure requirements related to recurring and nonrecurring fair value measurements. This guidance requires new disclosures on the transfers of assets and liabilities between Level 1 (assets and liabilities measured using observable inputs such as quoted prices in active markets) and Level 2 (assets and liabilities measured using inputs other than quoted prices in active markets that are either directly or indirectly observable) of the fair value measurement hierarchy, including the amount and reason of the transfers. Additionally, this guidance requires a roll forward of activities on purchases, sales, issuance, and settlements of the assets and liabilities measured using significant unobservable inputs (Level 3 fair value measurements). This guidance is effective for interim and annual reporting periods beginning after December 15, 2009, with the exception of the additional disclosure for Level 3 assets and liabilities, which is effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. This guidance is not expected to materially impact our results of operations or financial position, but will require changes to our

disclosures in our interim and annual financial statements.

40

---



## Item 7A. Quantitative and Qualitative Disclosures About Market Risk

We provide information, marketing and analytic services to the commercial real estate and related business community in the U.S., U.K. and France. Our functional currency for our operations in the U.K. and France is the local currency. As such, fluctuations in the British Pound and Euro may have an impact on our business, results of operations and financial position. For the year ended December 31, 2009, revenue denominated in foreign currencies was approximately 9.1% of total revenue. For the year ended December 31, 2009, our revenue would have decreased by approximately \$1.9 million if the U.S. dollar exchange rate used strengthened by 10%. In addition, we have assets and liabilities denominated in foreign currencies. A 10% strengthening of the U.S. dollar exchange rate against all currencies with which we have exposure at December 31, 2009 would have resulted in an increase of approximately \$210,000 in the carrying amount of net assets. For the year ended December 31, 2009, our revenue would have increased by approximately \$1.9 million if the U.S. dollar exchange rate used weakened by 10%. In addition, we have assets and liabilities denominated in foreign currencies. A 10% weakening of the U.S. dollar exchange rate against all currencies with which we have exposure at December 31, 2009 would have resulted in a decrease of approximately \$210,000 in the carrying amount of net assets. We currently do not use financial instruments to hedge our exposure to exchange rate fluctuations with respect to our foreign subsidiaries. We may seek to enter hedging transactions in the future to reduce our exposure to exchange rate fluctuations, but we may be unable to enter into hedging transactions successfully, on acceptable terms or at all. As of December 31, 2009, accumulated other comprehensive loss included a loss from foreign currency translation adjustments of approximately \$4.9 million.

We do not have material exposure to market risks associated with changes in interest rates related to cash equivalent securities held as of December 31, 2009. As of December 31, 2009, we had \$226.0 million of cash, cash equivalents and short-term investments. If there is an increase or decrease in interest rates, there will be a corresponding increase or decrease in the amount of interest earned on our cash, cash equivalents and short-term investments. Based on our ability to access our cash, cash equivalents and short-term investments, and our expected operating cash flows, we do not believe that increases or decreases in interest rates will impact our ability to operate our business in the foreseeable future.

Included within our long-term investments are investments in mostly AAA rated student loan ARS. These securities are primarily securities supported by guarantees from the FFELP of the U.S. Department of Education. As of December 31, 2009, auctions for \$32.8 million of our investments in auction rate securities failed. As a result, we may not be able to sell these investments at par value until a future auction on these investments is successful. In the event we need to immediately liquidate these investments, we may have to locate a buyer outside the auction process, who may be unwilling to purchase the investments at par, resulting in a loss. Based on an assessment of fair value of these investments in ARS as of December 31, 2009, we determined that there was a decline in the fair value of our ARS investments of approximately \$3.0 million, which was deemed to be a temporary impairment and recorded as an unrealized loss in accumulated other comprehensive loss in stockholders' equity. If the issuers are unable to successfully close future auctions and their credit ratings deteriorate, we may be required to adjust the carrying value of these investments as a temporary impairment and recognize a greater unrealized loss in accumulated other comprehensive loss or as an other-than-temporary impairment charge to earnings. Based on our ability to access our cash, cash equivalents and short-term investments, and our expected operating cash flows, we do not anticipate having to sell these securities below par value in order to operate our business in the foreseeable future. See Note 2 to the consolidated financial statements for further discussion.

We have approximately \$103.7 million in intangible assets as of December 31, 2009. As of December 31, 2009, we believe our intangible assets will be recoverable, however, changes in the economy, the business in which we operate and our own relative performance could change the assumptions used to evaluate intangible asset recoverability. In the event that we determine that an asset has been impaired, we would recognize an impairment charge equal to the amount by which the carrying amount of the assets exceeds the fair value of the asset. We continue to monitor these assumptions and their effect on the estimated recoverability of our intangible assets.



Item 8. Financial Statements and Supplementary Data

Financial Statements meeting the requirements of Regulation S-X are set forth beginning at page F-1. Supplementary data is set forth in “Management’s Discussion and Analysis of Financial Condition and Results of Operations” under the caption “Consolidated Results of Operations.”

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

None.

Item 9A. Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission’s rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow for timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

As of December 31, 2009, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures. Based on the foregoing, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective and were operating at the reasonable assurance level.

Management’s Report on Internal Control over Financial Reporting

Management of CoStar is responsible for establishing and maintaining adequate internal control over financial reporting and for the assessment of the effectiveness of internal control over financial reporting. As defined by the Securities and Exchange Commission, internal control over financial reporting is a process designed by, or supervised by, the Company’s principal executive and principal financial officers, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements in accordance with generally accepted accounting principles.

The Company’s internal control over financial reporting is supported by written 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 Company’s assets; (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 the Company’s management and directors; 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. 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 connection with the preparation of the Company's annual financial statements, management of the Company has undertaken an assessment of the effectiveness of the Company's internal control over financial reporting as of December 31, 2009 based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (“the COSO Framework”). Management's assessment included an evaluation of the design of the Company's internal control over financial reporting and testing of the operational effectiveness of the Company's internal control over financial reporting.

42

---

Based on this assessment, management did not identify any material weakness in the Company's internal control, and management has concluded that the Company's internal control over financial reporting was effective as of December 31, 2009.

Ernst & Young, LLP, the independent registered public accounting firm that audited the Company's financial statements included in this report, has issued an attestation report on the effectiveness of internal control over financial reporting, a copy of which is included in this Annual Report on Form 10-K.

There have been no changes in our internal control over financial reporting during our most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Item 9B.

Other Information.

None.

43

---

PART III

Item 10. Directors, Executive Officers and Corporate Governance

The information required by this Item is incorporated by reference to our Proxy Statement for our 2010 annual meeting of stockholders.

Item 11. Executive Compensation

The information required by this Item is incorporated by reference to our Proxy Statement for our 2010 annual meeting of stockholders.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

The information required by this Item is incorporated by reference to our Proxy Statement for our 2010 annual meeting of stockholders.

Item 13. Certain Relationships and Related Transactions, and Director Independence

The information required by this Item is incorporated by reference to our Proxy Statement for our 2010 annual meeting of stockholders.

Item 14. Principal Accountant Fees and Services

The information required by this Item is incorporated by reference to our Proxy Statement for our 2010 annual meeting of stockholders.

PART IV

Item 15. Exhibits and Financial Statement Schedules

(a)(1) The following financial statements are filed as a part of this report: CoStar Group, Inc. Consolidated Financial Statements.

(a)(2) Financial statement schedules:

Schedule II – Valuation and Qualifying Accounts

Years Ended December 31, 2009, 2008, and 2007 (in thousands):

	Balance at Beginning of Year	Charged to Expense	Write-offs, Net of Recoveries	Balance at End of Year
Allowance for doubtful accounts and billing adjustments (1)				
Year ended December 31, 2009	\$3,213	\$4,172	\$4,522	\$2,863
Year ended December 31, 2008	\$2,959	\$4,042	\$3,788	\$3,213
Year ended December 31, 2007	\$1,966	\$2,464	\$1,471	\$2,959

(1) Additions to the allowance for doubtful accounts are charged to bad debt expense. Additions to the allowance for billing adjustments are charged against revenues.



Additional financial statement schedules are omitted because they are not applicable or not required or because the required information is incorporated herein by reference or included in the financial statements or related notes included elsewhere in this report.

(a)(3) The documents required to be filed as exhibits to this Report under Item 601 of Regulation S-K are listed in the Exhibit Index included elsewhere in this report, which list is incorporated herein by reference.

45

---



## SIGNATURES

Pursuant to the requirements of Section 13 of the Securities Act of 1934, as amended, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Bethesda, State of Maryland, on the 25th day of February 2010.

## COSTAR GROUP, INC.

By: /s/ Andrew C. Florance  
Andrew C. Florance  
President and Chief Executive Officer

KNOW ALL PERSONS BY THESE PRESENTS, that each individual whose signature appears below constitutes and appoints Andrew C. Florance and Brian J. Radecki, and each of them individually, as their true and lawful attorneys-in-fact and agents, with full power of substitution, for him and in his name, place and stead, in any and all capacities, to sign any and all amendments to this report, and to file the same, with all exhibits thereto and to all documents in connection therewith, with the Securities and Exchange Commission, granting unto said attorneys-in-fact and agents, and each of them, full power and authority to do and perform each and every act and thing requisite and necessary to be done in connection therewith, as fully to all intents and purposes as he might or could do in person, herein by ratifying and confirming all that said attorneys-in-fact and agents or any of them, or his or their substitute or substitutes, may lawfully do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Act of 1934, as amended, this report has been signed by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Signature	Capacity	Date
/s/ Michael R. Klein Michael R. Klein	Chairman of the Board	February 25, 2010
/s/ Andrew C. Florance Andrew C. Florance	Chief Executive Officer and President and a Director (Principal Executive Officer)	February 25, 2010
/s/ Brian J. Radecki Brian J. Radecki	Chief Financial Officer (Principal Financial and Accounting Officer)	February 25, 2010
/s/ David Bonderman David Bonderman	Director	February 25, 2010
/s/ Warren H. Haber Warren H. Haber	Director	February 25, 2010

Edgar Filing: CYANOTECH CORP - Form 10-Q

/s/ Josiah O. Low, III	Director	February 25, 2010
Josiah O. Low, III		
/s/ Christopher Nassetta	Director	February 25, 2010
Christopher Nassetta		
/s/ Michael Glosserman	Director	February 25, 2010
Michael Glosserman		

INDEX TO EXHIBITS

Exhibit No.	Description
2.1	Offer Document by CoStar Limited for the share capital of Focus Information Limited (Incorporated by reference to Exhibit 2.1 to Amendment No. 2 to the Registration Statement on Form S-3 of the Registrant (Reg. No. 333-106769) filed with the Commission on August 14, 2003).
3.1	Restated Certificate of Incorporation (Incorporated by reference to Exhibit 3.1 the Registration Statement on Form S-1 of the Registrant (Reg. No. 333-47953) filed with the Commission on March 13, 1998 (the "1998 Form S-1").
3.2	Certificate of Amendment of Restated Certificate of Incorporation (Incorporated by reference to Exhibit 3.1 to the Registrant's Report on Form 10-Q for the quarter ended June 30, 1999).
3.3	Amended and Restated By-Laws (Incorporated by reference to Exhibit 3.3 to the Registrant's Report on Form 10-K for the year ended December 31, 2008).
4.1	Specimen Common Stock Certificate (Incorporated by reference to Exhibit 4.1 to the Registrant's Report on Form 10-K for the year ended December 31, 1999).
*10.1	CoStar Group, Inc. 1998 Stock Incentive Plan, as amended (Incorporated by reference to Exhibit 10.1 to the Registrant's Report on Form 10-Q for the quarter ended September 30, 2005).
*10.2	CoStar Group, Inc. 2007 Stock Incentive Plan, as amended (Incorporated by reference to Exhibit 10.2 to the Registrant's Report on Form 10-K for the year ended December 31, 2008).
*10.3	CoStar Group, Inc. 2007 Stock Incentive Plan French Sub-Plan (Incorporated by reference to Exhibit 10.3 to the Registrant's Report on Form 10-K for the year ended December 31, 2007).
*10.4	Form of Stock Option Agreement between the Registrant and certain of its officers, directors and employees (Incorporated by reference to Exhibit 10.8 to the Registrant's Report on Form 10-K for the year ended December 31, 2004).
*10.5	Form of Stock Option Agreement between the Registrant and Andrew C. Florance (Incorporated by reference to Exhibit 10.8.1 to the Registrant's Report on Form 10-K for the year ended December 31, 2004).
*10.6	Form of Restricted Stock Agreement between the Registrant and certain of its officers, directors and employees (Incorporated by reference to Exhibit 10.9 to the Registrant's Report on Form 10-K for the year ended December 31, 2004).
*10.7	Form of 2007 Plan Restricted Stock Grant Agreement between the Registrant and certain of its officers, directors and employees (Incorporated by reference to Exhibit 99.1 to the Registrant's Report on Form 8-K filed June 22, 2007).
*10.8	Form of 2007 Plan Incentive Stock Option Grant Agreement between the Registrant and certain of its officers and employees (Incorporated by reference to Exhibit 10.8 to the Registrant's Report on Form 10-K for the year ended December 31, 2008).
*10.9	Form of 2007 Plan Incentive Stock Option Grant Agreement between the Registrant and Andrew C. Florance (Incorporated by reference to Exhibit 10.9 to the Registrant's Report on Form 10-K for the year ended December 31, 2008).
*10.10	Form of 2007 Plan Nonqualified Stock Option Grant Agreement between the Registrant and certain of its officers and employees (Incorporated by reference to Exhibit 10.10 to the Registrant's Report on Form 10-K for the year ended December 31, 2008).
*10.11	

Edgar Filing: CYANOTECH CORP - Form 10-Q

Form of 2007 Plan Nonqualified Stock Option Grant Agreement between the Registrant and certain of its directors (Incorporated by reference to Exhibit 10.11 to the Registrant's Report on Form 10-K for the year ended December 31, 2008).

- \*10.12 Form of 2007 Plan Nonqualified Stock Option Grant Agreement between the Registrant and Andrew C. Florance (Incorporated by reference to Exhibit 10.12 to the Registrant's Report on Form 10-K for the year ended December 31, 2008).
- \*10.13 Form of 2007 Plan French Sub-Plan Restricted Stock Agreement between the Registrant and certain of its employees (Incorporated by reference to Exhibit 10.10 to the Registrant's Report on Form 10-K for the year ended December 31, 2007).
- \*10.14 CoStar Group, Inc. Employee Stock Purchase Plan (Incorporated by reference to Exhibit 10.1 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2006).
- \*10.15 Employment Agreement for Andrew C. Florance (Incorporated by reference to Exhibit 10.2 to Amendment No. 1 to the Registration Statement on Form S-1 of the Registrant (Reg. No. 333-47953) filed with the Commission on April 27, 1998).

## INDEX TO EXHIBITS — (Continued)

Exhibit No.	Description
*10.16	First Amendment to Andrew C. Florance Employment Agreement, effective January 1, 2009 (Incorporated by reference to Exhibit 10.16 to the Registrant's Report on Form 10-K for the year ended December 31, 2008).
*10.17	Executive Service Contract dated February 16, 2007, between Property Investment Exchange Limited and Paul Marples (Incorporated by reference to Exhibit 10.14 to the Registrant's Report on Form 10-K for the year ended December 31, 2007).
*10.18	Form of Indemnification Agreement between the Registrant and each of its officers and directors (Incorporated by reference to Exhibit 10.1 to the Registrant's Report on Form 10-Q for the quarter ended March 31, 2004).
10.19	Office Lease, dated August 12, 1999, between CoStar Realty Information, Inc. and Newlands Building Ventures, LLC (Incorporated by reference to Exhibit 10.2 to the Registrant's Report on Form 10-Q for the quarter ended September 30, 1999).
10.20	Office Sublease, dated June 14, 2002, between CoStar Realty Information, Inc., CoStar Group, Inc. and Gateway, Inc. (Incorporated by reference to Exhibit 10.2 to the Registrant's Report on Form 10-Q for the quarter ended June 30, 2002).
10.21	Exercise of option to extend lease term and sublease amendment, dated February 22, 2007 between Gateway, Inc. and CoStar Realty Information, Inc. and CoStar Group, Inc. (Incorporated by reference to Exhibit 10.11 to the Registrant's Report on Form 10-K for the year ended December 31, 2006).
10.22	Addendum No. 3 to Office Lease, dated as of May 12, 2004, between Newlands Building Venture, LLC, and CoStar Realty Information, Inc. (Incorporated by reference to Exhibit 10.1 to the Registrant's Report on Form 10-Q for the quarter ended June 30, 2004).
10.23	Office Lease, dated as of February 23, 2005, between CoStar Realty Information, Inc. and Crestpointe III, LLC. (Incorporated by reference to Exhibit 10.13 to the Registrant's Report on Form 10-K for the year ended December 31, 2004).
10.24	Office Lease Agreement, dated March 16, 2007, between Corporate Place I Business Trust and CoStar Group, Inc. (Incorporated by reference to Exhibit 10.2 to the Registrant's Report on Form 10-Q for the quarter ended March 31, 2007).
10.25	Agreement for Lease among Nokia U.K. Limited, Focus Information Limited and CoStar Group, Inc., dated November 23, 2007 (Incorporated by reference to Exhibit 10.22 to the Registrant's Report on Form 10-K for the year ended December 31, 2007).
10.26	Agreement for Lease between CoStar UK Limited and Wells Fargo & Company, dated August 25, 2009 (filed herewith).
10.27	Addendum No. 5 to Office Lease, dated as of October 23, 2009, between Newlands Building Venture, LLC, and CoStar Realty Information, Inc. (filed herewith).
10.28	Sub-Underlease between CoStar UK Limited and Wells Fargo & Company, dated November 18, 2009 (filed herewith).
10.29	Contract for Sale and Purchase between Focus Information Limited and Trafigura Limited, dated September 14, 2007 (Incorporated by reference to Exhibit 10.1 to the Registrant's Report on Form 10-Q for the quarter ended September 30, 2007).
21.1	Subsidiaries of the Registrant (filed herewith).
23.1	Consent of Ernst & Young LLP, Independent Registered Public Accounting Firm (filed herewith).
31.1	Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith).
31.2	Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith).
32.1	

Edgar Filing: CYANOTECH CORP - Form 10-Q

Certification of Principal Executive Officer pursuant to 18 U.S.C. Sec. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (filed herewith).

32.2 Certification of Principal Financial Officer pursuant to 18 U.S.C. Sec. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (filed herewith).

\* Management Contract or Compensatory Plan or Arrangement.

48

---

COSTAR GROUP, INC.

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

Reports of Independent Registered Public Accounting Firm	F-2
Consolidated Statements of Operations for the years ended December 31, 2007, 2008 and 2009	F-4
Consolidated Balance Sheets as of December 31, 2008 and 2009	F-5
Consolidated Statements of Stockholders' Equity for the years ended December 31, 2007, 2008 and 2009	F-6
Consolidated Statements of Cash Flows for the years ended December 31, 2007, 2008 and 2009	F-7
Notes to Consolidated Financial Statements	F-8

F-1

---

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Shareholders of CoStar Group, Inc.

We have audited the accompanying consolidated balance sheets of CoStar Group, Inc. as of December 31, 2009 and 2008, and the related consolidated statements of operations, stockholders' equity and cash flows for each of the three years in the period ended December 31, 2009. Our audits also included the financial statement schedule listed in the Index at Item 15(a). The financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements and schedule based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of CoStar Group, Inc. at December 31, 2009 and 2008, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2009 in conformity 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, present fairly in all material respects the information set forth therein.

As also discussed in Note 9 to the consolidated financial statements, under the heading Income Taxes, the Company adopted FASB authoritative guidance regarding Accounting for Uncertainty in Income Taxes effective January 1, 2007.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), CoStar's internal control over financial reporting as of December 31, 2009, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 25, 2010 expressed.

/s/ Ernst & Young LLP

McLean, Virginia

February 25, 2010



REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Shareholders of CoStar Group, Inc.

We have audited CoStar Group, Inc.'s ("CoStar") internal control over financial reporting as of December 31, 2009, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). CoStar'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 included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on 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, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, 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, CoStar maintained, in all material respects, effective internal control over financial reporting as of December 31, 2009, 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 as of December 31, 2009 and 2008 and the related consolidated statements of operations, stockholders' equity and cash flows for each of the three years in the period ended December 31, 2009 of CoStar Group, Inc. and our report dated February 25, 2010 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

McLean, Virginia

February 25, 2010

F-3

---

COSTAR GROUP, INC.  
CONSOLIDATED STATEMENTS OF OPERATIONS  
(in thousands, except per share data)

	Year Ended December 31,		
	2007	2008	2009
Revenues	\$ 192,805	\$ 212,428	\$ 209,659
Cost of revenues	76,704	73,408	73,714
Gross margin	116,101	139,020	135,945
Operating expenses:			
Selling and marketing	51,777	41,705	42,508
Software development	12,453	12,759	13,942
General and administrative	36,569	39,888	44,248
Gain on lease settlement, net	(7,613 )	<sup>3</sup> / <sub>4</sub>	<sup>3</sup> / <sub>4</sub>
Purchase amortization	5,063	4,880	3,412
	98,249	99,232	104,110
Income from operations	17,852	39,788	31,835
Interest income, net	8,045	4,914	1,253
Income before income taxes	25,897	44,702	33,088
Income tax expense, net	9,946	20,079	14,395
Net income	\$ 15,951	\$ 24,623	\$ 18,693
Net income per share <sup>3</sup> / <sub>4</sub> basic	\$0.84	\$1.27	\$0.95
Net income per share <sup>3</sup> / <sub>4</sub> diluted	\$0.82	\$1.26	\$0.94
Weighted average outstanding shares <sup>3</sup> / <sub>4</sub> basic	19,044	19,372	19,780
Weighted average outstanding shares <sup>3</sup> / <sub>4</sub> diluted	19,404	19,550	19,925

See accompanying notes.

COSTAR GROUP, INC.  
CONSOLIDATED BALANCE SHEETS  
(in thousands except per share data)

	December 31,	
	2008	2009
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 159,982	\$ 205,786
Short-term investments	35,268	20,188
Accounts receivable, less allowance for doubtful accounts of approximately \$3,213 and \$2,863 as of December 31, 2008 and 2009, respectively	12,294	12,855
Deferred income taxes, net	2,036	3,450
Prepaid expenses and other current assets	2,903	5,128
<b>Total current assets</b>	<b>212,483</b>	<b>247,407</b>
Long-term investments	29,340	29,724
Deferred income taxes, net	3,392	1,978
Property and equipment, net	16,876	19,162
Goodwill	54,328	80,321
Intangibles and other assets, net	16,421	23,390
Deposits and other assets	1,544	2,597
<b>Total assets</b>	<b>\$ 334,384</b>	<b>\$ 404,579</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 1,636	\$ 3,667
Accrued wages and commissions	7,217	9,696
Accrued expenses	7,754	14,167
Income taxes payable	1,907	¾
Deferred revenue	9,442	14,840
Deferred rent	1,180	1,377
<b>Total current liabilities</b>	<b>29,136</b>	<b>43,747</b>
Deferred income taxes, net	132	¾
Income taxes payable	1,695	1,826
Commitments and contingencies	¾	¾
Stockholders' equity:		
Preferred stock, \$0.01 par value; 2,000 shares authorized; none outstanding	¾	¾
Common stock, \$0.01 par value; 30,000 shares authorized; 19,733 and 20,617 issued and outstanding as of December 31, 2008 and 2009, respectively	197	206
Additional paid-in capital	333,983	364,635
Accumulated other comprehensive loss	(13,796 )	(7,565 )
Retained earnings (accumulated deficit)	(16,963 )	1,730
<b>Total stockholders' equity</b>	<b>303,421</b>	<b>359,006</b>
<b>Total liabilities and stockholders' equity</b>	<b>\$ 334,384</b>	<b>\$ 404,579</b>

See accompanying notes.

F-5

---

COSTAR GROUP, INC.  
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY  
(in thousands)

	Comprehensive Income	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Accumulated Other Comprehensive Income (Loss)	Retained Earnings (Accumulated Deficit)	Total Stockholders' Equity
Balance at December 31, 2006		19,081	\$ 191	\$ 302,936	\$ 4,520	\$ (57,537 )	\$ 250,110
Tax benefit adjustment		¾	¾	26	¾	¾	26
Balance at January 1, 2007		19,081	191	302,962	4,520	(57,537 )	250,136
Net income	15,951	¾	¾	¾	¾	15,951	15,951
Foreign currency translation adjustment	873	¾	¾	¾	873	¾	873
Net unrealized gain on investments	233	¾	¾	¾	233	¾	233
Comprehensive income	\$ 17,057						
Exercise of stock options		289	3	8,127	¾	¾	8,130
Restricted stock grants		131	1	(1 )	¾	¾	¾
Restricted stock grants surrendered		(58 )	¾	(635 )	¾	¾	(635 )
Consideration for Propex Stock compensation expense, net of forfeitures		22	¾	1,010	¾	¾	1,010
ESPP		9	¾	448	¾	¾	448
Excess tax benefit for exercised stock options		¾	¾	260	¾	¾	260
Balance at December 31, 2007		19,474	195	317,570	5,626	(41,586 )	281,805
Net income	24,623	¾	¾	¾	¾	24,623	24,623
Foreign currency translation adjustment	(14,061 )	¾	¾	¾	(14,061 )	¾	(14,061 )

Edgar Filing: CYANOTECH CORP - Form 10-Q

Net unrealized loss on investments	(5,361 )	¾	¾	¾	(5,361 )	¾	(5,361 )
Comprehensive income	\$ 5,201						
Exercise of stock options		198	2	6,555	¾	¾	6,557
Restricted stock grants		102	1	¾	¾	¾	1
Restricted stock grants surrendered		(49 )	(1 )	(695 )	¾	¾	(696 )
Stock compensation expense, net of forfeitures		¾	¾	4,907	¾	¾	4,907
ESPP		8	¾	329	¾	¾	329
Excess tax benefit for exercised stock options		¾	¾	5,317	¾	¾	5,317
Balance at December 31, 2008		19,733	197	333,983	(13,796 )	(16,963 )	303,421
Net income	18,693	¾	¾	¾	¾	18,693	18,693
Foreign currency translation adjustment	3,671	¾	¾	¾	3,671	¾	3,671
Net unrealized gain on investments	2,560	¾	¾	¾	2,560	¾	2,560
Comprehensive income	\$ 24,924						
Exercise of stock options		85	¾	2,232	¾	¾	2,232
Restricted stock grants		237	2	¾	¾	¾	2
Restricted stock grants surrendered		(44 )	¾	(672 )	¾	¾	(672 )
Stock compensation expense, net of forfeitures		¾	¾	6,438	¾	¾	6,438
ESPP		7	¾	230	¾	¾	230
Consideration for PPR		573	6	20,897	¾	¾	20,903
Consideration for Resolve Technology		26	1	1,124	¾	¾	1,125
		¾	¾	403	¾	¾	403

Excess tax  
benefit for  
exercised stock  
options

Balance at December 31, 2009	20,617	\$ 206	\$ 364,635	\$ (7,565 )	\$ 1,730	359,006
------------------------------------	--------	--------	------------	-------------	----------	---------

See accompanying notes.

F-6

---



COSTAR GROUP, INC.  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(in thousands)

	Year Ended December 31,		
	2007	2008	2009
Operating activities:			
Net income	\$ 15,951	\$ 24,623	\$ 18,693
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation	7,778	8,360	7,583
Amortization	8,369	8,441	7,093
Deferred income tax expense, net	9,946	2,148	(2,428 )
Provision for losses on accounts receivable	2,464	4,042	4,172
Excess tax benefit from stock options	(260 )	(5,317 )	(403 )
Stock-based compensation expense	5,440	4,940	6,460
Leasehold write-off	¾	¾	603
Changes in operating assets and liabilities, net of acquisitions:			
Accounts receivable	(2,944 )	(6,196 )	(1,610 )
Interest receivable	(67 )	533	97
Prepaid expenses and other current assets	(755 )	1,464	(1,521 )
Deposits and other assets	(670 )	652	(1,013 )
Accounts payable and other liabilities	6,981	(3,044 )	2,655
Deferred revenue	(501 )	262	(812 )
Net cash provided by operating activities	51,732	40,908	39,569
Investing activities:			
Purchases of investments	(116,609 )	(4,839 )	¾
Sales of investments	107,286	63,949	17,159
Purchases of property and equipment and other assets	(14,271 )	(3,656 )	(10,544 )
Acquisitions, net of cash acquired	(16,737 )	(3,024 )	(3,207 )
Net cash (used in) provided by investing activities	(40,331 )	52,430	3,408
Financing activities:			
Excess tax benefit from stock options	260	5,317	403
Repurchase of restricted stock to satisfy tax withholding obligations	(635 )	(695 )	(672 )
Proceeds from exercise of stock options	8,536	6,853	2,441
Net cash provided by financing activities	8,161	11,475	2,172
Effect of foreign currency exchange rates on cash and cash equivalents	64	(2,616 )	655
Net increase in cash and cash equivalents	19,626	102,197	45,804
Cash and cash equivalents at beginning of year	38,159	57,785	159,982
Cash and cash equivalents at end of year	\$ 57,785	\$ 159,982	\$ 205,786

See accompanying notes.

COSTAR GROUP, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2009

1. ORGANIZATION

CoStar Group, Inc. (the “Company”) has created a comprehensive, proprietary database of commercial real estate information covering the United States, as well as parts of the United Kingdom and France. Based on its unique database, the Company provides information, marketing and analytic services to the commercial real estate and related business community and operates within two segments, U.S. and International. The Company’s information, marketing and analytic services are typically distributed to its clients under subscription-based license agreements, which typically have a minimum term of one year and renew automatically.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation. Accounting policies are consistent for each operating segment.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles (“GAAP”) in the United States of America requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

Reclassifications

Certain previously reported amounts on the consolidated statements of cash flows have been reclassified to conform to the Company’s current presentation.

Revenue Recognition

The Company primarily derives revenues from providing access to its proprietary database of commercial real estate information. The Company generally charges a fixed monthly amount for its subscription-based services. Subscription contract rates are based on the number of sites, number of users, organization size, the client’s business focus and the number of services to which a client subscribes. Subscription-based license agreements typically have a minimum term of one year and renew automatically.

Revenue is recognized when (1) there is persuasive evidence of an arrangement, (2) the fee is fixed and determinable, (3) services have been rendered and payment has been contractually earned and (4) collectability is reasonably assured.

Revenues from subscription-based services are recognized on a straight-line basis over the term of the agreement. Deferred revenue results from advance cash receipts from customers or amounts billed in advance to customers from the sales of subscription licenses and is recognized over the term of the license agreement.

Cost of Revenues

Cost of revenues principally consists of salaries and related expenses for the Company's researchers who collect and analyze the commercial real estate data that is the basis for the Company's information, marketing and analytic services. Additionally, cost of revenues includes the cost of data from third party data sources, which is expensed as incurred, and the amortization of database technology.

F-8

---

COSTAR GROUP, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (CONTINUED)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — (CONTINUED)

Significant Customers

No single customer accounted for more than 5% of the Company's revenues for each of the years ended December 31, 2007, 2008 and 2009.

Foreign Currency Translation

The Company's functional currency in its foreign locations is the local currency. Assets and liabilities are translated into U.S. dollars as of the balance sheet date. Revenues, expenses, gains and losses are translated at the average exchange rates in effect during each period. Gains and losses resulting from translation are included in accumulated other comprehensive income (loss). Net gains or losses resulting from foreign currency exchange transactions are included in the consolidated statements of operations. There were no material gains or losses from foreign currency exchange transactions for the years ended December 31, 2009 and 2008.

Accumulated Other Comprehensive Loss

The components of accumulated other comprehensive loss were as follows (in thousands):

	Year Ended December 31,	
	2008	2009
Foreign currency translation adjustment	\$(8,521 )	\$(4,850 )
Accumulated net unrealized loss on investments, net of tax	(5,275 )	(2,715 )
Total accumulated other comprehensive loss	\$(13,796 )	\$(7,565 )

Advertising Costs

The Company expenses advertising costs as incurred. Advertising expenses were approximately \$2.3 million, \$2.8 million and \$3.3 million for the years ended December 31, 2007, 2008 and 2009, respectively.

Income Taxes

Deferred income taxes result from temporary differences between the tax basis of assets and liabilities and the basis reported in the Company's consolidated financial statements. Deferred tax liabilities and assets are determined based on the difference between the financial statement and the tax basis of assets and liabilities using enacted rates expected to be in effect during the year in which the differences reverse. Valuation allowances are provided against assets, including net operating losses, if it is anticipated that some or all of an asset may not be realized through future taxable earnings or implementation of tax planning strategies.

Net Income Per Share

Net income per share is computed by dividing net income by the weighted average number of common shares outstanding during the period on a basic and diluted basis. The Company's potentially dilutive securities include stock options and restricted stock. Diluted net income per share considers the impact of potentially dilutive securities except in periods in which there is a net loss, as the inclusion of the potential common shares would have an anti-dilutive effect.

Stock-Based Compensation

Equity instruments issued in exchange for employee services are accounted for using a fair-value based method and the fair value of such equity instruments is recognized as expense in the consolidated statements of operations.

F-9

---

## COSTAR GROUP, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (CONTINUED)

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — (CONTINUED)

## Stock-Based Compensation — (Continued)

Stock-based compensation cost is measured at the grant date of the share-based awards based on their fair values, and is recognized on a straight line basis as expense over the vesting periods of the awards, net of an estimated forfeiture rate.

Cash flows resulting from excess tax benefits are classified as part of cash flows from operating and financing activities. Excess tax benefits represent tax benefits related to stock based compensation in excess of the associated deferred tax asset for such equity compensation. Net cash proceeds from the exercise of stock options were approximately \$8.5 million; \$6.9 million and \$2.4 million for the years ended December 31, 2007, 2008 and 2009, respectively. There were approximately \$260,000, \$5.3 million and \$403,000 of excess tax benefits realized from stock option exercises for the years ended December 31, 2007, 2008 and 2009.

Stock-based compensation expense for stock options, restricted stock and the employee stock purchase plan included in the Company's results of operations for the years ended December 31, was as follows (in thousands):

	Year Ended December 31,		
	2007	2008	2009
Cost of revenues	\$926	\$547	\$888
Selling and marketing	1,118	400	1,125
Software development	340	423	588
General and administrative	3,056	3,570	3,859
Total	\$5,440	\$4,940	\$6,460

## Cash and Cash Equivalents

The Company considers all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents. Cash equivalents consist of money market fund investments and U.S. Government Securities. As of December 31, 2008 and 2009, cash of approximately \$518,000 and \$519,000, respectively, was held to support letters of credit for security deposits.

## Investments

The Company determines the appropriate classification of debt and equity investments at the time of purchase and reevaluates such designation as of each balance sheet date. The Company considers all of its investments to be available-for-sale. Short-term investments consist of commercial paper, government/federal notes and bonds and corporate obligations with maturities greater than 90 days at the time of purchase. Available-for-sale short-term investments with contractual maturities beyond one year are classified as current in the Company's consolidated balance sheets because they represent the investment of cash that is available for current operations. Long-term investments consist of auction rate securities. Investments are carried at fair market value.

## Concentration of Credit Risk and Financial Instruments

The Company performs ongoing credit evaluations of its customers' financial condition and generally does not require that its customers' obligations to the Company be secured. The Company maintains reserves for credit losses, and such losses have been within management's expectations. The large size and widespread nature of the Company's customer base and lack of dependence on individual customers mitigate the risk of nonpayment of the Company's accounts receivable. The carrying amount of the accounts receivable approximates the net realizable value. The carrying value of the Company's financial instruments including cash and cash equivalents, short-term investments, long-term investments, accounts receivable, accounts payable, and accrued expenses approximates fair value.

F-10

---

COSTAR GROUP, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (CONTINUED)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — (CONTINUED)

Allowance for Doubtful Accounts

The allowance for doubtful accounts is based on the Company's assessment of the collectability of customer accounts. The Company regularly reviews the allowance by considering factors such as historical experience, the aging of the balances, and current economic conditions that may affect a customer's ability to pay.

Property and Equipment

Property and equipment are stated at cost. All repairs and maintenance costs are expensed as incurred. Depreciation and amortization are calculated on a straight-line basis over the following estimated useful lives of the assets:

Leasehold improvements	Shorter of lease term or useful life
Furniture and office equipment	Five to seven years
Research vehicles	Five years
Computer hardware and software	Two to five years

Qualifying internal-use software costs incurred during the application development stage, which consist primarily of outside services and purchased software license costs, are capitalized and amortized over the estimated useful life of the asset. All other costs are expensed as incurred.

Goodwill, Intangibles and Other Assets

Goodwill represents the excess of costs over the fair value of assets of businesses acquired. Goodwill and intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but instead tested for impairment at least annually by reporting unit. The Company's operating segments, U.S. and International, are the reporting units tested for potential impairment. The goodwill impairment test is a two-step process. The first step is to determine the fair value of each reporting unit. The estimate of the fair value of each reporting unit is based on a projected discounted cash flow model that includes significant assumptions and estimates including the Company's future financial performance and a weighted average cost of capital. The fair value of each reporting unit is compared to the carrying amount of the reporting unit. If the carrying value of the reporting unit exceeds the fair value, then the second step of the process is performed to measure the impairment loss. The impairment loss is measured based on a projected discounted cash flow method using a discount rate determined by the Company's management to be commensurate with the risk in its current business model.

Intangible assets with estimable useful lives that arose from acquisitions on or after July 1, 2001, are amortized over their respective estimated useful lives using a method of amortization that reflects the pattern in which the economic benefits of the intangible assets are consumed or otherwise used up, and reviewed for impairment.

Acquired database technology, customer base and trade names and other are related to the Company's acquisitions (See Notes 3, 7 and 8). Acquired database technology and trade names and other are amortized on a straight-line basis over periods ranging from two to ten years. The acquired intangible asset characterized as customer base consists of one distinct intangible asset composed of acquired customer contracts and the related customer relationships. Acquired customer bases that arose from acquisitions prior to July 1, 2001 are amortized on a straight-line basis principally over a period of ten years. Acquired customer bases that arose from acquisitions on or after July 1, 2001 are amortized on a 125% declining balance method over ten years. The cost of capitalized building photography is



amortized on a straight-line basis over five years.

F-11

---

COSTAR GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (CONTINUED)

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — (CONTINUED)

### Long-Lived Assets

Long-lived assets, such as property, plant, and equipment, and purchased intangibles subject to amortization, are reviewed for impairment whenever events or changes in circumstances indicate that 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 an asset to estimate undiscounted future cash flows expected to be generated by the asset or asset group. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized by the amount for which the carrying amount of the asset exceeds the fair value of the asset.

Assets to be disposed of would be separately presented in the balance sheet and reported at the lower of the carrying amount or fair value less costs to sell, and would no longer be depreciated. The assets and liabilities of a disposed group classified as held for sale would be presented separately in the appropriate asset and liability sections of the balance sheet.

### Recent Accounting Pronouncements

In February 2007, the FASB issued authoritative guidance on the fair value option for financial assets and financial liabilities, which permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. This guidance is effective for fiscal years beginning on or after December 31, 2007. The Company adopted this guidance on January 1, 2008 and has not elected to apply the fair value option to any of its financial instruments. The adoption of this guidance did not have a material impact on the Company's results of operations or financial position.

In December 2007, the FASB issued authoritative guidance on business combinations, which changes the accounting for any business combination the Company enters into with an acquisition date after December 31, 2008. Under this guidance, an acquiring entity is required to recognize all the assets acquired and liabilities assumed in a transaction at the acquisition date fair value with limited exceptions. This guidance changes the accounting treatment and disclosure for certain specific items in a business combination. The Company adopted this guidance on January 1, 2009 and has recorded assets acquired and liabilities assumed at fair value.

In December 2007, the FASB issued authoritative guidance on non-controlling interest, which establishes new accounting and reporting standards for the non-controlling interest in a subsidiary and for the deconsolidation of a subsidiary. This guidance is effective for fiscal years beginning on or after December 15, 2008. The Company adopted this guidance on January 1, 2009. The adoption of this guidance did not have a material impact on the Company's results of operations or financial position.

In April 2008, the FASB issued authoritative guidance on existing intangibles or expected future cash flows from those intangibles, which is effective for all fiscal years and interim periods beginning after December 15, 2008. Early adoption of this guidance is not permitted. This guidance requires additional footnote disclosures about the impact of the Company's ability or intent to renew or extend agreements related to existing intangibles or expected future cash flows from those intangibles, how the Company accounts for costs incurred to renew or extend such agreements, the time until the next renewal or extension period by asset class, and the amount of renewal or extension costs capitalized, if any. For any intangibles acquired after December 31, 2008, this guidance requires that the Company consider its experience regarding renewal and extensions of similar arrangements in determining the useful life of such intangibles. If the Company does not have experience with similar arrangements, this guidance requires that the

Company use the assumptions of a market participant putting the intangible to its highest and best use in determining the useful life. The Company adopted this guidance on January 1, 2009. The adoption of this guidance did not have a material impact on the Company's results of operations or financial position.

F-12

---

COSTAR GROUP, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (CONTINUED)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — (CONTINUED)

Recent Accounting Pronouncements— (Continued)

In June 2008, the FASB issued authoritative guidance related to determining whether instruments granted in share-based payment transactions are participating securities. This guidance clarifies that unvested share-based payment awards with a right to receive non-forfeitable dividends are participating securities. This guidance is effective for all annual and interim periods beginning after December 15, 2008. Adoption of this standard will require the two-class method of calculating basic earnings per share to the extent that unvested share-based payments have the right to receive non-forfeitable dividends. The Company adopted this guidance on January 1, 2009. The adoption of this guidance did not have a material impact on the Company's results of operations or financial position.

In April 2009, the FASB issued authoritative guidance related to the initial recognition, measurement and subsequent accounting for assets and liabilities arising from pre-acquisition contingencies in a business combination. It requires that such assets acquired or liabilities assumed be initially recognized at fair value at the acquisition date if fair value can be determined during the measurement period. When fair value cannot be determined, companies should typically account for the acquired contingencies using existing guidance. This guidance requires that companies expense acquisition and deal-related costs that were previously allowed to be capitalized. This guidance also requires that a systematic and rational basis for subsequently measuring and accounting for the assets or liabilities be developed depending on their nature. This guidance was effective for contingent assets or liabilities arising from business combinations with an acquisition date on or after January 1, 2009. The adoption of this guidance changes the accounting treatment and disclosure for certain specific items in a business combination with an acquisition date subsequent to December 31, 2008. The Company adopted this guidance on January 1, 2009, and expensed acquisition and deal-related costs of approximately \$700,000 associated primarily with the acquisitions of Property and Portfolio Research, Inc. ("PPR") and Resolve Technology, Inc. ("Resolve Technology").

In April 2009, the FASB issued authoritative guidance for determining whether a market is active or inactive, and whether a transaction is distressed. This guidance is applicable to all assets and liabilities (financial and non-financial) and will require enhanced disclosures. The Company adopted this guidance for its interim period ending June 30, 2009. The adoption of this guidance did not have a material impact on the Company's results of operations or financial position, but did require additional disclosures in the Company's financial statements.

In April 2009, the FASB issued authoritative guidance requiring disclosures in interim reporting periods concerning the fair value of financial instruments that were previously only required in the annual financial statements. The Company adopted the provisions of this guidance for the interim period ending June 30, 2009. The adoption of this guidance did not have a material impact on the Company's results of operations or financial position, but did require additional disclosures in the Company's financial statements.

In April 2009, the FASB issued authoritative guidance that redefines what constitutes an other-than-temporary impairment, defines credit and non-credit components of an other-than-temporary impairment, prescribes their financial statement treatment, and requires enhanced disclosures relating to such impairments. The Company adopted this guidance for the interim period ending June 30, 2009. The adoption of this guidance did not have a material impact on the Company's results of operations or financial position, but did require additional disclosures in the Company's financial statements.

In May 2009, the FASB issued authoritative guidance which establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued. This guidance was effective for all interim and annual reporting periods ending after June 15, 2009. This guidance has not and is not expected to result in significant changes in the subsequent events that the Company reports, either through recognition or disclosure, in its financial statements.

F-13

---

COSTAR GROUP, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (CONTINUED)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — (CONTINUED)

Recent Accounting Pronouncements— (Continued)

In June 2009, the FASB issued authoritative guidance to amend the manner in which entities evaluate whether consolidation is required for variable interest entities (VIE). Previously, variable interest holders were required to determine whether they had a controlling financial interest in a VIE based on a quantitative analysis of the expected gains and/or losses of the entity. The new guidance requires an enterprise with a variable interest in a VIE to qualitatively assess whether it has a controlling financial interest in the entity, and if so, whether it is the primary beneficiary. This guidance also requires that companies continually evaluate VIEs for consolidation, rather than assessing whether consolidation is required based upon the occurrence of triggering events. This guidance enhances disclosures to provide financial statement users with greater transparency about transfers of financial assets and a transferor's continuing involvement with transferred financial assets. This guidance will be effective for the first annual reporting period beginning after November 15, 2009. This guidance is not expected to materially impact the Company's results of operations, financial position or related disclosures.

In June 2009, the FASB issued authoritative guidance which replaced the previous hierarchy of U.S. GAAP and establishes the FASB Codification as the single source of authoritative U.S. GAAP recognized by the FASB to be applied by nongovernmental entities. This guidance is effective for financial statements issued for interim and annual periods ending after September 15, 2009. This guidance did not materially impact the Company's results of operations or financial position, but did require changes to the disclosures in the Company's financial statements.

In July 2009, the FASB issued authoritative guidance to improve the consistency with which companies apply fair value measurements guidance to liabilities. This guidance is effective for interim and annual periods beginning after September 30, 2009. This guidance is not expected to materially impact the Company's results of operations, financial position or related disclosures.

In October 2009, the FASB issued authoritative guidance that amends existing guidance for identifying separate deliverables in a revenue-generating transaction where multiple deliverables exist, and provides guidance for measuring and allocating revenue to one or more units of accounting. In addition, the FASB issued authoritative guidance on arrangements that include software elements. Under this guidance, tangible products containing software components and non-software components that are essential to the functionality of the tangible product will no longer be within the scope of the software revenue recognition guidance. This guidance is effective using the prospective application or the retrospective application for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010 with earlier application permitted. The Company is currently assessing the impacts adoption of this guidance may have on its financial statements.

In January 2010, the FASB issued authoritative guidance that amends the disclosure requirements related to recurring and nonrecurring fair value measurements. This guidance requires new disclosures on the transfers of assets and liabilities between Level 1 (assets and liabilities measured using observable inputs such as quoted prices in active markets) and Level 2 (assets and liabilities measured using inputs other than quoted prices in active markets that are either directly or indirectly observable) of the fair value measurement hierarchy, including the amount and reason of the transfers. Additionally, this guidance requires a roll forward of activities on purchases, sales, issuance, and settlements of the assets and liabilities measured using significant unobservable inputs (Level 3 fair value measurements). This guidance is effective for interim and annual reporting periods beginning after December 15, 2009, with the exception of the additional disclosure for Level 3 assets and liabilities, which is effective for fiscal

years beginning after December 15, 2010, and for interim periods within those fiscal years. This guidance is not expected to materially impact the Company's results of operations or financial position, but will require changes to the disclosures in its interim and annual financial statements.

F-14

---

COSTAR GROUP, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (CONTINUED)

### 3. ACQUISITIONS

On April 1, 2008, the Company acquired certain assets of First CLS, Inc. (doing business as the Dorey Companies and DoreyPRO), an Atlanta-based provider of local commercial real estate information for \$3.0 million in initial cash consideration and deferred consideration of \$1.7 million paid during the third quarter of 2009.

On July 17, 2009, the Company acquired all of the issued and outstanding equity securities of PPR, and its wholly owned subsidiary Property and Portfolio Research Ltd., providers of real estate analysis, market forecasts and credit risk analytics to the commercial real estate industry. The Company acquired PPR from DMG Information, Inc. (“DMGI”) in exchange for 572,999 shares of CoStar common stock, which had an aggregate value of approximately \$20.9 million as of the closing date. On July 17, 2009, 433,667 shares of the Company’s common stock were issued to DMGI, and the remaining 139,332 shares were issued to DMGI on September 28, 2009 after taking into account post-closing purchase price adjustments. The purchase accounting is preliminary and is subject to change upon completion of the purchase accounting.

The purchase price for the PPR acquisition was allocated as follows (in thousands):

Working capital	\$(5,479 )
Acquired trade names and other	810
Acquired customer base	5,300
Acquired database technology	3,700
Goodwill	16,572
Total purchase consideration	\$20,903

On October 19, 2009, the Company acquired all of the outstanding capital stock of Resolve Technology, a Delaware corporation, for approximately \$4.5 million, consisting of approximately \$3.4 million in cash and 25,886 shares, or approximately \$1.1 million, of CoStar common stock, which shares are subject to a three-year lockup. Additionally, the seller may be entitled to receive (i) a potential deferred cash payout two years after closing based on the incremental growth of Resolve Technology’s revenue, and (ii) other potential deferred cash payouts for successful completion of operational and sales milestones during the period from closing through June 30, 2013, which period may be subject to extension to a date no later than December 31, 2014. The purchase accounting is preliminary and is subject to change upon completion of the purchase accounting.

The purchase price for the Resolve acquisition was allocated as follows (in thousands):

Purchase price in cash and stock	\$4,499
Deferred consideration	3,052
Total purchase consideration	\$7,551
Working capital	\$(550 )
Acquired trade names and other	430
Acquired customer base	890
Acquired database technology	1,200
Goodwill	5,581



Total purchase consideration

\$7,551

F-15

---

COSTAR GROUP, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (CONTINUED)

### 3. ACQUISITIONS — (CONTINUED)

These acquisitions were accounted for using purchase accounting. The purchase price for the First CLS, Inc. acquisition was primarily allocated to acquired customer base and goodwill. For each of the PPR and Resolve Technology acquisitions, the purchase price was allocated to various working capital accounts, developed technology, customer base, trademarks, non-competition agreements and goodwill. The acquired customer base for the acquisitions, which consists of one distinct intangible asset for each acquisition and is composed of acquired customer contracts and the related customer relationships, is being amortized on a 125% declining balance method over ten years. The identified intangibles will be amortized over their estimated useful lives. Goodwill for these acquisitions will not be amortized, but is subject to annual impairment tests. Goodwill is comprised of acquired workforce. The results of operations of First CLS, Inc., PPR, and Resolve Technology have been consolidated with those of the Company since the respective dates of the acquisitions and are not considered material to the Company's consolidated financial statements. Accordingly, pro forma financial information has not been presented for any of the acquisitions.

### 4. INVESTMENTS

The Company determines the appropriate classification of debt and equity investments at the time of purchase and reevaluates such designation as of each balance sheet date. The Company considers all of its investments to be available-for-sale. Short-term investments consist of commercial paper, government/federal notes and bonds and corporate obligations with maturities greater than 90 days at the time of purchase. Available-for-sale short-term investments with contractual maturities beyond one year are classified as current in the Company's consolidated balance sheets because they represent the investment of cash that is available for current operations. Long-term investments consist of auction rate securities. Investments are carried at fair market value.

Scheduled maturities of investments classified as available-for-sale as of December 31, 2009 are as follows (in thousands):

Maturity	Fair Value
Due in:	
2010	\$3,072
2011-2014	16,634
2015-2019	106
2020 and thereafter	30,100
Available-for-sale investments	\$49,912

The realized gains on the Company's investments for the years ended December 31, 2008 and 2009 were approximately \$329,000 and \$4,000, respectively. The realized losses on the Company's investments for the years ended December 31, 2008 and 2009 were approximately \$489,000 and \$5,000, respectively.

Unrealized holding gains and losses, net of the related tax effect, on available-for-sale securities are excluded from earnings and are reported as a separate component of accumulated other comprehensive income (loss) in stockholders' equity until realized. Realized gains and losses from the sale of available-for-sale securities are determined on a specific-identification basis. A decline in market value of any available-for-sale security below cost that is deemed to be other than temporary results in a reduction in carrying amount to fair value. The impairment is charged to earnings and a new cost basis for the security is established. Dividend and interest income are recognized when earned.



COSTAR GROUP, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (CONTINUED)

## 4. INVESTMENTS — (CONTINUED)

As of December 31, 2009, the amortized cost basis and fair value of investments classified as available-for-sale are as follows (in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Collateralized debt obligations	\$ 12,987	\$ 5	\$ (14 )	\$ 12,978
Corporate debt securities	6,396	331	¾	6,727
Residential mortgage-backed securities	394	¾	(7 )	387
Government-sponsored enterprise obligations	97	¾	(1 )	96
Auction rate securities	32,750	¾	(3,026 )	29,724
Available-for-sale investments	\$ 52,624	\$ 336	\$ (3,048 )	\$ 49,912

The unrealized losses on the Company's investments as of December 31, 2008 and 2009 were generated primarily from changes in interest rates. The losses are considered temporary, as the contractual terms of these investments do not permit the issuer to settle the security at a price less than the amortized cost of the investment. Because the Company does not intend to sell these instruments and it is not more likely than not that the Company will be required to sell these instruments prior to anticipated recovery, which may be maturity, it does not consider these investments to be other-than-temporarily impaired as of December 31, 2008 and 2009. See Note 5 to the consolidated financial statements for further discussion on the fair value of the Company's financial assets.

The components of the investments in an unrealized loss position for more than twelve months consists of the following (in thousands):

	December 31,			
	2008			2009
	Aggregate Fair Value	Gross Unrealized Losses	Aggregate Fair Value	Gross Unrealized Losses
Collateralized debt obligations	\$19,151	\$(1,323 )	\$7,578	\$ (14 )
Corporate debt securities	2,558	(156 )	¾	¾
Residential mortgage-backed securities	427	(15 )	387	(7 )
Government-sponsored enterprise obligations	¾	¾	96	(1 )
Auction rate securities	¾	¾	29,724	(3,026 )
	\$22,136	\$(1,494 )	\$37,785	\$ (3,048 )

The components of the investments in an unrealized loss position for less than twelve months consists of the following (in thousands):

	December 31,			
	2008			2009
	Aggregate Fair Value	Gross Unrealized Losses	Aggregate Fair Value	Gross Unrealized Losses
Collateralized debt obligations	\$3,022	\$(84 )	\$¾	\$ ¾

Edgar Filing: CYANOTECH CORP - Form 10-Q

Corporate debt securities	3,807	(268	)	$\frac{3}{4}$	$\frac{3}{4}$
Residential mortgage-backed securities	36	(1	)	$\frac{3}{4}$	$\frac{3}{4}$
Government-sponsored enterprise obligations	130	(14	)	$\frac{3}{4}$	$\frac{3}{4}$
Auction rate securities	29,340	(3,710	)	$\frac{3}{4}$	$\frac{3}{4}$
	\$36,335	\$(4,077	)	$\frac{3}{4}$	\$ $\frac{3}{4}$

F-17

---

COSTAR GROUP, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (CONTINUED)

## 4. INVESTMENTS — (CONTINUED)

The gross unrealized gains on the Company's investments as of December 31, 2008 and 2009 were approximately \$128,000 and \$336,000, respectively.

## 5. FAIR VALUE

In September 2006, the FASB issued authoritative guidance which defines fair value, establishes a framework for measuring fair value in accordance with GAAP and expands disclosures about fair value measurements. The Company adopted this guidance as of January 1, 2008 for financial instruments. Although the adoption of the guidance did not materially impact its financial position, results of operations, or cash flow, the Company is now required to provide additional disclosures as part of its financial statements.

There is a three-tier fair value hierarchy, which categorizes the inputs used in measuring fair value. These tiers include: Level 1, defined as observable inputs such as quoted prices in active markets; Level 2, defined as inputs other than quoted prices in active markets that are either directly or indirectly observable; and Level 3, defined as unobservable inputs in which little or no market data exists, therefore requiring an entity to develop its own assumptions.

The following table represents the Company's fair value hierarchy for its financial assets (cash, cash equivalents and investments) and liabilities measured at fair value on a recurring basis as of December 31, 2009 (in thousands):

	Level 1	Level 2	Level 3	Total
<b>Assets:</b>				
Cash	\$38,721	\$¾	\$¾	\$38,721
Money market funds	167,065	¾	¾	167,065
Collateralized debt obligations	¾	12,978	¾	12,978
Corporate debt securities	¾	6,727	¾	6,727
Residential mortgage-backed securities	¾	387	¾	387
Government-sponsored enterprise obligations	¾	96	¾	96
Auction rate securities	¾	¾	29,724	29,724
Total assets measured at fair value	\$205,786	\$20,188	\$29,724	\$255,698
<b>Liabilities:</b>				
Deferred consideration	\$¾	\$¾	\$3,082	\$3,082
Total liabilities measured at fair value	\$¾	\$¾	\$3,082	\$3,082

The Company's Level 2 assets consist of collateralized debt obligations, corporate debt securities, residential mortgage-backed securities and government-sponsored enterprise obligations, which do not have directly observable quoted prices in active markets. The Company's Level 2 assets are valued using matrix pricing.

The Company's Level 3 assets consist of auction rate securities ("ARS"), whose underlying assets are primarily student loan securities supported by guarantees from the Federal Family Education Loan Program ("FFELP") of the U.S. Department of Education.

COSTAR GROUP, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (CONTINUED)

## 5. FAIR VALUE — (CONTINUED)

The following table summarizes changes in fair value of the Company's Level 3 assets from December 31, 2007 to December 31, 2009 (in thousands):

	Auction Rate Securities
Balance at December 31, 2007	\$53,975
Unrealized loss included in other comprehensive loss	(3,710 )
Net settlements	(20,925 )
Balance at December 31, 2008	\$29,340
Unrealized gain included in other comprehensive loss	684
Net settlements	(300 )
Balance at December 31, 2009	\$29,724

ARS are variable rate debt instruments whose interest rates are reset approximately every 28 days. The underlying securities have contractual maturities greater than twenty years. The ARS are recorded at fair value.

As of December 31, 2009, the Company held ARS with \$32.8 million par value, all of which failed to settle at auction. The majority of these investments are of high credit quality with AAA credit ratings and are primarily student loan securities supported by guarantees from the FFELP of the U.S. Department of Education. The Company may not be able to liquidate and fully recover the carrying value of the ARS in the near term. As a result, these securities are classified as long-term investments in the Company's consolidated balance sheet as of December 31, 2009.

While the Company continues to earn interest on its ARS investments at the contractual rate, these investments are not currently trading and therefore do not currently have a readily determinable market value. Accordingly, the estimated fair value of the ARS no longer approximates par value. The Company has used a discounted cash flow model to determine the estimated fair value of its investment in ARS as of December 31, 2009. The assumptions used in preparing the discounted cash flow model include estimates for interest rates, credit spreads, timing and amount of cash flows, liquidity risk premiums, expected holding periods, and default risk. Based on this assessment of fair value, as of December 31, 2009, the Company determined there was a decline in the fair value of its ARS investments of approximately \$3.0 million. The decline was deemed to be a temporary impairment and recorded as an unrealized loss in accumulated other comprehensive loss in stockholders' equity. In addition, while a majority of the ARS are currently rated AAA, if the issuers are unable to successfully close future auctions and their credit ratings deteriorate, the Company may be required to record additional unrealized losses in accumulated other comprehensive loss or an other-than-temporary impairment charge to earnings on these investments.

The Company's Level 3 liabilities consist of a \$3.1 million liability for deferred consideration related to the October 19, 2009 acquisition of Resolve Technology. The deferred consideration is for (i) a potential deferred cash payout two years after closing based on the incremental growth of Resolve Technology's revenue, and (ii) other potential deferred cash payouts for successful completion of operational and sales milestones during the period from closing through June 30, 2013, which period may be subject to extension to a date no later than December 31, 2014.

The following table summarizes changes in fair value of the Company's Level 3 liabilities from December 31, 2008 to December 31, 2009 (in thousands):

	Deferred Consideration
Balance at December 31, 2008	\$ ¾
Deferred consideration upon acquisition	3,052
Accretion for 2009	30
Balance at December 31, 2009	\$ 3,082

F-19

---



COSTAR GROUP, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (CONTINUED)

## 5. FAIR VALUE — (CONTINUED)

The Company has used a discounted cash flow model to determine the estimated fair value of its Level 3 liabilities as of December 31, 2009. The significant assumptions used in preparing the discounted cash flow model include the discount rate, estimates for future incremental revenue growth and probabilities for completion of operational and sales milestones.

## 6. PROPERTY AND EQUIPMENT

Property and equipment consists of the following (in thousands):

	December 31,	
	2008	2009
Leasehold improvements	\$7,808	\$10,333
Furniture, office equipment and research vehicles	19,305	20,279
Computer hardware and software	27,938	28,259
	55,051	58,871
Accumulated depreciation and amortization	(38,175 )	(39,709 )
Property and equipment, net	\$16,876	\$19,162

## 7. GOODWILL

The changes in the carrying amount of goodwill by operating segment consist of the following (in thousands):

	United States	International	Total
Goodwill, December 31, 2007	\$ 30,428	\$ 31,426	\$ 61,854
Acquisitions	1,119	¾	1,119
Effect of foreign currency translation	¾	(8,645 )	(8,645 )
Goodwill, December 31, 2008	31,547	22,781	54,328
Acquisitions	23,858	¾	23,858
Effect of foreign currency translation	¾	2,280	2,280
Purchase accounting adjustment	(145 )	¾	(145 )
Goodwill, December 31, 2009	\$ 55,260	\$ 25,061	\$ 80,321

The Company recorded goodwill of approximately \$1.1 million in connection with the First CLS, Inc. acquisition in April 2008, which was decreased by \$145,000 in 2009, upon completion of purchase accounting. Approximately \$1.7 million in additional goodwill was recorded in connection with the First CLS, Inc. acquisition as a result of the payment of deferred consideration of \$1.7 million in August 2009. The Company recorded goodwill of approximately \$16.6 million in connection with the July 2009 acquisition of PPR. Initially in July 2009, the Company had recorded \$12.1 million in goodwill for the PPR acquisition, that was increased by \$4.5 million in December 2009 upon completion of the Company's review of the income tax attributes and deferred taxes related to the PPR purchase accounting. The Company recorded goodwill of approximately \$5.6 million in connection with the Resolve Technology acquisition in October 2009.

During the fourth quarters of 2008 and 2009, the Company completed the annual impairment test of goodwill and concluded that goodwill was not impaired.

F-20

---

COSTAR GROUP, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (CONTINUED)

## 8. INTANGIBLES AND OTHER ASSETS

Intangibles and other assets consist of the following (in thousands, except amortization period data):

	December 31,		Weighted-Average Amortization Period (in years)
	2008	2009	
Building photography	\$11,011	\$11,504	5
Accumulated amortization	(7,711 )	(9,089 )	
Building photography, net	3,300	2,415	
Acquired database technology	20,711	25,790	4
Accumulated amortization	(20,361 )	(21,144 )	
Acquired database technology, net	350	4,646	
Acquired customer base	48,198	55,770	10
Accumulated amortization	(37,192 )	(41,208 )	
Acquired customer base, net	11,006	14,562	
Acquired trade names and other	7,744	9,755	7
Accumulated amortization	(5,979 )	(7,988 )	
Acquired trade names and other, net	1,765	1,767	
Intangibles and other assets, net	\$16,421	\$23,390	

Amortization expense for intangibles and other assets was approximately \$8.4 million for the years ended December 31, 2007 and 2008, respectively and \$7.1 million for the year ended December 31, 2009.

In the aggregate, amortization for intangibles and other assets existing as of December 31, 2009 for future periods is expected to be approximately \$3.8 million, \$3.4 million, \$3.3 million, \$2.3 million and \$1.8 million for the years ending December 31, 2010, 2011, 2012, 2013 and 2014, respectively.

COSTAR GROUP, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (CONTINUED)

## 9. INCOME TAXES

The components of the provision (benefit) for income taxes attributable to operations consist of the following (in thousands):

	Year Ended December 31,		
	2007	2008	2009
Current:			
Federal	\$574	\$18,289	\$15,194
State	821	3,842	1,593
Foreign	¾	¾	26
Total current	1,395	22,131	16,813
Deferred:			
Federal	9,716	(408 )	(2,097 )
State	72	(52 )	(199 )
Foreign	(1,237 )	(1,592 )	(122 )
Total deferred	8,551	(2,052 )	(2,418 )
Total provision for income taxes	\$9,946	\$20,079	\$14,395

The components of deferred tax assets and liabilities consists of the following (in thousands):

	December 31,	
	2008	2009
Deferred tax assets:		
Reserve for bad debts	\$928	\$1,093
Accrued compensation	2,144	3,156
Stock compensation	2,115	3,168
Net operating losses	3,077	2,985
Accrued reserve	¾	238
Capital loss carryovers	345	348
Unrealized loss on securities	2,088	1,076
Other liabilities	1,401	317
Total deferred tax assets	12,098	12,381
Deferred tax liabilities:		
Prepays	(522 )	(638 )
Depreciation	(626 )	(587 )
Intangibles	(2,607 )	(2,743 )
Total deferred tax liabilities	(3,755 )	(3,968 )
Net deferred tax asset	8,343	8,413
Valuation allowance	(3,047 )	(2,985 )
Net deferred taxes	\$5,296	\$5,428

The net long-term deferred tax liability shown on the balance sheet includes deferred tax liabilities and assets related to the international operations of the Company.

F-22

---

COSTAR GROUP, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (CONTINUED)

## 9. INCOME TAXES — (CONTINUED)

For the years ended December 31, 2008 and 2009, a valuation allowance has been established for certain deferred tax assets due to the uncertainty of realization. The Company's change in valuation allowance was an increase of approximately \$3.0 million for the year ended December 31, 2008 and a decrease of approximately \$62,000 for the year ended December 31, 2009. The decrease for the year ended December 31, 2009 is primarily due to the decrease in unrealized losses on securities, which was offset by an increase in the valuation allowance for foreign loss carryforwards. The valuation allowance for the deferred tax asset for unrealized losses has been recorded as an adjustment to accumulated other comprehensive loss. The valuation allowance for the years ended December 31, 2008 and 2009 also includes an allowance for capital loss carryforwards and for state net operating loss carryforwards.

For the year ended December 31, 2009, the Company had income of approximately \$39.0 million subject to applicable U.S. federal and state income tax laws and a loss of approximately \$5.9 million subject to applicable international tax laws.

The Company's provision for income taxes resulted in effective tax rates that varied from the statutory federal income tax rate as follows (in thousands):

	Year Ended December 31,		
	2007	2008	2009
Expected federal income tax provision at statutory rate	\$8,805	\$15,646	\$11,581
State income taxes, net of federal benefit	841	2,505	1,778
Foreign income taxes, net effect	156	497	347
Stock compensation	146	87	300
(Decrease) increase in valuation allowance	(274 )	1,023	1,446
Disregarded entity election	¾	¾	(1,477 )
Other adjustments	272	321	420
Income tax expense, net	\$9,946	\$20,079	\$14,395

The Company paid approximately \$1.1 million, \$13.4 million, and \$19.4 million in income taxes for the years ended December 31, 2007, 2008 and 2009, respectively.

The Company has net operating loss carryforwards for international income tax purposes of approximately \$12.6 million, which do not expire.

The Company adopted FASB authoritative guidance for uncertain income tax positions on January 1, 2007. As a result of the implementation of this guidance, the Company recognized no material adjustment in the liability for unrecognized income tax benefits. At the adoption date of January 1, 2007, the Company had \$217,000 of unrecognized tax benefits, all of which would favorably affect the effective tax rate if recognized in future periods, and \$52,000 of accrued penalties and \$47,000 of accrued interest. The Company's continuing practice is to recognize interest and penalties related to income tax matters in income tax expense.

The following tables summarize the activity related to the Company's unrecognized tax benefits (in thousands):

Unrecognized tax benefit as of January 1, 2007	\$217
--	-------

Edgar Filing: CYANOTECH CORP - Form 10-Q

Increase for current year tax positions	44
Decrease for prior year tax positions	(6 )
Expiration of the statute of limitation for assessment of taxes	(22 )
Unrecognized tax benefit as of December 31, 2007	\$233

F-23

---

COSTAR GROUP, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (CONTINUED)

## 9. INCOME TAXES — (CONTINUED)

Unrecognized tax benefit as of December 31, 2007	\$233
Increase for current year tax positions	1,451
Decrease for prior year tax positions	(9 )
Expiration of the statute of limitation for assessment of taxes	(117 )
Unrecognized tax benefit as of December 31, 2008	1,558
Increase for current year tax positions	69
Increase for prior year tax positions	257
Expiration of the statute of limitation for assessment of taxes	(28 )
Unrecognized tax benefit as of December 31, 2009	\$1,856

Approximately \$217,000 and \$142,000 of the unrecognized tax benefit as of December 31, 2009, and 2008, respectively, would favorably affect the annual effective tax rate, if recognized in future periods. During 2009, the Company recognized approximately \$(10,000) of interest and \$20,000 of penalties, and had total accruals of approximately \$164,000 for interest and \$54,000 for penalties as of December 31, 2009. During 2008, the Company recognized approximately \$145,000 of interest and \$9,000 of penalties, and had total accruals of approximately \$173,000 for interest and \$34,000 for penalties as of December 31, 2008. The Company does not anticipate the amount of the unrecognized tax benefits to change significantly over the next twelve months.

The Company's federal and state income tax returns for tax years 2006 through 2008 remain open to examination. The Company's U.K. income tax returns for tax years 2003 through 2008 remain open to examination.

## 10. GAIN ON LEASE SETTLEMENT, NET

On September 14, 2007, CoStar Limited, a wholly owned U.K. subsidiary of CoStar, entered into an agreement with Trafigura Limited to assign to Trafigura the leasehold interest in the office space located in London. The lease assignment was completed on December 19, 2007. As a result, CoStar U.K. was paid approximately \$7.6 million, net of expenses, for the assignment of the lease. The expenses associated with the lease settlement included legal, moving and the disposal of assets.

## 11. COMMITMENTS AND CONTINGENCIES

The Company leases office facilities and office equipment under various noncancelable-operating leases. The leases contain various renewal options. Rent expense for the years ended December 31, 2007, 2008 and 2009 was approximately \$8.1 million, \$8.0 million and \$9.1 million, respectively.

Future minimum lease payments as of December 31, 2009 are as follows (in thousands):



Edgar Filing: CYANOTECH CORP - Form 10-Q

2010	\$10,530
2011	6,840
2012	4,911
2013	2,410
2014	651
2015 and thereafter	883
	\$26,225

F-24

---

COSTAR GROUP, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (CONTINUED)

11. COMMITMENTS AND CONTINGENCIES — (CONTINUED)

The Company and its wholly owned subsidiary CoStar U.K. Limited are defendants in legal proceedings filed in England by Nokia U.K. Limited (“Nokia”) related to obligations under an agreement to sublease certain office space from Nokia. Nokia served its complaint upon the Company in September 2009, and the litigation is in its very early stages. If there is a trial, it is not expected to occur until October 2010. The Company has filed a response asserting that Nokia’s claim is without merit. The Company intends to defend itself vigorously against Nokia’s claim. Since the outcome of these legal proceedings is uncertain at this time and because Nokia has requested equitable relief as an alternative to financial relief, the Company cannot estimate the amount of liability, if any, that could result from an adverse resolution of this matter.

On December 23, 2008, the Company initiated a Financial Industry Regulatory Authority (“FINRA”) arbitration against Credit Suisse First Boston (“CSFB”) related to CSFB’s purchase of auction rate securities for the Company’s account. An arbitration hearing was originally scheduled to begin during the week beginning December 7, 2009, but was rescheduled at the request of CSFB and is now set to begin on March 8, 2010. The Company expects to receive a ruling on its claim during the second quarter of 2010. Since the outcome of this legal proceeding is uncertain at this time, the Company cannot estimate the amount of gain or loss, if any, that could result from the resolution of this matter.

On December 8, 2009, a former employee filed a lawsuit against the Company in the United States District Court for the Southern District of California alleging violations of the Fair Labor Standards Act and California state wage-and-hour laws and seeking unspecified damages under those laws. The complaint also seeks to declare a class of all similarly situated employees to pursue similar claims. The Company believes that the lawsuit is meritless and intends to defend itself vigorously against these claims and any certification of class status. Nevertheless, because the lawsuit is in its early stages, the outcome of the claim is uncertain at this time and the Company cannot estimate the amount of liability, if any, that could result from an adverse resolution of this matter.

In December 2009, the Company and LoopNet, Inc. settled all pending litigation between the companies. No monetary consideration was involved in the settlement.

Currently, and from time to time, the Company is involved in litigation incidental to the conduct of its business. In accordance with GAAP, the Company records a provision for a liability when it is both probable that a liability has been incurred and the amount can be reasonably estimated. At the present time, while it is reasonably possible that an unfavorable outcome may occur as a result of the Company’s current litigation, management has concluded that it is not probable that a loss has been incurred in connection with the Company’s current litigation. In addition, the Company is unable to estimate the possible loss or range of loss that could result from an unfavorable outcome in the Company’s current litigation and accordingly, the Company has not recognized any liability in the consolidated financial statements for unfavorable results, if any. Legal defense costs are expensed as incurred.

COSTAR GROUP, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (CONTINUED)

## 12. SEGMENT REPORTING

Due to the increased size, complexity, and funding requirements associated with the Company's international expansion, in 2007 the Company began to manage the business geographically in two operating segments, with the primary areas of measurement and decision-making being the U.S. and International, which includes the U.K. and France. The Company's subscription-based information services, consisting primarily of CoStar Property Professional®, CoStar Tenant®, CoStar COMPS Professional®, and FOCUS™ services, currently generate more than 95% of the Company's total revenues. CoStar Property Professional, CoStar Tenant, and CoStar COMPS Professional are generally sold as a suite of similar services and comprise the Company's primary service offering in the U.S. operating segment. FOCUS is the Company's primary service offering in the International operating segment. Management relies on an internal management reporting process that provides revenue and segment EBITDA, which is the Company's net income before interest, income taxes, depreciation and amortization. Management believes that segment EBITDA is an appropriate measure for evaluating the operational performance of our segments. EBITDA is used by management to internally measure operating and management performance and to evaluate the performance of the business. However, this measure should be considered in addition to, not as a substitute for or superior to, income from operations or other measures of financial performance prepared in accordance with GAAP.

Summarized information by segment was as follows (in thousands):

	Year Ended December 31,		
	2007	2008	2009
Revenues			
United States	\$ 170,298	\$ 190,075	\$ 191,556
International			
External customers	22,507	22,353	18,103
Intersegment revenue	¾	¾	898
Total international revenue	22,507	22,353	19,001
Intersegment eliminations	¾	¾	(898 )
Total revenues	\$ 192,805	\$ 212,428	\$ 209,659
EBITDA			
United States	\$ 32,872	\$ 58,813	\$ 47,697
International	1,127	(2,224 )	(1,186 )
Total EBITDA	\$ 33,999	\$ 56,589	\$ 46,511
Reconciliation of EBITDA to net income			
EBITDA	\$ 33,999	\$ 56,589	\$ 46,511
Purchase amortization in cost of revenues	(2,170 )	(2,284 )	(2,389 )
Purchase amortization in operating expenses	(5,063 )	(4,880 )	(3,412 )
Depreciation and other amortization	(8,914 )	(9,637 )	(8,875 )
Interest income, net	8,045	4,914	1,253
Income tax expense, net	(9,946 )	(20,079 )	(14,395 )
Net income	\$ 15,951	\$ 24,623	\$ 18,693

Intersegment revenue is attributable to services performed by Property and Portfolio Research Ltd., a wholly owned subsidiary of PPR, for PPR. Intersegment revenue is recorded at cost plus an agreed margin, which the Company believes approximates fair value. U.S. EBITDA includes a corresponding cost for the services performed by Property

and Portfolio Research Ltd. for PPR

F-26

---

COSTAR GROUP, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (CONTINUED)

## 12. SEGMENT REPORTING — (CONTINUED)

International EBITDA includes a corporate allocation of approximately \$2.6 million, \$1.1 million and \$500,000 for the years ended December 31, 2007, 2008 and 2009, respectively.

Summarized information by segment consists of the following (in thousands):

	December 31,	
	2008	2009
Property and equipment, net		
United States	\$13,927	\$14,851
International	2,949	4,311
T o t a l   p r o p e r t y   a n d   e q u i p m e n t , net	\$16,876	\$19,162
Goodwill		
United States	\$31,547	\$55,260
International	22,781	25,061
Total goodwill	\$54,328	\$80,321
Assets		
United States	\$353,084	\$424,479
International	43,474	44,558
Total segment assets	\$396,558	\$469,037
Reconciliation of segment assets to total assets		
Total segment assets	\$396,558	\$469,037
Investment in subsidiaries	(18,343 )	(18,344 )
Intercompany receivables	(43,831 )	(46,114 )
Total assets	\$334,384	\$404,579
Liabilities		
United States	\$24,180	\$37,838
International	40,053	46,678
Total segment liabilities	\$64,233	\$84,516
Reconciliation of segment liabilities to total liabilities		
Total segment liabilities	\$64,233	\$84,516
Intercompany payables	(33,270 )	(38,943 )
Total liabilities	\$30,963	\$45,573

COSTAR GROUP, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (CONTINUED)

## 13. STOCKHOLDERS' EQUITY

## Preferred Stock

The Company has 2,000,000 shares of preferred stock, \$0.01 par value, authorized for issuance. The Board of Directors may issue the preferred stock from time to time as shares of one or more classes or series.

## Common Stock

The Company has 30,000,000 shares of common stock, \$0.01 par value, authorized for issuance. Dividends may be declared and paid on the common stock, subject in all cases to the rights and preferences of the holders of preferred stock and authorization by the Board of Directors. In the event of liquidation or winding up of the Company and after the payment of all preferential amounts required to be paid to the holders of any series of preferred stock, any remaining funds shall be distributed among the holders of the issued and outstanding common stock.

## 14. NET INCOME PER SHARE

The following table sets forth the calculation of basic and diluted net income per share (in thousands except per share data):

	Year Ended December 31,		
	2007	2008	2009
Numerator:			
Net income	\$ 15,951	\$ 24,623	\$ 18,693
Denominator:			
Denominator for basic net income per share $\frac{3}{4}$ weighted-average outstanding shares	19,044	19,372	19,780
Effect of dilutive securities:			
Stock options and restricted stock	360	178	145
Denominator for diluted net income per share $\frac{3}{4}$ weighted-average outstanding shares	19,404	19,550	19,925
Net income per share $\frac{3}{4}$ basic	\$ 0.84	\$ 1.27	\$ 0.95
Net income per share $\frac{3}{4}$ diluted	\$ 0.82	\$ 1.26	\$ 0.94

Stock options to purchase approximately 80,400, 250,200 and 483,800 shares were outstanding as of December 31, 2007, 2008 and 2009, respectively, but were not included in the computation of diluted earnings per share because the exercise price of the stock options was greater than the average share price of the common shares and, therefore, the effect would have been anti-dilutive.

COSTAR GROUP, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (CONTINUED)

15. EMPLOYEE BENEFIT PLANS

Stock Incentive Plans

In June 1998, the Company's Board of Directors adopted the 1998 Stock Incentive Plan (as amended, the "1998 Plan") prior to consummation of the Company's initial public offering. In April 2007, the Company's Board of Directors adopted the CoStar Group, Inc. 2007 Stock Incentive Plan (as amended, the "2007 Plan"), subject to stockholder approval, which was obtained on June 7, 2007. All shares of common stock that were authorized for issuance under the 1998 Plan that, as of June 7, 2007, remained available for issuance under the 1998 Plan (excluding shares subject to outstanding awards) were rolled into the 2007 Plan and, as of that date, no shares of common stock were available under the 1998 Plan. The 1998 Plan continues to govern unexercised and unexpired awards issued under the 1998 Plan prior to June 7, 2007. The 1998 Plan provides for the grant of stock and stock options to officers, directors and employees of the Company and its subsidiaries. Stock options granted under the 1998 Plan might be incentive or non-qualified. The exercise price for an incentive stock option may not be less than the fair market value of the Company's common stock on the date of grant. The vesting period of the options and restricted stock grants is determined by the Board of Directors and is generally three to four years. Upon the occurrence of a Change of Control, as defined in the 1998 Plan, all outstanding unexercisable options and restricted stock grants under the 1998 Plan immediately become exercisable.

The 2007 Plan provides for the grant of stock options, restricted stock, restricted stock units, and stock appreciation rights to officers, employees, directors and consultants of the Company and its subsidiaries. Stock options granted under the 2007 Plan may be non-qualified or may qualify as incentive stock options. Except in limited circumstances related to a merger or other acquisition, the exercise price for an option may not be less than the fair market value of the Company's common stock on the date of grant. The vesting period for each grant of options, restricted stock, restricted stock units and stock appreciation rights under the 2007 Plan is determined by the Board of Directors and is generally three to four years, subject to minimum vesting periods for restricted stock and restricted stock units of at least one year. The Company has reserved the following shares of common stock for issuance under the 2007 Plan: (a) 1,000,000 shares of common stock, plus (b) 121,875 shares of common stock that were authorized for issuance under the 1998 Plan that, as of June 7, 2007, remained available for issuance under the 1998 Plan (not including any Shares that were subject as of such date to outstanding awards under the 1998 Plan), and (c) any shares of common stock subject to outstanding awards under the 1998 Plan as of June 7, 2007 that on or after such date cease for any reason to be subject to such awards (other than by reason of exercise or settlement of the awards to the extent they are exercised for or settled in vested and nonforfeitable shares). Unless terminated sooner, the 2007 Plan will terminate in April 2017, but will continue to govern unexercised and unexpired awards issued under the 2007 Plan prior to that date. Approximately 880,000 and 430,000 shares were available for future grant under the 2007 Plan as of December 31, 2008 and 2009, respectively.

COSTAR GROUP, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (CONTINUED)

## 15. EMPLOYEE BENEFIT PLANS — (CONTINUED)

## Stock Incentive Plans — (Continued)

Option activity was as follows:

	Number of Shares	Range of Exercise Price	Weighted- Average Exercise Price	Weighted- Average Remaining Contract Life (in years)	Aggregate Intrinsic Value (in thousands)
Outstanding at December 31, 2006	1,274,477	9.00 - \$52.13	\$32.23		
Granted	7,000	48.25 - \$54.12	\$50.77		
Exercised	(288,757 )	9.00 - \$45.18	\$28.16		
Canceled or expired	(24,875 )	21.28 - \$51.92	\$44.82		
Outstanding at December 31, 2007	967,845	16.20 - \$54.12	\$33.25		
Granted	93,900	43.99 - \$55.07	\$45.76		
Exercised	(198,434 )	17.77 - \$45.18	\$33.05		
Canceled or expired	(47,725 )	39.00 - \$52.13	\$46.36		
Outstanding at December 31, 2008	815,586	16.20 - \$55.07	\$33.98		
Granted	267,756	25.00 - \$40.13	\$31.05		
Exercised	(85,228 )	17.35 - \$36.38	\$26.20		
Canceled or expired	(44,818 )	30.06 - \$46.81	\$39.40		
Outstanding at December 31, 2009	953,296	16.20 - \$55.07	\$33.60	5.54	\$9,119
Exercisable at December 31, 2007	826,782	16.20 - \$52.13	\$31.07		
Exercisable at December 31, 2008	701,975	16.20 - \$54.12	\$31.84		
Exercisable at December 31, 2009	650,063	16.20 - \$55.07	\$33.60	3.87	\$6,376



The aggregate intrinsic value is calculated as the difference between (i) the closing price of the common stock at December 31, 2007, 2008 and 2009 and (ii) the exercise prices of the underlying awards, multiplied by the shares underlying options as of December 31, 2007, 2008 and 2009, that had an exercise price less than the closing price on that date. Options to purchase 288,757, 198,434, and 85,228 shares were exercised for the years ended December 31, 2007, 2008, and 2009, respectively. The aggregate intrinsic value of options exercised, determined as of the date of option exercise, was \$7.5 million, \$3.4 million and \$1.2 million, respectively.

At December 31, 2009, there was \$11.3 million of unrecognized compensation cost related to stock-based payments, net of forfeitures, which is expected to be recognized over a weighted-average-period of 2.2 years.

The weighted-average grant date fair value of each option granted during the years ended December 2007, 2008 and 2009 was \$32.70, \$27.81 and \$12.72, respectively.

F-30

---

COSTAR GROUP, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (CONTINUED)

## 15. EMPLOYEE BENEFIT PLANS — (CONTINUED)

## Stock Incentive Plans — (Continued)

The Company estimated the fair value of each option granted on the date of grant using the Black-Scholes option-pricing model, using the assumptions noted in the following table:

	Year Ended December 31,					
	2007		2008		2009	
Dividend yield	0	%	0	%	0	%
Expected volatility	61	%	59	%	43	%
Risk-free interest rate	4.7	%	3.0	%	2.2	%
Expected life (in years)	5		5		3	

The assumptions above and the estimation of expected forfeitures are based on multiple facts, including historical employee behavior patterns of exercising options and post-employment termination behavior, expected future employee option exercise patterns, and the historical volatility of the Company's stock price.

The following table summarizes information regarding options outstanding at December 31, 2009:

Range of Exercise Price	Number of Shares	Options Outstanding		Options Exercisable	
		Weighted-Average Contractual Life (in years)	Weighted-Average Exercise Price	Number of Shares	Weighted-Average Exercise Price
16.20 - \$20.30	146,522	2.13	\$ 18.85	146,522	\$ 18.85
20.60 - \$24.88	44,000	2.33	\$ 23.13	44,000	\$ 23.13
25.00 - \$25.00	133,600	9.16	\$ 25.00	0	\$ 0.00
25.01 - \$30.06	139,516	3.26	\$ 28.71	139,516	\$ 28.71
30.75 - \$37.42	108,276	8.93	\$ 36.62	7,063	\$ 31.86
38.63 - \$39.53	106,057	4.00	\$ 39.10	106,057	\$ 39.10
39.81 - \$43.99	106,375	7.31	\$ 43.00	50,289	\$ 42.56
44.06 - \$51.92	150,950	5.74	\$ 47.89	149,616	\$ 47.88
54.12 - \$54.12	3,000	7.42	\$ 54.12	2,000	\$ 54.12
55.07 - \$55.07	15,000	8.67	\$ 55.07	5,000	\$ 55.07
\$	953,296	5.54	\$ 33.60	650,063	\$ 33.60

16.20 -  
\$55.07

The following table presents unvested restricted stock awards activity for the year ended December 31, 2009:

	Number of Shares	Weighted-Average Grant Date Fair Value per Share
Unvested restricted stock at December 31, 2008	273,353	\$ 49.12
Granted	236,661	\$ 29.43
Vested	(67,433 )	\$ 45.52
Canceled	(23,234 )	\$ 34.33
Unvested restricted stock at December 31, 2009	419,347	\$ 39.40

F-31

---

COSTAR GROUP, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (CONTINUED)

15. EMPLOYEE BENEFIT PLANS — (CONTINUED)

Employee 401(k) Plan

The Company maintains a 401(k) Plan (the “401(k)”) as a defined contribution retirement plan for all eligible employees. The 401(k) provides for tax-deferred contributions of employees’ salaries, limited to a maximum annual amount as established by the Internal Revenue Service. In 2007 and 2008, the Company matched 100% of employee contributions up to a maximum of 6% of total compensation. In 2009, the Company matched 50% of employee contributions up to a maximum of 6% of total compensation. Amounts contributed to the 401(k) by the Company to match employee contributions for the years ended December 31, 2007, 2008 and 2009 were approximately \$2.3 million, \$2.6 million and \$1.4 million, respectively. The Company paid administrative expenses in connection with the 401(k) plan of approximately \$22,000, \$28,000 and \$0 for the years ended December 31, 2007, 2008 and 2009, respectively.

Employee Pension Plan

The Company maintains a company personal pension plan for all eligible employees in the Company’s London, England office. The plan is a defined contribution plan. Employees are eligible to contribute a portion of their salaries, subject to a maximum annual amount as established by the Inland Revenue. The Company contributes a match subject to the percentage of the employees’ contribution. Amounts contributed to the plan by the Company to match employee contributions for the years ended December 31, 2007, 2008 and 2009 were approximately \$281,000, \$265,000 and \$130,000, respectively.

Employee Stock Purchase Plan

As of August 1, 2006, the Company introduced an Employee Stock Purchase Plan (“ESPP”), pursuant to which eligible employees participating in the plan authorize the Company to withhold from the employees’ compensation and use the withheld amounts to purchase shares of the Company’s common stock at 90% of the market price. Participating employees are able to purchase common stock under this plan during the offering period. The offering period begins the second Saturday before each of the Company’s regular pay dates and ends on each of the Company’s regular pay dates. There were 78,840 and 72,237 shares available for purchase under the plan as of December 31, 2008 and 2009, respectively and approximately 7,400 and 6,600 shares of the Company’s common stock were purchased during 2008 and 2009, respectively.

16. RELATED PARTY TRANSACTIONS

In April 2009, the Company entered into an engagement with ghSMART & Company, Inc. (“ghSMART”), a management consulting firm, to evaluate the Company’s sales force senior management and provide guidance with respect to hiring and recruiting best practices for the Company’s sales force. Randy Street, a Partner of ghSMART, is the brother-in-law of the Company’s Chief Executive Officer. Mr. Street has acted and will continue to act as the senior client manager on this project. He has a less than 0.5 percent equity stake in ghSMART. Mr. Street is paid 25 percent of the amounts paid by the Company pursuant to the engagement. Pursuant to the engagement, the Company paid ghSMART approximately \$202,000 plus expenses. The Audit Committee reviewed and approved the engagement with ghSMART prior to commencement of the engagement. In October 2009, the Audit Committee reviewed and approved phase II of the engagement for an additional amount of approximately \$255,000 plus expenses. Mr. Street will act in the same capacity during phase II and receive the same percentage compensation for this portion of the engagement. The Company may enter into additional engagements with ghSMART in the future.

F-32

---

COSTAR GROUP, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (CONTINUED)

17. SUBSEQUENT EVENTS

In February 2010, the Company purchased a 169,429 square-foot LEED Gold certified office building located at 1331 L Street, NW in downtown Washington, D.C. together with the tenancy in the underlying ground lease for the property for a purchase price of \$41.25 million in cash. This facility will be used primarily by the Company's U.S. segment. The Company intends to begin relocating its Bethesda-based employees and infrastructure to the new building starting in the second quarter of 2010. The Company currently expects to complete its relocation by October 2010 and allow the lease of its Bethesda property to expire.

In February 2010, the Company assumed the ground lease for the parcel of land under a building purchased in Washington, D.C. The lease, which expires February 29, 2088, requires the payment of minimum annual rent of \$778,000 through February 29, 2012, then \$918,040 annually to February 29, 2024. Thereafter, the minimum rate is adjusted to fair market value, as defined in the lease, once every 7 years.

Subsequent events have been evaluated through February 25, 2010, the date these financial statements were issued.