

ARBITRON INC  
Form 10-Q  
May 06, 2005

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, DC 20549**

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**FORM 10-Q**

**þ Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the quarterly period ended March 31, 2005**

Or

**o Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

Commission file number: 1-1969

**ARBITRON INC.**

(Exact name of registrant as specified in its charter)

**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**52-0278528**  
(I.R.S. Employer Identification No.)

**142 West 57<sup>th</sup> Street  
New York, New York 10019**  
(Address of principal executive offices) (Zip Code)

**(212) 887-1300**  
(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes  No

The registrant had 31,417,816 shares of common stock, par value \$0.50 per share, outstanding as of April 29, 2005.

ARBITRON INC.

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**PART I FINANCIAL INFORMATION**  
**ITEM 1. FINANCIAL STATEMENTS**

**ARBITRON INC.**  
 Consolidated Balance Sheets  
 (In thousands, except par value data)

	<b>March 31, 2005 (unaudited)</b>	<b>December 31, 2004 (audited)</b>
<b>Assets</b>		
Current assets		
Cash and cash equivalents	\$ 121,566	\$ 86,901
Trade accounts receivable, net of allowance for doubtful accounts of \$1,172 in 2005 and \$1,124 in 2004	22,259	23,369
Deferred tax assets	4,362	4,362
Prepaid expenses and other current assets	6,770	5,529
<b>Total current assets</b>	<b>154,957</b>	<b>120,161</b>
Investment in affiliate	7,040	12,130
Property and equipment, net of accumulated depreciation of \$20,411 in 2005 and \$19,456 in 2004	19,811	18,536
Goodwill, net	37,773	37,773
Other intangibles, net	2,988	3,381
Noncurrent deferred tax assets	2,065	3,025
Other noncurrent assets	1,031	1,115
<b>Total assets</b>	<b>\$ 225,665</b>	<b>\$ 196,121</b>
<b>Liabilities and Stockholders Equity</b>		
Current liabilities		
Accounts payable	\$ 5,142	\$ 5,444
Accrued expenses and other current liabilities	36,239	30,955
Deferred revenue	54,324	59,608
<b>Total current liabilities</b>	<b>95,705</b>	<b>96,007</b>
Noncurrent liabilities		
Long-term debt	50,000	50,000
Other noncurrent liabilities	5,259	4,734
<b>Total liabilities</b>	<b>150,964</b>	<b>150,741</b>

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Stockholders' equity		
Common stock, \$0.50 par value, authorized 500,000 shares, issued 32,336 shares in 2005 and 2004	16,168	16,168
Additional paid-in capital	114,348	101,914
Accumulated earnings (net distributions to Ceridian in excess of accumulated earnings) prior to spin-off	(242,870)	(242,870)
Retained earnings subsequent to spin-off	190,073	173,360
Common stock held in treasury, 967 shares in 2005 and 1,376 shares in 2004	(484)	(688)
Accumulated other comprehensive loss	(2,534)	(2,504)
Total stockholders' equity	74,701	45,380
Total liabilities and stockholders' equity	\$ 225,665	\$ 196,121

See notes to consolidated financial statements.

**ARBITRON INC.**  
Consolidated Statements of Income  
(In thousands, except per share data)  
(unaudited)

	<b>Three Months Ended March 31,</b>	
	<b>2005</b>	<b>2004</b>
Revenue	\$ 79,195	\$ 76,585
Costs and expenses		
Cost of revenue	20,218	21,697
Selling, general and administrative	16,153	14,791
Research and development	8,038	6,863
Total costs and expenses	44,409	43,351
Operating income	34,786	33,234
Proportionate share of net loss of affiliate	(2,090)	(1,328)
Income before interest and income tax expense	32,696	31,906
Interest income	609	202
Interest expense	1,051	2,429
Income before income tax expense	32,254	29,679
Income tax expense	12,418	11,575
Net income	\$ 19,836	\$ 18,104
Net income per weighted average common share		
Basic	\$ 0.64	\$ 0.59
Diluted	\$ 0.63	\$ 0.57
Dividends declared per share	\$ 0.10	\$
Weighted average common shares used in calculations		
Basic	31,140	30,794
Potentially dilutive securities	388	709
Diluted	31,528	31,503

See notes to consolidated financial statements.



**ARBITRON INC.**  
Consolidated Statements of Cash Flows  
(In thousands)  
(unaudited)

	<b>Three Months Ended March 31,</b>	
	<b>2005</b>	<b>2004</b>
Cash flows from operating activities		
Net income	\$ 19,836	\$ 18,104
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization of property and equipment	1,017	1,108
Other amortization	393	210
Loss on asset disposals	50	178
Asset impairment charge		328
Deferred income taxes	979	4,861
Proportionate share of net loss of affiliate	2,090	1,328
Distributions from affiliate	3,000	2,600
Bad debt expense	123	100
Tax benefit from stock option exercises	2,651	1,331
Noncash compensation	96	49
Changes in operating assets and liabilities, excluding effects of business acquisition		
Trade accounts receivable	954	3,905
Prepaid expenses and other assets	(2,539)	(2,387)
Accounts payable	(294)	(1,016)
Accrued expenses and other current liabilities	2,177	2,586
Deferred revenue	(5,280)	(7,890)
Other noncurrent liabilities	525	448
Net cash provided by operating activities	25,778	25,843
Cash flows from investing activities		
Additions to property and equipment	(2,342)	(1,307)
Payment for business acquisition		(8,928)
Net cash used by investing activities	(2,342)	(10,235)
Cash flows from financing activities		
Proceeds from stock option exercises and stock purchase plan	11,270	4,676
Payment of long-term debt		(20,000)
Net cash provided (used) by financing activities	11,270	(15,324)
Effect of exchange rate changes on cash	(41)	91
Net increase in cash and cash equivalents	34,665	375
Cash and cash equivalents at beginning of period	86,901	68,433



Cash and cash equivalents at end of period	\$ 121,566	\$ 68,808
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See notes to consolidated financial statements.

**ARBITRON INC.**

Notes to Consolidated Financial Statements

March 31, 2005

(unaudited)

**1. Basis of Presentation and Consolidation**

***Presentation***

The accompanying unaudited consolidated financial statements of Arbitron Inc. (the Company or Arbitron ) have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments considered for fair presentation have been included. The consolidated balance sheet as of December 31, 2004 was audited at that date but does not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company s Annual Report on Form 10-K for the year ended December 31, 2004.

***Consolidation***

The consolidated financial statements of Arbitron reflect the consolidated financial position, results of operations and cash flows of Arbitron Inc. and its subsidiaries: Arbitron Holdings Inc., Audience Research Bureau S.A. de C.V., Ceridian Infotech (India) Private Limited, CSW Research Limited and Euro Fieldwork Limited.

**2. Pro Forma Disclosures of Stock-Based Compensation**

The Company applies the intrinsic-value-based method of accounting prescribed by Accounting Principles Board ( APB ) Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations including Financial Accounting Standards Board ( FASB ) Interpretation No. 44, *Accounting for Certain Transactions Involving Stock Compensation*, an interpretation of APB Opinion No. 25, to account for its fixed-plan stock options. Under this method, compensation expense is recorded on the date of grant only if the current market price of the underlying stock exceeded the exercise price. Statement of Financial Accounting Standards ( SFAS ) No. 123, *Accounting for Stock-Based Compensation* (as amended by SFAS No. 148, *Accounting for Stock-Based Compensation-Transitions and Disclosures*), established accounting and disclosure requirements using a fair-value-based method of accounting for stock-based employee compensation plans. As allowed by SFAS No. 123, the Company has elected to continue to apply the intrinsic-value-based method of accounting described above, and has adopted only the disclosure requirements of SFAS No. 123. The following table illustrates the effect on net income if the fair-value-based method had been applied to all outstanding and unvested awards in each period (dollars in thousands, except per share data):

**ARBITRON INC.**  
Notes to Consolidated Financial Statements    Continued  
March 31, 2005  
(unaudited)

	<b>Three Months Ended March 31,</b>	
	<b>2005</b>	<b>2004</b>
Net income, as reported	\$ 19,836	\$ 18,104
Add: Stock-based compensation expense, net of tax	59	30
Less: Stock-based compensation expense determined under fair value method, net of tax	1,032	718
 Pro forma net income	 \$ 18,863	 \$ 17,416
 Basic net income per weighted average common share, as reported	 \$ 0.64	 \$ 0.59
Pro forma basic net income per weighted average common share	\$ 0.61	\$ 0.57
Diluted net income per weighted average common share, as reported	\$ 0.63	\$ 0.57
Pro forma diluted net income per weighted average common share	\$ 0.60	\$ 0.55
 Options granted to employees and directors	 495,466	 4,942
Weighted-average exercise price	\$ 40.89	\$ 42.38
Weighted-average fair value	\$ 13.75	\$ 10.57
Weighted-average assumptions:		
Expected lives in years	6.5	4.0
Expected volatility	29.1%	27.3%
Expected dividend rate	1.00%	
Risk-free interest rate	4.05%	2.74%

### 3. Long-Term Debt

Long-term debt consisted of senior secured fixed-rate notes in the amount of \$50.0 million as of March 31, 2005, and December 31, 2004. The notes bear interest at a fixed rate of 9.96% and mature January 31, 2008. The senior-secured-notes agreement contains certain financial covenants and also contains a make-whole provision that applies in the event of early prepayment of principal. The fair values of the senior secured notes as of March 31, 2005, and December 31, 2004, were \$52.7 million and \$53.8 million, respectively, and were estimated using a cash flow valuation model and available market data for securities with similar maturity dates. Under the terms of the senior secured notes, the Company is required to maintain certain financial ratios and meet other financial conditions. The senior secured notes limit, among other things, the Company's ability to buy and sell assets, incur additional indebtedness, grant or incur liens on its assets, pay cash dividends over a certain amount, make investments or acquisitions, repurchase or redeem capital stock and engage in certain mergers or consolidations. The Company was in compliance with its covenants as of March 31, 2005.

If a default occurs under the terms of Arbitron's secured senior notes, the lenders could proceed against the lenders collateral, which includes a first-priority lien on substantially all of the assets of Arbitron and its domestic subsidiaries and a pledge of the capital stock of all of its domestic subsidiaries and of 65% of the capital stock of its foreign subsidiaries. In addition, a default may result in higher rates of interest and the inability to obtain additional capital.



**ARBITRON INC.**

Notes to Consolidated Financial Statements Continued

March 31, 2005

(unaudited)

**4. Stockholders Equity**

Changes in stockholders equity for the three months ended March 31, 2005, were as follows (in thousands):

	<b>Balance as of</b>			<b>Common</b>	<b>Non- cash</b>	<b>Tax Benefit from Stock</b>	<b>Other Compre-</b>	<b>Balance as of</b>
	<b>Dec. 31, 2004</b>	<b>Net Income</b>	<b>Dividends Declared</b>	<b>Stock Issued</b>	<b>Compen- sation</b>	<b>Option Exercises</b>	<b>hensive Loss</b>	<b>March 31, 2005</b>
Common stock	\$ 16,168	\$	\$	\$	\$	\$	\$	\$ 16,168
Additional paid-in capital	101,914			9,687	96	2,651		114,348
Accumulated earnings (net distributions to Ceridian in excess of earnings)	(242,870)							(242,870)
Retained earnings subsequent to spin-off	173,360	19,836	(3,123)					190,073
Common stock held in treasury	(688)			204				(484)
Accumulated other comprehensive income (loss)	(2,504)						(30)	(2,534)
Total stockholders equity	\$ 45,380	\$ 19,836	\$ (3,123)	\$ 9,891	\$ 96	\$ 2,651	\$ (30)	\$ 74,701
Shares outstanding	30,960			409				31,369

**5. Net Income Per Weighted Average Common Share**

The computations of basic and diluted net income per weighted average common share for the three months ended March 31, 2005, and 2004 are based on Arbitron's weighted average shares of common stock and potentially dilutive securities outstanding, respectively.

Potentially dilutive securities are calculated in accordance with the treasury stock method, which assumes that the proceeds from the exercise of all stock options are used to repurchase the Company's common stock at the average market price for the period.

## **6. Comprehensive Income**

The Company's comprehensive income is comprised of net income, foreign currency translation adjustments and changes in additional minimum pension liability.

**ARBITRON INC.**

Notes to Consolidated Financial Statements Continued

March 31, 2005

(unaudited)

The components of comprehensive income were as follows (in thousands):

	<b>Three Months Ended March 31,</b>	
	<b>2005</b>	<b>2004</b>
Net income	\$ 19,836	\$ 18,104
Items of other comprehensive income		
Change in foreign currency translation adjustment	(48)	106
Change in fair value of interest rate swap		490
Income tax benefit (expense), net	18	(184)
Comprehensive income	\$ 19,806	\$ 18,516

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

	<b>March 31,</b>	<b>December</b>
	<b>2005</b>	<b>31, 2004</b>
Foreign currency translation adjustment	\$ 418	\$ 466
Additional minimum pension liability	(4,538)	(4,538)
Income tax benefit	1,586	1,568
Accumulated other comprehensive loss	\$ (2,534)	\$ (2,504)

**7. Retirement Plans**

Arbitron's United States employees participate in a defined-benefit pension plan that closed to new participants effective January 1, 1995. Arbitron subsidizes health care benefits for eligible retired employees who participate in the pension plan and were hired before January 1, 1992.

The components of periodic benefit costs for the defined-benefit pension plan and postretirement plan were as follows (in thousands):

	<b>Defined-Benefit Pension Plan</b>		<b>Postretirement Plan</b>	
	<b>Three Months Ended March 31,</b>		<b>Three Months Ended March 31,</b>	
	<b>2005</b>	<b>2004</b>	<b>2005</b>	<b>2004</b>
Service cost	\$ 202	\$ 186	\$ 10	\$ 7

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Interest cost	387	354	20	13
Expected return on plan assets	(410)	(381)		
Amortization of prior service cost	6	5		
Amortization of net loss	140	117	8	3
Net periodic benefit cost	\$ 325	\$ 281	\$ 38	\$ 23



**ARBITRON INC.**

Notes to Consolidated Financial Statements Continued

March 31, 2005

(unaudited)

Arbitron estimates that it will contribute \$1.0 million in 2005 to the defined-benefit pension plan.

**8. New Accounting Pronouncement**

In December 2004, the FASB enacted Statement of Financial Accounting Standards 123 revised 2004 ( SFAS 123R ), *Share-Based Payment* , which replaces SFAS No. 123, and supersedes APB Opinion No. 25. SFAS 123R requires the measurement of all employee share-based payments to employees, including grants of employee stock options, using a fair-value-based method and the recording of such expense in our consolidated statements of income. The accounting provisions of SFAS 123R were to be effective for reporting periods beginning after June 15, 2005. However, on April 14, 2005, the Securities and Exchange Commission announced that the effective date of SFAS 123R will be postponed until January 1, 2006, for calendar-year companies.

Arbitron is required to adopt SFAS 123R in the first quarter of 2006. The pro forma disclosures previously permitted under SFAS 123 no longer will be an alternative to financial statement recognition. See Note 2 in the Notes to Consolidated Financial Statements for the pro forma net income and net income per share amounts for the three months ended March 31, 2005, and 2004. Although Arbitron has not yet determined whether the adoption of SFAS 123R will result in amounts that are similar to the current pro forma disclosures under SFAS 123, the Company is evaluating the requirements under SFAS 123R and expects the adoption to have an adverse impact on the Company's consolidated statements of income and net income per share.

## **ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

**The following discussion should be read in conjunction with Arbitron's consolidated financial statements and the notes related to those consolidated financial statements contained elsewhere in this Form 10-Q.**

### **Forward-Looking Statements**

This quarterly report on Form 10-Q contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. The statements regarding Arbitron in this document that are not historical in nature, particularly those that utilize terminology such as may, will, should, likely, expects, anticipates, believes or plans, or comparable terminology, are forward-looking statements based on current expectations about future events, which Arbitron has derived from information currently available to it. These forward-looking statements involve known and unknown risks and uncertainties that may cause our results to be materially different from results implied in such forward-looking statements. These risks and uncertainties include whether we will be able to:

renew all or part of contracts with large customers as they expire;

successfully execute our business strategies, including implementation of our Portable People Meter (PPM<sup>SM</sup>) services;

effectively manage the impact of consolidation in the radio and advertising agency industries;

keep up with rapidly changing technological needs of our customer base, including creating new proprietary software systems and new customer products and services that meet these needs in a timely manner;

successfully manage the impact on our business of any economic downturn generally and in the advertising market in particular; and

successfully manage the impact on costs of data collection due to privacy concerns and/or government regulations.

Additional important factors known to Arbitron that could cause forward-looking statements to turn out to be incorrect are identified and discussed from time to time in Arbitron's filings with the Securities and Exchange Commission, including in particular the risk factors discussed under the caption **ITEM 1. BUSINESS** Business Risks in Arbitron's Annual Report on Form 10-K for the year ended December 31, 2004.

The forward-looking statements contained in this document speak only as of the date hereof, and Arbitron undertakes no obligation to correct or update any forward-looking statements, whether as a result of new information, future events or otherwise.

### **Overview**

Arbitron is an international media and marketing research firm primarily serving radio, cable television, advertising agencies, advertisers, outdoor and out-of-home media and, through its Scarborough joint venture, broadcast television and print media. Arbitron currently has four main services:

measuring radio audiences in local markets in the United States and Mexico;

measuring national radio audiences and the audience size of network radio programs and commercials;

providing application software used for accessing and analyzing media audience and marketing information data; and

providing consumer, shopping and media usage information services to radio, cable television, advertising agencies, advertisers, retailers, outdoor and out-of-home media, online industries and, through its Scarborough joint venture, broadcast television and print media.

Arbitron's quantitative radio audience measurement business and related software sales accounted for approximately 95% of its revenue for the three months ended March 31, 2005. Consolidation in the radio broadcasting industry has led to Arbitron's dependence on a limited number of key customers. In 2004, Clear Channel Communications, Inc. ( Clear Channel Communications ) and Infinity Broadcasting Corp. ( Infinity Broadcasting ) represented approximately 21% and 10%, respectively, of Arbitron's revenue. Arbitron's agreements with these customers are not exclusive and contain no renewal obligations. In August 2004, Arbitron entered into license agreements with Infinity Broadcasting, effective April 1, 2004, to provide audience estimates, software and other ancillary services to Infinity Broadcasting's radio stations through the Company's Winter 2008 survey. On December 27, 2004, the Company entered into new license agreements with Clear Channel Communications to provide radio ratings and software services for Clear Channel Communication's radio stations and networks through the Company's Fall 2008 survey.

Arbitron cannot give any assurances that it could replace the revenue that would be lost should a key customer fail to renew all or part of its agreements with Arbitron. The loss of a key customer would materially impact Arbitron's business, financial position and operating results.

Due to the slow economic growth of the radio industry as well as the high penetration of current services in the core radio station business, Arbitron expects that its annual organic rate of revenue growth will be slower than historical trends for the foreseeable future.

Arbitron entered into an agreement on May 31, 2000, with Nielsen Media Research, Inc. ( Nielsen Media Research ), a provider of U.S. television and cable audience measurement services, under which Arbitron granted Nielsen Media Research an option to join Arbitron in the potential commercial deployment of the Portable People Meter ( Portable People Meter or PPM) in the United States for audience measurement services. In the event Nielsen Media Research exercises the option, the parties would form a joint venture to commercially deploy and operate the business of utilizing the Portable People Meter for the collection of listening and viewing audience data. In 2003, Arbitron worked with Nielsen Media Research on response rate issues and a variety of engineering tests. In 2004, Arbitron reported on the outcomes of three collaborative tests of the PPM that were conducted with Nielsen Media Research. Arbitron continues to work with Nielsen Media Research to resolve outstanding issues and to negotiate business terms for a potential Portable People Meter joint venture.

In third quarter 2004, Arbitron began recruiting consumers to participate in a market demonstration to be conducted in Houston, Texas, in 2005 and 2006 to confirm the results of previous tests and demonstrate enhancements to the Portable People Meter system that have been made since it was tested in Philadelphia.

A Portable People Meter business impact study that is being led by the Radio Advertising Bureau, and undertaken by Forrester Research, is researching the impact on the radio industry of electronic measurement and a move from diaries to the Portable People Meter for radio audience measurement. The study should be completed in mid-2005.

As of January 1, 2005, BBM Canada, the Canadian industry cooperative for audience ratings, made the Portable People Meter the official ratings system for buying and selling commercial airtime on French-language television in the markets of Quebec and Montreal.

In April 2005, TNS, Arbitron's PPM licensee for certain countries in Europe, Asia-Pacific, the Middle East and Africa, announced an agreement of intent with the Norwegian National Radio's Steering Committee to launch a Portable People Meter panel for radio. This could make Norway the first country to use the Portable People Meter as

currency for radio ratings.

Arbitron began testing additional marketing research applications of the Portable People Meter technology in 2003. One application that Arbitron began testing was the use of the Portable People Meter as the media

collection tool for a national marketing-oriented panel designed to correlate advertising with shopping behavior and sales. The objective is to provide multimedia exposure data combined with sales data from a single source to produce a measure of advertising effectiveness for advertisers, agencies and broadcasters.

On September 29, 2004, Arbitron announced that Arbitron and VNU, Inc. had agreed to jointly explore the development of a new national marketing research service which collects multi-media and purchase information from a common sample of consumers. On April 29, 2005, Arbitron and VNU, Inc., entered into a cost sharing agreement to share costs and capital expenditures associated with the development and deployment, by year-end 2005, of a pilot panel of more than 6,000 households as a demonstration of the national marketing service. A formal joint venture between Arbitron and VNU, Inc. for the national marketing panel is under discussion. Procter & Gamble is also collaborating with the two companies to help ensure that the service properly addresses the needs of marketers. This is a new type of service for which market acceptance is not yet known.

The continuing development and anticipated rollout of PPM services will require significant capital resources and will increase Arbitron's operating costs over the next several years. As a result of the national test marketing pilot panel, the Company expects to incur up to approximately \$11.3 million of additional expenditures in 2005, approximately \$4.3 million of which would constitute expenses that have a direct impact on the Company's net income and approximately \$7.0 million of which would be capitalizable. Furthermore, in the event Arbitron decides to proceed with commercializing either a PPM ratings service or a PPM marketing application service, significant additional start-up expenses would be incurred prior to revenue being generated from such commercialization which initially would adversely affect Arbitron's financial position and operating results.

Arbitron uses listener diaries to gather radio listening data from sample households in the United States local markets for which it currently provides radio ratings. A representative sample of the population in each local market is randomly selected for each survey and is recruited by telephone. It is increasingly difficult and more costly to obtain consent from the phone sample to participate in the surveys and to get a usable diary returned to Arbitron. Arbitron must achieve response rates sufficient to maintain confidence in its ratings, the support of the industry and accreditation by the Media Rating Council. Response rates are a quality measure of survey performance and an important factor impacting costs associated with data collection. Overall response rates have declined over the past several years. If response rates continue to decline further, Arbitron's radio audience measurement business could be adversely affected. Arbitron commits extensive efforts and resources to address the decline of response rates. Additional initiatives in 20 low-response-rate markets have had a positive impact on response rates, which have increased by approximately 2.7% in those markets from the Fall 2003 to the Fall 2004 survey. In 2005 these additional initiatives are expanding into 10 more low-response-rate markets. In addition, the response rate decline in all markets slowed significantly from the Fall 2003 to the Fall 2004 survey compared to the Fall 2003 to the Fall 2002 survey.

Arbitron announced on February 28, 2005, that its Board of Directors approved the payment of the Company's first quarterly cash dividend of \$0.10 per common share. The dividend was paid on April 1, 2005, to stockholders of record as of the close of business on March 15, 2005.

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

Critical accounting policies and estimates are those that are both important to the presentation of the Company's financial position and results of operations, and require management's most difficult, complex or subjective judgments.

The Company capitalizes software development costs with respect to major internal-use software initiatives or enhancements in accordance with Statement of Position 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*. The costs are capitalized from the time that the preliminary project stage is completed and management considers it probable that the software will be used to perform the function intended until

the time the software is placed in service for its intended use. Management performs an assessment quarterly to determine if it is probable that all capitalized software will be used to perform its intended function. If an impairment exists, the software cost is written down to estimated fair value. As of March 31, 2005, and December 31, 2004, the Company's capitalized software developed for internal use had carrying amounts of \$10.2 million and \$8.5 million, respectively, including \$6.0 million and \$5.7 million, respectively, of software related to the Portable People Meter.

Arbitron uses the asset and liability method of accounting for income taxes. Under this method, income tax expense is recognized for the amount of taxes payable or refundable for the current year and for deferred tax liabilities and assets for the future tax consequences of events that have been recognized in an entity's financial statements or tax returns. Management must make assumptions, judgments and estimates to determine the current

provision for income taxes and also deferred tax assets and liabilities and any valuation allowance to be recorded against a deferred tax asset. Judgments, assumptions and estimates relative to the current provision for income tax take into account current tax laws, interpretation of current tax laws and possible outcomes of current and future audits conducted by foreign and domestic tax authorities. Changes in tax law or interpretation of tax laws and the resolution of current and future tax audits could significantly impact the amounts provided for income taxes in the consolidated financial statements. Assumptions, judgments and estimates relative to the value of a deferred tax asset take into account predictions of the amount and category of future taxable income. Actual operating results and the underlying amount and category of income in future years could render current assumptions, judgments and estimates of recoverable net deferred taxes inaccurate. Any of the assumptions, judgments and estimates mentioned above could cause actual income tax obligations to differ from estimates, thus impacting Arbitron's financial position and results of operations.



**Results of Operations*****Comparison of the Three Months Ended March 31, 2005 to the Three Months Ended March 31, 2004***

The following table sets forth information with respect to the consolidated statements of income of Arbitron:

**Consolidated Statements of Income**  
**(Dollars in thousands, except per share amounts)**

	<b>Three Months Ended March 31,</b>		<b>Increase (Decrease)</b>		<b>Percentage of Revenue</b>	
	<b>2005</b>	<b>2004</b>	<b>Dollars</b>	<b>Percent</b>	<b>2005</b>	<b>2004</b>
Revenue	\$ 79,195	\$ 76,585	\$ 2,610	3.4%	100.0%	100.0%
Costs and expenses						
Cost of revenue	20,218	21,697	(1,479)	(6.8%)	25.5%	28.3%
Selling, general and administrative	16,153	14,791	1,362	9.2%	20.4%	19.3%
Research and development	8,038	6,863	1,175	17.1%	10.2%	9.0%
Total costs and expenses	44,409	43,351	1,058	2.4%	56.1%	56.6%
Operating income	34,786	33,234	1,552	4.7%	43.9%	43.4%
Proportionate share of net loss of affiliate	(2,090)	(1,328)	(762)	(57.4%)	(2.6%)	(1.7%)
Income before interest and income tax expense	32,696	31,906	790	2.5%	41.3%	41.7%
Interest income	609	202	407	201.5%	0.7%	0.3%
Interest expense	1,051	2,429	(1,378)	(56.7%)	1.3%	3.2%
Income before income tax expense	32,254	29,679	2,575	8.7%	40.7%	38.8%
Income tax expense	12,418	11,575	843	7.3%	15.7%	15.1%
Net income	\$ 19,836	\$ 18,104	\$ 1,732	9.6%	25.0%	23.7%
Net income per weighted average common share						
Basic	\$ 0.64	\$ 0.59	\$ 0.05	8.5%		
Diluted	\$ 0.63	\$ 0.57	\$ 0.06	10.5%		
Other data						
EBIT	\$ 32,696	\$ 31,906	\$ 790	2.5%		
EBITDA	\$ 34,106	\$ 33,224	\$ 882	2.7%		
EBIT and EBITDA Reconciliation						
Net income	\$ 19,836	\$ 18,104	\$ 1,732			
Income tax expense	12,418	11,575	843			

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Interest income	609	202	407
Interest expense	1,051	2,429	(1,378)
EBIT	32,696	31,906	790
Depreciation and amortization	1,410	1,318	92
EBITDA	\$ 34,106	\$ 33,224	\$ 882

**Revenue.** Revenue increased 3.4% to \$79.2 million for the three months ended March 31, 2005, from \$76.6 million for the same period in 2004. Approximately \$1.2 million of the increase was due to increases in the ratings and qualitative subscriber base, analytical software applications and escalations in multiyear customer contracts and contract renewals. The Marketing Resources Plus ( MRP ) acquisition accounted for \$1.4 million of the increase. On March 11, 2004, Arbitron acquired certain assets of Marketing Resources Plus from Interactive Market Systems, Inc. for \$8.9 million in cash. Revenue for the three months ended March 31, 2005, was impacted by \$2.9 million due to the timing of the delivery of 17 Scarborough markets. These markets were delivered in the fourth quarter of 2004; therefore the revenue was recognized in the fourth quarter of 2004. In previous years these 17 markets had been delivered in the first quarter of the following year. Due to the slow economic growth of the radio industry as well as the high penetration of current services in the core radio station business, Arbitron expects that its annual organic rate of revenue growth will be slower than historical trends.

**Cost of Revenue.** Cost of revenue decreased 6.8% to \$20.2 million for the three months ended March 31, 2005, from \$21.7 million for the same period in 2004, and decreased as a percentage of revenue to 25.5% in 2005 from 28.3% in 2004. The \$1.5 million decrease was primarily related to a decrease in Scarborough royalties of \$2.1 million, which is due to the timing of the delivery of 17 Scarborough markets. These markets delivered in the fourth quarter of 2004, therefore the royalties were recognized in the fourth quarter of 2004. The decrease in royalties was partially offset by increased data collection costs of \$0.4 million.

**Selling, General and Administrative.** Selling, general and administrative expenses increased 9.2% to \$16.2 million for the three months ended March 31, 2005, from \$14.8 million for the same period in 2004, and increased as a percentage of revenue to 20.4% in 2005 from 19.3% in 2004. The \$1.4 million increase was due to increased U.S. Media Services (Arbitron's core quantitative, qualitative and software application services) expenses of \$0.8 million and increased PPM expenses of \$0.4 million. The increase was also due to the MRP acquisition, which accounted for \$0.8 million of the increase. These increases were partially offset by a decrease of \$0.7 million in expenses for Online Radio Ratings Services, which was primarily due to the write-off of assets associated with the discontinuance of the Measurecast service in 2004. Due to SFAS 123R, *Share-Based Payment*, Arbitron expects that, with regard to the expensing of stock compensation, its selling, general and administrative expenses will increase substantially beginning January 1, 2006.

**Research and Development.** Research and development expenses increased 17.1% to \$8.0 million during the three months ended March 31, 2005, from \$6.9 million for the same period in 2004, and increased as a percentage of revenue to 10.2% in 2005 from 9.0% in 2004. The MRP acquisition and PPM research and development accounted for \$0.5 million and \$0.3 million of the increase, respectively. The remainder of the increase was primarily attributed to U.S. Media Services, where there was increased spending related to the maintenance, upgrade and replacement of legacy operating and reporting systems. Research and development expenses are expected to continue to increase in the future due to the deployment of a pilot panel for the new national marketing research service.

**Operating Income.** Operating income increased 4.7% to \$34.8 million for the three months ended March 31, 2005, from \$33.2 million for the same period in 2004. Operating margin increased to 43.9% in 2005 from 43.4% in 2004. Operating margins for the year 2005 will be negatively impacted due to the deployment of a pilot panel for the new national marketing research service.

**Proportionate Share of Net Loss of Affiliate.** Proportionate share of net loss of affiliate (relating to the Company's Scarborough joint venture) increased 57.4% to \$2.1 million for the three months ended March 31, 2005, from \$1.3 million for the same period in 2004. Scarborough experiences losses during the first and third quarters of each year because most of its services are delivered and revenue is recognized in the second and fourth quarters. The increase in the net loss of affiliate was primarily due to the timing of the delivery of 17 Scarborough markets. These markets were delivered in the fourth quarter of 2004. In previous years these 17 markets had been delivered in the first

quarter of the following year.

**Interest Income.** Interest income increased 201.5% to \$0.6 million for the three months ended March 31, 2005, from \$0.2 million for the same period in 2004. The \$0.4 million increase is due to both increased cash levels and increased interest rates.

**Interest Expense.** Interest expense decreased 56.7% to \$1.1 million for the three months ended March 31, 2005 from \$2.4 million for the same period in 2004. The decrease is due to no longer having an average balance outstanding under the credit facility for the three months ended March 31, 2005, compared to having a \$54.8 million

average balance under the credit facility for the three months ended March 31, 2004. The Company's credit facility was closed by the request of the Company on January 31, 2005.

**Income Tax Expense.** Arbitron's effective tax rate was 38.5% for the three months ended March 31, 2005 and 39% for the three months ended March 31, 2004. The effective tax rate was reduced from 39.0% to 38.5% to reflect a reduction in the expected state tax rate.

**Net Income.** Net income increased 9.6% to \$19.8 million for the three months ended March 31, 2005, from \$18.1 million for the same period in 2004. The Company expects that net income in 2005 will be reduced by approximately \$4.3 million due to the deployment of a pilot panel for the new national marketing research service.

**EBIT and EBITDA.** Earnings before interest and income taxes ( EBIT ) increased 2.5% to \$32.7 million and earnings before interest, income tax expense, depreciation and amortization ( EBITDA ) increased 2.7% to \$34.1 million for the three months ended March 31, 2005, from \$31.9 million and \$33.2 million, respectively, for the same period in 2004. Arbitron has presented EBIT and EBITDA as supplemental information that management of Arbitron believes may be useful to investors to evaluate the Company's results because they exclude certain items that are not directly related to the Company's core operating performance. EBIT is calculated by adding back net interest expense and income tax expense to net income. EBITDA is calculated by adding back net interest expense, income tax expense, depreciation and amortization to net income. EBIT and EBITDA should not be considered substitutes either for net income, as indicators of Arbitron's operating performance, or for cash flow, as measures of Arbitron's liquidity. In addition, because EBIT and EBITDA may not be calculated identically by all companies, the presentation here may not be comparable to other similarly titled measures reported by other companies.

## Liquidity and Capital Resources

Working capital was \$59.3 million and \$24.2 million as of March 31, 2005, and December 31, 2004, respectively. Cash and cash equivalents was \$121.6 million as of March 31, 2005. Management expects that the cash position as of March 31, 2005, and cash flow generated from operations will be sufficient to support the Company's operations for the foreseeable future.

Net cash provided by operating activities was \$25.8 million for the three months ended March 31, 2005, and 2004.

Net cash used by investing activities was \$2.3 million and \$10.2 million for the three months ended March 31, 2005 and 2004, respectively. In March of 2004, Arbitron purchased MRP for \$8.9 million. Arbitron did not make any business acquisitions during the three months ended March 31, 2005.

Net cash provided by financing activities was \$11.3 million for the three months ended March 31, 2005. Net cash used by financing activities was \$15.3 million for the three months ended March 31, 2004. The Company received \$11.3 million of cash from stock option exercises and employee stock purchase plans for the three months ended March 31, 2005, compared to \$4.7 million for the same period in 2004. Additionally, the Company did not make any debt payments for the three months ended March 31, 2005, compared to debt payments of \$20.0 million for the same period in 2004.

Arbitron's senior secured notes in the amount of \$50.0 million mature on January 31, 2008. Arbitron's senior secured notes contain non-investment-grade financial terms, covenants and operating restrictions that increase the cost of financing and restrict financial flexibility. Under the terms of the senior secured notes, Arbitron is required to maintain certain leverage and coverage ratios and meet other financial conditions. The senior secured notes limit, among other things, Arbitron's ability to buy and sell assets, incur additional indebtedness, grant or incur liens on its assets, pay cash dividends over a certain amount, make certain investments or acquisitions, repurchase or redeem

capital stock and engage in certain mergers or consolidations. The terms of the senior secured notes may restrict or prohibit Arbitron's ability to raise additional capital when needed or could prevent Arbitron from making acquisitions or investing in other growth initiatives. Arbitron has met all covenants since the inception of all borrowings.

Arbitron announced on February 28, 2005, that its Board of Directors approved the payment of the Company's first quarterly cash dividend of \$0.10 per common share. The dividend was paid on April 1, 2005, to stockholders of record as of the close of business on March 15, 2005.

In 2004, Clear Channel Communications and Infinity Broadcasting represented approximately 21% and 10%, respectively, of Arbitron's revenue. Arbitron's agreements with these customers are not exclusive and contain no renewal obligations. In August 2004, Arbitron entered into license agreements with Infinity Broadcasting, effective April 1, 2004, to provide audience estimates, software and other ancillary services to Infinity Broadcasting's radio stations through the Company's Winter 2008 survey. On December 27, 2004, the Company entered into new license agreements with Clear Channel Communications to provide radio ratings and software services for Clear Channel Communication's radio stations and networks through the Company's Fall 2008 survey. Arbitron cannot give any assurances that it will retain current customers or that it will be able to replace the revenue that is lost should a key customer fail to renew its agreements with Arbitron.

Since 2004, Arbitron has been focusing on a demonstration to be conducted in Houston, Texas, in 2005 and 2006 to confirm the results of previous tests and demonstrate enhancements to the Portable People Meter system that have been made since it was tested in Philadelphia. Arbitron continues to work with Nielsen Media Research to resolve outstanding issues and to negotiate business terms for a potential Portable People Meter joint venture.

In 2003, Arbitron began testing additional marketing research applications of the Portable People Meter technology. One application that Arbitron began testing was the use of the Portable People Meter as the media collection tool for a national marketing-oriented panel designed to correlate advertising with shopping behavior and sales. The objective is to provide multimedia exposure data combined with sales data from a single source to produce a measure of advertising effectiveness for advertisers, agencies and broadcasters. On September 29, 2004, Arbitron announced that Arbitron and VNU, Inc. signed an agreement to explore the development of a new national marketing research service. On April 29, 2005, Arbitron and VNU, Inc., entered into a cost-sharing agreement to share costs and capital expenditures associated with the development and deployment, by year-end 2005, of a pilot panel of more than 6,000 households as a demonstration of the national marketing research service. A formal joint venture between Arbitron and VNU, Inc. for the national marketing panel is under discussion. Procter & Gamble is collaborating with the two companies to ensure that the service properly addresses the needs of marketers. This is a new type of service for which market acceptance is not yet known.

The continuing development and anticipated rollout of PPM services will require both significant capital resources and operating costs over the next several years. As a result of the national test marketing pilot panel, the Company expects to incur up to approximately \$11.3 million of additional expenditures in 2005, approximately \$4.3 million of which would constitute expenses that have a direct impact on the Company's net income and approximately \$7.0 million of which would be capitalizable. The Company expects to fund these obligations with existing cash balances. In the event Arbitron decides to proceed with commercializing either a PPM ratings service or a PPM marketing application service, there would be significant start-up expenses that would adversely affect Arbitron's financial position and operating results.

### **New Accounting Pronouncement**

In December 2004, the Financial Accounting Standards Board ( FASB ) enacted Statement of Financial Accounting Standards 123 revised 2004 ( SFAS 123R ), *Share-Based Payment*, which replaces Statement of Financial Accounting Standards No. 123 ( SFAS 123 ), *Accounting for Stock-Based Compensation*, and supersedes APB Opinion No. 25 ( APB 25 ), *Accounting for Stock Issued to Employees*. SFAS 123R requires the measurement of all employee share-based payments to employees, including grants of employee stock options, using a fair-value-based method and the recording of such expense in our consolidated statements of income. The accounting provisions of SFAS 123R were to be effective for reporting periods beginning after June 15, 2005. However, on April 14, 2005, the Securities and Exchange Commission announced that the effective date of SFAS 123R will be postponed until January 1, 2006, for calendar-year companies.

Arbitron is required to adopt SFAS 123R in the first quarter of 2006. The pro forma disclosures previously permitted under SFAS 123 no longer will be an alternative to financial statement recognition. See Note 2 in the Notes to Consolidated Financial Statements for the pro forma net income and net income per share amounts for the three months ended March 31, 2005 and 2004. Although Arbitron has not yet determined whether the adoption of SFAS 123R will result in amounts that are similar to the current pro forma disclosures under SFAS 123, the Company is evaluating the requirements under SFAS 123R and expects the adoption to have an adverse impact on the Company's consolidated statements of income and net income per share.

**Seasonality**

Arbitron recognizes revenue for products and services over the terms of license agreements as products and services are delivered, and expenses are recognized as incurred. Arbitron gathers radio-listening data in approximately 296 United States local markets. All markets are measured at least twice per year (April-May-June for the Spring Survey and October-November-December for the Fall Survey ). In addition, all major markets are



measured two additional times per year (January-February-March for the Winter Survey and July-August-September for the Summer Survey). Arbitron's revenue is generally higher in the first and third quarters as a result of the delivery of the Fall Survey and Spring Survey, respectively, to all markets, compared to revenue in the second and fourth quarters, when delivery of the Winter Survey and Summer Survey, respectively, is only provided to major markets. Arbitron's expenses are generally higher in the second and fourth quarters as the Spring Survey and Fall Survey are being conducted.

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

#### ***Interest Risk***

The Company currently has no outstanding floating rate debt. A hypothetical market interest rate change of 1% would have no effect on the Company's results of operations. However, changes in market interest rates would impact the fair value of the Company's senior notes. The fair values of the senior secured notes as of March 31, 2005, and December 31, 2004, were \$52.7 million and \$53.8 million, respectively, and were estimated using a cash flow valuation model and available market data for securities with similar maturity dates.

#### ***Foreign Currency Risk***

Arbitron's foreign operations are not significant at this time, and, therefore, Arbitron's exposure to foreign currency risk is minimal.

### **ITEM 4. CONTROLS AND PROCEDURES**

#### **Evaluation of Disclosure Controls and Procedures**

The Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's President and Chief Executive Officer and the Company's Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) of the rules promulgated under the Securities Exchange Act of 1934, as amended) as of the end of the most recent fiscal quarter. Based upon that evaluation, the Company's President and Chief Executive Officer and the Company's Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective in timely alerting them to material information relating to the Company (including its consolidated subsidiaries) required to be included in the Company's periodic Securities and Exchange Commission filings.

#### **Changes in Internal Control Over Financial Reporting**

There were no changes in our internal control over financial reporting during the quarter ended March 31, 2005, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## **PART II OTHER INFORMATION**

### **ITEM 6. EXHIBITS**

<u>Exhibit No.</u>	<u>Description</u>
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Exhibit 10.1	Schedule of 2004 Bonuses and Bonus Parameters for Named Executive Officers *
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Exhibit 31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

Exhibit 31.2 Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

Exhibit 32.1      Certifications of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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\*Indicates management contract or compensatory plan, contract or arrangement required to be filed as an Exhibit.

SIGNATURE

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

ARBITRON INC.

By: /s/ WILLIAM J. WALSH  
William J. Walsh  
Executive Vice President of Finance and Planning and  
Chief Financial Officer (on behalf of the registrant  
and as  
the registrant's principal accounting officer)

Date: May 6, 2005