

Digimarc CORP  
Form 10-Q  
October 26, 2011  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

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

September 30, 2011 For the quarterly period ended September 30, 2011

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: 001-34108

**DIGIMARC CORPORATION**

(Exact name of registrant as specified in its charter)

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**Oregon**  
(State or other jurisdiction of  
incorporation or organization) **26-2828185**  
(I.R.S. Employer  
Identification No.)  
**9405 SW Gemini Drive, Beaverton, Oregon 97008**  
(Address of principal executive offices) (Zip Code)  
**(503) 469-4800**  
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  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 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 and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer   
Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company   
Indicate by check mark whether the registrant is a shell company (as defined in rule 12b-2 of the Exchange Act). Yes  No

As of October 19, 2011, there were 6,966,590 shares of the registrant's common stock, par value \$0.001 per share, outstanding.

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**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Financial Statements.****DIGIMARC CORPORATION****BALANCE SHEETS****(In thousands, except share data)****(UNAUDITED)**

|  | <b>September 30,<br/>2011</b> | <b>December 31,<br/>2010</b> |
|--|-------------------------------|------------------------------|
| <b>ASSETS</b>  |                               |                              |
| Current assets:  |                               |                              |
| Cash and cash equivalents  | \$ 2,119                      | \$ 6,340                     |
| Marketable securities  | 24,414                        | 28,441                       |
| Trade accounts receivable, net   | 3,420                         | 3,481                        |
| Other current assets   | 1,486                         | 1,345                        |
| <b>Total current assets</b>  | <b>31,439</b>                 | <b>39,607</b>                |
| Marketable securities  | 4,683                         | 11,163                       |
| Property and equipment, net  | 1,468                         | 1,330                        |
| Intangibles, net   | 2,661                         | 2,174                        |
| Investments in joint ventures  | 1,199                         | 1,029                        |
| Deferred tax assets  | 2,361                         |                              |
| Other assets   | 428                           | 462                          |
| <b>Total assets</b>  | <b>\$ 44,239</b>              | <b>\$ 55,765</b>             |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>  |                               |                              |
| Current liabilities:   |                               |                              |
| Accounts payable and other accrued liabilities   | \$ 1,631                      | \$ 1,519                     |
| Deferred revenue   | 1,928                         | 2,562                        |
| <b>Total current liabilities</b>   | <b>3,559</b>                  | <b>4,081</b>                 |
| Long-term liabilities  | 479                           | 525                          |
| <b>Total liabilities</b>   | <b>4,038</b>                  | <b>4,606</b>                 |
| Commitments and contingencies (Note 11)  |                               |                              |
| Shareholders' equity:  |                               |                              |
| Preferred stock (10,000 shares issued and outstanding at September 30, 2011 and December 31, 2010)                             | 50                            | 50                           |
| Common stock (6,965,577 and 7,443,450 shares issued and outstanding at September 30, 2011 and December 31, 2010, respectively) | 7                             | 7                            |
| Additional paid-in capital   | 33,448                        | 49,609                       |
| Retained earnings  | 6,696                         | 1,493                        |
| <b>Total shareholders' equity</b>  | <b>40,201</b>                 | <b>51,159</b>                |
| <b>Total liabilities and shareholders' equity</b>  | <b>\$ 44,239</b>              | <b>\$ 55,765</b>             |

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See Notes to Unaudited Financial Statements.

**Table of Contents****DIGIMARC CORPORATION****STATEMENTS OF OPERATIONS****(In thousands, except per share data)****(UNAUDITED)**

|  | <b>Three<br/>Months<br/>Ended<br/>September 30,<br/>2011</b> | <b>Three<br/>Months<br/>Ended<br/>September 30,<br/>2010</b> | <b>Nine<br/>Months<br/>Ended<br/>September 30,<br/>2011</b> | <b>Nine<br/>Months<br/>Ended<br/>September 30,<br/>2010</b> |
|--|--|--|---|---|
| <b>Revenue:</b>  |  |  |   |   |
| Service  | \$ 3,108   | \$ 2,761   | \$ 9,342  | \$ 9,193  |
| License and subscription                               | 5,442  | 2,476  | 17,772  | 11,484  |
| <b>Total revenue</b>                                   | <b>8,550</b>   | <b>5,237</b>   | <b>27,114</b>   | <b>20,677</b>   |
| <b>Cost of revenue:</b>                                |  |  |   |   |
| Service  | 1,665  | 1,410  | 4,863   | 4,693   |
| License and subscription                               | 77   | 59   | 218   | 173   |
| <b>Total cost of revenue</b>                           | <b>1,742</b>   | <b>1,469</b>   | <b>5,081</b>  | <b>4,866</b>  |
| <b>Gross profit</b>                                    | <b>6,808</b>   | <b>3,768</b>   | <b>22,033</b>   | <b>15,811</b>   |
| <b>Operating expenses:</b>                             |  |  |   |   |
| Sales and marketing                                    | 1,166  | 953  | 3,285   | 2,453   |
| Research, development and engineering                  | 1,958  | 1,471  | 5,617   | 4,051   |
| General and administrative                             | 2,000  | 1,842  | 7,117   | 5,414   |
| Intellectual property                                  | 259  | 315  | 826   | 891   |
| <b>Total operating expenses</b>                        | <b>5,383</b>   | <b>4,581</b>   | <b>16,845</b>   | <b>12,809</b>   |
| <b>Operating income (loss)</b>                         | <b>1,425</b>   | <b>(813)</b>   | <b>5,188</b>  | <b>3,002</b>  |
| <b>Net loss from joint ventures</b>                    | <b>(695)</b>   | <b>(558)</b>   | <b>(1,930)</b>  | <b>(1,576)</b>  |
| <b>Interest income, net</b>                            | <b>43</b>  | <b>62</b>  | <b>149</b>  | <b>184</b>  |
| <b>Income (loss) before provision for income taxes</b> | <b>773</b>   | <b>(1,309)</b>   | <b>3,407</b>  | <b>1,610</b>  |
| <b>(Provision) benefit for income taxes</b>            | <b>(134)</b>   | <b>(151)</b>   | <b>1,796</b>  | <b>(190)</b>  |
| <b>Net income (loss)</b>                               | <b>\$ 639</b>  | <b>\$ (1,460)</b>  | <b>\$ 5,203</b>   | <b>\$ 1,420</b>   |
| <b>Earnings (loss) per share:</b>                      |  |  |   |   |
| <b>Net income (loss) per share basic</b>               | <b>\$ 0.10</b>   | <b>\$ (0.21)</b>   | <b>\$ 0.77</b>  | <b>\$ 0.20</b>  |
| <b>Net income (loss) per share diluted</b>             | <b>\$ 0.09</b>   | <b>\$ (0.21)</b>   | <b>\$ 0.71</b>  | <b>\$ 0.19</b>  |
| <b>Weighted average shares outstanding basic</b>       | <b>6,706</b>   | <b>7,098</b>   | <b>6,755</b>  | <b>7,097</b>  |
| <b>Weighted average shares outstanding diluted</b>     | <b>7,344</b>   | <b>7,098</b>   | <b>7,366</b>  | <b>7,497</b>  |

See Notes to Unaudited Financial Statements.

Table of Contents**DIGIMARC CORPORATION****STATEMENTS OF SHAREHOLDERS EQUITY**

(In thousands, except share data)

(UNAUDITED)

|  | Preferred stock |        | Common stock |        | Additional<br>paid-in<br>capital | Retained<br>Earnings<br>(Accumulated<br>Deficit) | Total<br>shareholders<br>equity |
|--|-----------------|--------|--------------|--------|----------------------------------|--|---------------------------------|
|  | Shares          | Amount | Shares       | Amount |                                  |  |                                 |
| <b>BALANCE AT DECEMBER 31, 2009</b>        | 10,000          | \$ 50  | 7,205,701    | \$ 7   | \$ 49,283                        | \$ (2,681)                                       | \$ 46,659                       |
| Exercise of stock options                  |                 |        | 313,832      |        | 3,045                            |  | 3,045                           |
| Issuance of restricted common stock        |                 |        | 124,560      |        |                                  |  |                                 |
| Purchase and retirement of common stock    |                 |        | (200,643)    |        | (5,824)                          |  | (5,824)                         |
| Stock-based compensation                   |                 |        |              |        | 3,105                            |  | 3,105                           |
| Net income                                 |                 |        |              |        |                                  | 4,174  | 4,174                           |
| <b>BALANCE AT DECEMBER 31, 2010</b>        | 10,000          | \$ 50  | 7,443,450    | \$ 7   | \$ 49,609                        | \$ 1,493   | \$ 51,159                       |
| Exercise of stock options                  |                 |        | 159,420      |        | 1,555                            |  | 1,555                           |
| Issuance of restricted common stock        |                 |        | 123,400      |        |                                  |  |                                 |
| Purchase and retirement of common stock    |                 |        | (760,693)    |        | (21,594)                         |  | (21,594)                        |
| Stock-based compensation                   |                 |        |              |        | 3,086                            |  | 3,086                           |
| Excess tax benefit from stock-based awards |                 |        |              |        | 792                              |  | 792                             |
| Net income                                 |                 |        |              |        |                                  | 5,203  | 5,203                           |
| <b>BALANCE AT SEPTEMBER 30, 2011</b>       | 10,000          | \$ 50  | 6,965,577    | \$ 7   | \$ 33,448                        | \$ 6,696   | \$ 40,201                       |

See Notes to Unaudited Financial Statements.

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**DIGIMARC CORPORATION**  
**STATEMENTS OF CASH FLOWS**

(In thousands)

(UNAUDITED)

|   | Nine<br>Months<br>Ended<br>September<br>30,<br>2011 | Nine<br>Months<br>Ended<br>September<br>30,<br>2010 |
|---|---|---|
| Cash flows from operating activities:   |   |   |
| Net income  | \$ 5,203  | \$ 1,420  |
| Adjustments to reconcile net income to net cash provided by operating activities: |   |   |
| Depreciation and amortization, property and equipment                             | 474   | 430   |
| Amortization, intangibles   | 86  | 54  |
| Stock-based compensation  | 3,038   | 2,287   |
| Net loss from joint ventures  | 1,930   | 1,576   |
| Deferred income tax benefit   | (2,633)   |   |
| Tax benefit from stock-based awards   | 792   |   |
| Excess tax benefit from stock-based compensation                                  | (792)   |   |
| Changes in operating assets and liabilities:                                      |   |   |
| Trade accounts receivable, net  | 61  | 469   |
| Other current assets  | 131   | (111)   |
| Other assets, net   | 34  | (35)  |
| Accounts payable and other accrued liabilities                                    | 73  | (63)  |
| Deferred revenue  | (641)   | (180)   |
| <b>Net cash provided by operating activities</b>                                  | <b>7,756</b>  | <b>5,847</b>  |
| Cash flows from investing activities:   |   |   |
| Purchase of property and equipment  | (612)   | (236)   |
| Capitalized patent costs  | (525)   | (811)   |
| Investments in joint ventures   | (2,100)   | (2,100)   |
| Sale or maturity of marketable securities   | 60,304  | 78,965  |
| Purchase of marketable securities   | (49,797)  | (83,256)  |
| <b>Net cash provided by (used in) investing activities</b>                        | <b>7,270</b>  | <b>(7,438)</b>                                      |
| Cash flows from financing activities:   |   |   |
| Issuance of common stock  | 1,555   | 8   |
| Purchase of common stock  | (21,594)  | (40)  |
| Excess tax benefit from stock-based awards  | 792   |   |
| <b>Net cash used in financing activities</b>                                      | <b>(19,247)</b>                                     | <b>(32)</b>   |
| <b>Net decrease in cash and cash equivalents</b>                                  | <b>(4,221)</b>                                      | <b>(1,623)</b>                                      |
| Cash and cash equivalents at beginning of period                                  | 6,340   | 8,884   |
| <b>Cash and cash equivalents at end of period</b>                                 | <b>\$ 2,119</b>                                     | <b>\$ 7,261</b>                                     |
| Supplemental disclosure of cash flow information:                                 |   |   |
| Cash paid for income taxes  | \$ 13   | \$ 62   |



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### Supplemental schedule of non-cash investing activities:

|  |    |    |    |    |
|--|----|----|----|----|
| Stock-based compensation capitalized to patent costs | \$ | 48 | \$ | 31 |
|--|----|----|----|----|

See Notes to Unaudited Financial Statements.

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**DIGIMARC CORPORATION**

**NOTES TO FINANCIAL STATEMENTS**

**(Dollar amounts in thousands, except per share data)**

**(UNAUDITED)**

**1. Description of Business and Summary of Significant Accounting Policies**

*Description of Business*

Digimarc Corporation ( Digimarc or the Company ) enables governments and enterprises around the world to give digital identities to media and objects that computers can sense and recognize and to which they can react. The Company s technology provides the means to infuse persistent digital information, perceptible only to computers and digital devices, into all forms of media content. The unique digital identifier placed in media generally persists with it regardless of the distribution path and whether it is copied, manipulated or converted to a different format, and does not affect the quality of the content or the enjoyment or other traditional uses of it. The Company s technology permits computers and digital devices to quickly identify relevant data from vast amounts of media content.

*The Company*

The Company was formed as DMRC LLC on June 18, 2008 and began independent operations on August 2, 2008 following the completion of a spin-off of the watermarking business of the former Digimarc Corporation into a new company. The record holders of the former Digimarc Corporation received shares of common stock of the new Digimarc Corporation in proportion to their holdings in the former company. The shareholders received their shares effective October 16, 2008. The Company originally operated as a Delaware corporation, but re-incorporated in Oregon, where the corporate offices are located, in 2010.

*Interim Financial Statements*

The accompanying financial statements have been prepared from the Company s records without audit and, in management s opinion, include all adjustments (consisting of only normal recurring adjustments) necessary to fairly reflect the financial condition and the results of operations for the periods presented. Certain information and note disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States (the U.S. ) have been condensed or omitted in accordance with the rules and regulations of the Securities and Exchange Commission ( SEC ).

These financial statements should be read in conjunction with the audited financial statements included in the Company s Annual Report on Form 10-K for the year ended December 31, 2010, which was filed with the SEC on March 3, 2011. The results of operations for the interim periods presented in these financial statements are not necessarily indicative of the results for the full year.

*Use of Estimates*

The preparation of financial statements in accordance with accounting principles generally accepted in the U.S. requires Digimarc to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses, and related disclosure of contingent assets and liabilities. Certain of the Company s accounting policies require higher degrees of judgment than others in their application. These include revenue recognition on long-term license and service contracts, impairments and estimation of useful lives of long-lived assets, contingencies and litigation, patent costs, stock-based compensation and income taxes (valuation allowance). Digimarc bases its estimates on historical experience and on various other assumptions that are believed to be reasonable in the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

*Cash Equivalents*

The Company considers all highly liquid marketable securities with original maturities of 90 days or less at the date of acquisition to be cash equivalents. Cash equivalents include money market funds, certificates of deposit, commercial paper, and investments in government bonds totaling \$2,024 and \$6,036 at September 30, 2011 and December 31, 2010, respectively. Cash equivalents are carried at cost or amortized cost,

which approximates market.

*Marketable Securities*

The Company considers all investments with original maturities over 90 days that mature in less than one year to be short-term marketable securities. Both short- and long-term marketable securities primarily include federal agency notes, company notes, and commercial paper. The Company's marketable securities are classified as held-to-maturity as of the balance sheet date and are reported at amortized cost, which approximates market.

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A decline in the market value of any security below cost that is deemed to be other-than-temporary results in a reduction in carrying amount of fair value. The impairment is charged to earnings and a new cost basis for the security is established. To determine whether an impairment is other-than-temporary, the Company considers whether it has the ability and intent to hold the investment until a market price recovery and considers whether evidence indicating that the cost of the investment is recoverable outweighs evidence to the contrary. There have been no other-than-temporary impairments identified or recorded by the Company.

Premiums and discounts are amortized or accreted over the life of the related security as an adjustment to yield using a method that approximates the effective interest method. Under this method, dividend and interest income are recognized when earned.

*Fair Value of Financial Instruments*

Accounting Standards Certification ( ASC ) 820 *Fair Value Measurements and Disclosures* defines fair value, establishes a framework for measuring fair value under generally accepted accounting principles, and enhances disclosures about fair value measurements. ASC 820 describes a fair value hierarchy based on three levels of inputs, of which the first two are considered observable and the last unobservable, that may be used to measure fair value, which are the following:

Level 1 Pricing inputs are quoted prices available in active markets for identical investments as of the reporting date.

Level 2 Pricing inputs are quoted for similar investments, or inputs that are observable, either directly or indirectly, for substantially the full term through corroboration with observable market data. Level 2 includes investments valued at quoted prices adjusted for legal or contractual restrictions specific to these investments.

Level 3 Pricing inputs are unobservable for the investment; that is, inputs that reflect the reporting entity's own assumptions about the assumptions market participants would use in pricing the asset or liability. Level 3 includes private portfolio investments that are supported by little or no market activity.

The estimated fair values of the Company's financial instruments, which include cash and cash equivalents, short-term marketable securities, accounts receivable, accounts payable and other accrued liabilities approximate their carrying values due to the short-term nature of these instruments. The Company records marketable securities at amortized cost, which approximates fair value. The fair value is based on quoted market prices in active markets for identical assets, a Level 1 input.

|  | September 30, 2011 | December 31, 2010 |
|--|--------------------|-------------------|
| Marketable securities, at amortized cost | \$ 28,707          | \$ 43,898         |
| Cash equivalents, included above         | \$                 | \$ 4,294          |
| Money market funds                       | \$ 2,413           | \$ 1,742          |

*Concentrations of Business and Credit Risk*

A significant portion of the Company's business depends on a limited number of large contracts. The loss of any large contract may result in loss of revenue and margin on a prospective basis. Financial instruments that potentially subject Digimarc to concentrations of credit risk consist primarily of cash and cash equivalents, marketable securities, and trade accounts receivable. Digimarc places its cash and cash equivalents with major banks and financial institutions and at times deposits may exceed insured limits. Other than cash used for operating needs, which may include short-term marketable securities with the Company's principal banks, Digimarc's investment policy limits its credit exposure to any one financial institution or type of financial instrument by limiting the maximum of 5% or \$1,000, whichever is greater, to be invested in any one issuer except for the U.S. Government and U.S. federal agencies, which have no limits, at the time of purchase. The Company's investment policy also limits its credit exposure by limiting the maximum of 40% of its cash and cash equivalents and marketable securities, or \$15 million, whichever is greater, to be invested in any one industry category, e.g., financial or energy industries, at the time of purchase. As a result, Digimarc's credit risk associated with cash and cash equivalents and investments is believed to be minimal.

*Equity Method Investments*

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The Company accounts for the joint ventures under the equity method of accounting pursuant to ASC 323 *Investments Equity Method and Joint Ventures*. Under the equity method, investments are carried at cost, plus or minus the Company's proportionate share, based on present ownership interests, of: (a) the investee's profit or loss after the date of acquisition; (b) changes in the Company's equity that have not been recognized in the investee's profit or loss; and (c) certain other adjustments. Distributions received from the investee (such as dividends) reduce the carrying amount of the investment.

The Company reviews its equity investments for impairment whenever there is a loss in value of an investment which is other than a temporary decline. The Company conducts its equity investment impairment analyses in accordance with ASC 323, which requires the Company to record an impairment charge for a decrease in value of an investment when the decline in the investment is considered to be other than temporary.

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### *Impairment of Long-Lived Assets*

The Company accounts for long-lived assets in accordance with the provisions of ASC 360 *Property, Plant and Equipment*. This statement requires that long-lived assets and certain identifiable intangibles be 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 future net undiscounted cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Fair value is determined based on discounted cash flows or appraised values, depending on the nature of the asset. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell. Through September 30, 2011, there have been no material impairment losses.

### *Research and Development*

Research and development costs are expensed as incurred in accordance with the provisions of ASC 730 *Research and Development*.

### *Software Development Costs*

Under ACS 985 *Software*, software development costs are to be capitalized beginning when a product's technological feasibility has been established and ending when a product is made available for general release to customers. To date, the establishment of technological feasibility of the Company's products has occurred shortly before general release and, therefore, software development costs qualifying for capitalization have been immaterial. Accordingly, the Company has not capitalized any software development costs and has charged all such costs to research and development expense.

### *Patent Costs*

Costs associated with the application and award of patents in the U.S. and various other countries are capitalized and amortized on a straight-line basis over the term of the patents as determined at award date, which varies depending on the pendency period of the application, generally approximating seventeen years. Capitalized patent costs include internal legal labor, professional legal fees, government filing fees and translation fees related to obtaining the Company's patent portfolio.

Costs associated with the maintenance and annuity fees of patents are accounted for as prepaid assets at the time of payment and amortized over the respective periods, generally from one to four years.

### *Revenue Recognition*

See Note 3 for detailed disclosures of the Company's revenue recognition policy.

### *Stock-Based Compensation*

ASC 718 requires the measurement and recognition of compensation for all stock-based awards made to employees and directors including stock options and restricted stock based on estimated fair values.

The Company uses the Black-Scholes option pricing model as its method of valuation for stock-option awards. The Company's determination of the fair value of stock-option awards on the date of grant using an option pricing model is affected by its stock price as well as assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to, the expected life of the award, the Company's expected stock price volatility over the term of the award and actual and projected exercise behaviors. Although the fair value of stock-option awards is determined in accordance with ASC 718 and SAB No. 107 *Shared-Based Payment*, the Black-Scholes option pricing model requires the input of highly subjective assumptions, and other reasonable assumptions could provide differing results.

### *Income Taxes*

The Company accounts for income taxes under the asset and liability method. Under the asset and liability method, deferred income taxes reflect the future tax consequences of differences between the tax bases of assets and liabilities and their financial reporting amounts at each year-end. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is

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recognized in income in the period that includes the enactment date. Valuation allowances are established when necessary to reduce deferred tax assets to the amount expected to be realized.

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### **2. Recent Accounting Standards Update**

In May 2011, the Financial Accounting Standards Board ( FASB ) issued Accounting Standards Update ( ASU ) No. 2011-04, *Fair Value Measurement: Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS*, which provides common requirements for measuring fair value and for disclosing information about fair value measurements in accordance with U.S. generally accepted accounting principles (GAAP) and International Financial Reporting Standards (IFRS). The amendments of ASU No. 2011-04 are effective during interim and annual periods beginning after December 15, 2011. Early application is prohibited. The Company is currently assessing the potential impact of this standard, but does not expect the adoption of the standard will have a material impact on the financial condition or results of operations of the Company.

In April 2010, the FASB issued ASU No. 2010-17, *Revenue Recognition Milestone Method (Topic 605): Milestone Method of Revenue Recognition, a consensus of the FASB Emerging Issues Task Force*, which provides guidance on defining a milestone and determining when it may be appropriate to apply the milestone method of revenue recognition for research or development transactions. ASU No. 2010-17 is effective for milestones achieved in fiscal years, and interim periods within those years, beginning on or after June 15, 2010. The Company has adopted the provisions of this standard and noted no material impact on the financial condition or results of operations of the Company.

In October 2009, the FASB issued ASU No. 2009-13, *Revenue Recognition: Multiple-Deliverable Revenue Arrangements a consensus of the FASB Emerging Issues Task Force*, which eliminates the use of the residual method for allocating consideration, as well as the criteria that requires objective and reliable evidence of fair value of undelivered elements in order to separate the elements in a multiple-element arrangement. By removing the criterion requiring the use of objective and reliable evidence of fair value in separately accounting for deliverables, the recognition of revenue will more closely align with the economics of the revenue arrangements. The standard also replaces the term fair value in the revenue allocation guidance with selling price to clarify that the allocation of revenue is based on entity-specific assumptions rather than assumptions of a marketplace participant. ASU No. 2009-13 is effective for revenue arrangements entered or materially modified in fiscal years beginning on or after June 15, 2010. The Company has adopted the provisions of this standard and noted no material impact on the financial condition or results of operations of the Company.

### **3. Revenue Recognition**

Revenues are primarily generated from development services and from licensing the Company's patent portfolio:

Service revenue consists primarily of software development and consulting services. The majority of service revenue arrangements are structured as time and materials consulting agreements, or fixed price consulting agreements.

License revenue, including royalty revenue, originates primarily from licensing the Company's technology and patents where the Company receives royalties as its income stream. Subscription revenue consists primarily of revenue from the sale of web-based subscriptions related to various software products, which are more recurring in nature.

Revenue is recognized in accordance with ASC 605 and 985 when the following four criteria are met:

- (i) persuasive evidence of an arrangement exists,
- (ii) delivery has occurred,
- (iii) the fee is fixed or determinable, and
- (iv) collection is probable.



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Some customer arrangements encompass multiple deliverables, such as patent license, professional services, software subscriptions, and maintenance fees. For arrangements that include multiple deliverables, the Company identifies separate units of accounting at inception based on the consensus reached under ASC 605, which provides that revenue arrangements with multiple deliverables should be divided into separate units of accounting if certain criteria are met. The consideration for the arrangement is allocated to the separate units of accounting using the relative selling price method.

The relative selling price method allocates the consideration based on the Company's specific assumptions rather than assumptions of a marketplace participant, and any discount in the arrangement proportionally to each deliverable on the basis of each deliverable's selling price.

Applicable revenue recognition criteria is considered separately for each separate unit of accounting as follows:

Revenue from professional service arrangements is generally determined based on time and materials. Revenue for professional services is recognized as the services are performed. Billing for services rendered generally occurs within one month after the services are provided.

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License revenue is recognized when amounts owed to the Company have been earned, are fixed or determinable (within the Company's normal 30 to 60 day payment terms), and collection is probable. If the payment terms extend beyond the Company's normal 30 to 60 days, the fee may not be considered to be fixed or determinable, and the revenue would then be recognized when installments are due.

The Company records revenue from certain license agreements upon cash receipt as a result of collectability not being reasonably assured.

The Company's standard payment terms for license arrangements are 30 to 60 days. Extended payment terms increase the likelihood the Company will grant a customer a concession, such as reduced license payments or additional rights, rather than hold firm on minimum commitments in an agreement to the point of losing a potential advocate and licensee of patented technology in the marketplace. Extended payment terms on patent license arrangements are not considered to be fixed or determinable if payments are due beyond the Company's standard payment terms, primarily because of the risk of substantial modification present in the Company's patent licensing business. As such, revenue on license arrangements with extended payment terms are recognized as fees become fixed and determinable.

Subscription revenue is accounted for under ASC 985 *Software*. Subscription revenue is generally paid in advance and recognized over the term of the license, which is generally twelve months, or upon delivery and acceptance if the Company grants a perpetual license with no further obligations.

Deferred revenue consists of billings in advance for professional services, licenses and subscriptions for which revenue has not been earned.

**4. Segment Information***Geographic Information*

The Company derives its revenue from a single reporting segment: media management solutions. Revenue is generated in this segment through licensing of intellectual property, subscriptions to various products and services, and the delivery of services pursuant to contracts with various customers. The Company markets its products in the U.S. and in non-U.S. countries through its sales personnel.

Revenue by geographic area, based upon the bill-to location, is as follows:

|               | Three<br>Months<br>Ended<br>September 30,<br>2011 | Three<br>Months<br>Ended<br>September 30,<br>2010 | Nine<br>Months<br>Ended<br>September 30,<br>2011 | Nine<br>Months<br>Ended<br>September 30,<br>2010 |
|---------------|---|---|--|--|
| Domestic      | \$ 5,221  | \$ 1,868  | \$ 17,321  | \$ 11,211  |
| International | 3,329   | 3,369   | 9,793  | 9,466  |
| <b>Total</b>  | <b>\$ 8,550</b>                                   | <b>\$ 5,237</b>                                   | <b>\$ 27,114</b>                                 | <b>\$ 20,677</b>                                 |

*Major Customers*

Customers who accounted for more than 10% of the Company's revenues are as follows:

| Three<br>Months | Three<br>Months | Nine<br>Months | Nine<br>Months |
|-----------------|-----------------|----------------|----------------|
|-----------------|-----------------|----------------|----------------|

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|                                  | Ended<br>September<br>30,<br>2011 | Ended<br>September<br>30,<br>2010 | Ended<br>September<br>30,<br>2011 | Ended<br>September<br>30,<br>2010 |
|----------------------------------|-----------------------------------|-----------------------------------|-----------------------------------|-----------------------------------|
| Intellectual Ventures Affiliates | 35%                               |                                   | 33%                               |                                   |
| Central Banks                    | 30%                               | 45%                               | 27%                               | 35%                               |
| The Nielsen Company              | 12%                               | 17%                               | 11%                               | 13%                               |
| Verance                          | *                                 | *                                 | 10%                               | *                                 |
| Civolution                       | *                                 | 17%                               | *                                 | *                                 |
| TVaura LLC                       | *                                 | 12%                               | *                                 | 10%                               |
| Arbitron                         |                                   |                                   |                                   | 22%                               |

\* Less than 10%

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**5. Stock-Based Compensation**

Stock-based compensation includes expense charges for all stock-based awards to employees and directors. These awards include option grants and restricted stock awards.

*Determining Fair Value*

*Preferred Stock*

The Board of Directors authorized 10,000 shares of Series A Redeemable Nonvoting Preferred stock (Series A Preferred) to be issued to the executive officers. The Series A Redeemable Nonvoting Preferred stock has no voting rights, except as required by law, and may be redeemed at the option of the Company's Board of Directors at any time on or after June 18, 2013.

The Series A Preferred is redeemable based on the stated fair value of \$5.00 per share, and the related stock compensation expense is recognized over the non-redeemable period of 5 years, or 60 months, through June 2013 using the straight-line method. The Series A Preferred has no dividend rights and no rights to the undistributed earnings of the Company.

*Stock Options*

*Valuation and Amortization Method.* The Company estimates the fair value of stock-based awards granted on date of grant using the Black-Scholes option valuation model. The Company amortizes the fair value of all awards on a straight-line basis over the requisite service periods, which are generally the vesting periods.

*Expected Life.* The expected life of awards granted represents the period of time that they are expected to be outstanding. For 2011, the Company determines the expected life based on historical experience with similar awards, giving consideration to the contractual terms, vesting schedules and pre-vesting and post-vesting forfeitures. For 2010, the Company determined the initial expected life based on a simplified method in accordance with SAB 110 *Shared-Based Payment*, giving consideration to the contractual terms, vesting schedules and post-vesting forfeitures. Stock options granted generally vest over four years for employee grants and one to two years for director grants, and have contractual terms of ten years.

*Expected Volatility.* For 2011, the Company estimates the volatility of its common stock at the date of grant based on the historical volatility of its common stock based on historical prices over the most recent period commensurate with the estimated expected life of the award. For 2010, the Company's estimate of volatility was based on a 50/50 blend of the Company's own historical volatility and an independent analysis of a peer group's historical volatility, calculated by individual entity basis, of its common stock based on historical stock prices over the most recent period commensurate with the estimated expected life of the award.

*Risk-Free Interest Rate.* The Company bases the risk-free interest rate used in the Black-Scholes option valuation model on an interest rate on a Treasury bond with a maturity commensurate with each expected life estimate.

*Expected Dividend Yield.* The Company has never paid any cash dividends on its common stock and does not anticipate paying any cash dividends in the foreseeable future. Consequently, the Company uses an expected dividend yield of zero in the Black-Scholes option valuation model.

A summary of the weighted average assumptions and results for options granted are as follows:

|                          | <b>2011</b> | <b>2010</b> |
|--------------------------|-------------|-------------|
| Expected life (in years) | 5.75        | 5.2 -6.0    |
| Expected volatility      | 42%         | 52% -55%    |
| Risk-free interest rate  | 2.3%        | 2.5% -3.0%  |
| Expected dividend yield  | 0%          | 0%          |

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|                                     | <b>Three<br/>Months<br/>Ended<br/>September<br/>30,<br/>2011</b> | <b>Three<br/>Months<br/>Ended<br/>September<br/>30,<br/>2010</b> | <b>Nine<br/>Months<br/>Ended<br/>September<br/>30,<br/>2011</b> | <b>Nine<br/>Months<br/>Ended<br/>September<br/>30,<br/>2010</b> |
|-------------------------------------|--|--|---|---|
| Fair value of stock options granted | \$   | \$   | \$ 954  | \$ 1,159  |

*Expected Forfeitures.* The Company uses a zero forfeiture for both the stock options granted to employees, which vest monthly, and the stock options granted to the Company's Directors. Initial option grants, for new Directors, vest 50% on the first anniversary of the date of grant and then monthly thereafter, and annual option grants, for continuing Directors, vest monthly. The Company records stock-based compensation expense only for those awards that are expected to vest, including awards made to Directors who are expected to continue with the Company through the year following the date of grant.

**Table of Contents***Restricted Stock*

The Compensation Committee of the Board of Directors has awarded restricted stock shares under the Company's 2008 Stock Incentive Plan to certain employees and Directors. The shares subject to the restricted stock awards vest over a certain period, usually four years, following the date of the grant. Specific terms of the restricted stock awards are governed by Restricted Stock Agreements between the Company and the award recipients.

The fair value of restricted stock awards granted is based on the fair market value of the Company's common stock on the date of the grant (measurement date), and is recognized over the vesting period of the related restricted stock using the straight-line method.

**Stock-based Compensation**

|                                       | Three<br>Months<br>Ended<br>September 30,<br>2011 | Three<br>Months<br>Ended<br>September 30,<br>2010 | Nine<br>Months<br>Ended<br>September 30,<br>2011 | Nine<br>Months<br>Ended<br>September 30,<br>2010 |
|---------------------------------------|---|---|--|--|
| Stock-based compensation:             |   |   |  |  |
| Cost of revenue                       | \$ 158  | \$ 84   | \$ 446   | \$ 272   |
| Sales and marketing                   | 87  | 50  | 248  | 141  |
| Research, development and engineering | 174   | 79  | 440  | 225  |
| General and administrative            | 590   | 542   | 1,761  | 1,576  |
| Intellectual property                 | 48  | 27  | 143  | 73   |
| Stock-based compensation expense      | 1,057   | 782   | 3,038  | 2,287  |
| Capitalized to patent costs           | 22  | 9   | 48   | 31   |
| Total stock-based compensation        | \$ 1,079  | \$ 791  | \$ 3,086   | \$ 2,318   |

Total unrecognized compensation costs related to non-vested stock-based awards granted under all equity compensation plans, including preferred stock, stock options and restricted stock are as follows:

|                                 | As of<br>September 30,<br>2011 | As of<br>December 31,<br>2010 |
|---------------------------------|--------------------------------|-------------------------------|
| Unrecognized compensation costs | \$ 7,795                       | \$ 6,212                      |

Total unrecognized compensation costs will be adjusted for any future changes in estimated forfeitures.

The Company expects to recognize these compensation costs for stock options and restricted stock over weighted average periods through September 2015 as follows:

|                         | Stock<br>Options | Restricted<br>Stock |
|-------------------------|------------------|---------------------|
| Weighted average period | 0.94 years       | 1.62 years          |

*Stock Option Activity*

As of September 30, 2011, under all of the Company's stock-based compensation plans, options to purchase an additional 1,000,014 shares were authorized for future grants under the plans. The Company issues new shares upon option exercises.

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Options granted, exercised, canceled and expired under the Company's stock option plans are summarized as follows:

| <b>Three-months ended September 30, 2011:</b> | <b>Options</b> | <b>Weighted<br/>Average<br/>Exercise<br/>Price</b> | <b>Weighted<br/>Average<br/>Grant Date<br/>Fair<br/>Value</b> | <b>Aggregate<br/>Intrinsic<br/>Value</b> |
|---|----------------|--|---|--|
| Outstanding at June 30, 2011                  | 994,323        | \$ 11.99   | \$ 7.03   |  |
| Options granted                               |                |  |   |  |
| Options exercised                             | (85,252)       | \$ 9.64  | \$ 6.30   |  |
| Options canceled or expired                   |                |  |   |  |
| <b>Outstanding at September 30, 2011</b>      | <b>909,071</b> | <b>\$ 12.21</b>                                    | <b>\$ 7.09</b>  | <b>\$ 12,318</b>                         |
| Exercisable at September 30, 2011             | 491,535        | \$ 11.11   |   | \$ 7,073                                 |
| <b>Unvested at September 30, 2011</b>         | <b>417,536</b> | <b>\$ 13.51</b>                                    |   | <b>\$ 5,245</b>                          |

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|  | Options   | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Grant Date<br>Fair<br>Value | Aggregate<br>Intrinsic<br>Value |
|--|-----------|--|--|---------------------------------|
| <b>Nine-months ended September 30, 2011:</b> |           |  |  |                                 |
| Outstanding at December 31, 2010             | 993,491   | \$ 10.47                                 | \$ 6.55  |                                 |
| Options granted                              | 75,000    | \$ 30.01                                 | \$ 12.72   |                                 |
| Options exercised                            | (159,420) | \$ 9.75                                  | \$ 6.34  |                                 |
| Options canceled or expired                  |           |  |  |                                 |
| Outstanding at September 30, 2011            | 909,071   | \$ 12.21                                 | \$ 7.09  | \$ 12,318                       |
| Exercisable at September 30, 2011            | 491,535   | \$ 11.11                                 |  | \$ 7,073                        |
| Unvested at September 30, 2011               | 417,536   | \$ 13.51                                 |  | \$ 5,245                        |

The aggregate intrinsic value is based on the closing price of \$25.38 per share of Digimarc common stock on September 30, 2011, which would have been received by the optionees had all of the options with exercise prices less than \$25.38 per share been exercised on that date.

The following table summarizes information about stock options outstanding at September 30, 2011:

| Range of Exercise Prices | Options Outstanding   |  |                              | Options Exercisable   |  |                              |
|--------------------------|-----------------------|--|------------------------------|-----------------------|--|------------------------------|
|                          | Number<br>Outstanding | Remaining<br>Contractual<br>Life (Years) | Weighted<br>Average<br>Price | Number<br>Exercisable | Remaining<br>Contractual<br>Life (Years) | Weighted<br>Average<br>Price |
| \$9.64                   | 671,155               | 7.08                                     | \$ 9.64                      | 380,284               | 7.08                                     | \$ 9.64                      |
| \$9.91                   | 30,000                | 7.58                                     | \$ 9.91                      | 30,000                | 7.58                                     | \$ 9.91                      |
| \$14.99                  | 102,916               | 8.26                                     | \$ 14.99                     | 38,751                | 8.26                                     | \$ 14.99                     |
| \$18.01                  | 30,000                | 8.58                                     | \$ 18.01                     | 30,000                | 8.58                                     | \$ 18.01                     |
| \$30.01                  | 75,000                | 9.26                                     | \$ 30.01                     | 12,500                | 9.26                                     | \$ 30.01                     |
| \$9.64 - \$30.01         | 909,071               | 7.46                                     | \$ 12.21                     | 491,535               | 7.35                                     | \$ 11.11                     |

*Restricted Stock Activity*

The following table reconciles the unvested balance of restricted stock:

|   | Number of<br>Shares | Weighted<br>Average<br>Grant Date<br>Fair Value |
|---|---------------------|---|
| <b>Three-months ended September 30, 2011:</b> |                     |   |
| Unvested balance, June 30, 2011               | 283,860             | \$ 20.42  |
| Granted                                       | 9,220               | \$ 36.24  |
| Vested  | (12,100)            | \$ 19.23  |
| Canceled                                      | (200)               | \$ 30.01  |
| Unvested balance, September 30, 2011          | 280,780             | \$ 20.98  |

|  | Number of<br>Shares | Weighted<br>Average<br>Grant Date<br>Fair Value |
|--|---------------------|---|
| <b>Nine-months ended September 30, 2011:</b> |                     |   |



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|                                      |          |          |
|--------------------------------------|----------|----------|
| Unvested balance, December 31, 2010  | 197,760  | \$ 14.25 |
| Granted                              | 123,400  | \$ 30.23 |
| Vested                               | (39,785) | \$ 16.10 |
| Canceled                             | (595)    | \$ 25.73 |
| Unvested balance, September 30, 2011 | 280,780  | \$ 20.98 |

**Table of Contents****6. Trade Accounts Receivable***Trade Accounts Receivable*

Trade accounts receivable are recorded at the invoiced amount.

|  | September 30,<br>2011 | December 31,<br>2010 |
|--|-----------------------|----------------------|
| Trade accounts receivable                                | \$ 3,420              | \$ 3,481             |
| Allowance for doubtful accounts                          |                       |                      |
| Trade accounts receivable, net                           | \$ 3,420              | \$ 3,481             |
| Unpaid deferred revenues included in accounts receivable | \$ 1,069              | \$ 2,045             |

*Allowance for doubtful accounts*

The allowance for doubtful accounts is the Company's best estimate of the amount of probable credit losses in the Company's existing accounts receivable. The Company determines the allowance based on historical write-off experience and current information. The Company reviews its allowance for doubtful accounts monthly. Account balances are charged off against the allowance after all means of collection have been exhausted and the potential for recovery is considered remote.

*Unpaid deferred revenues*

The unpaid deferred revenues that are included in accounts receivable are billed in accordance with the provisions of the contracts with the Company's customers. Unpaid deferred revenues from the Company's cash-basis revenue recognition customers are not included in accounts receivable or deferred revenue accounts.

*Major customers*

Customers who accounted for more than 10% of accounts receivable, net, are as follows:

|                     | September 30,<br>2011 | December 31,<br>2010 |
|---------------------|-----------------------|----------------------|
| Central Banks       | 45%                   | 43%                  |
| The Nielsen Company | 29%                   | 29%                  |
| Civolution          | 11%                   | 11%                  |

**7. Property and Equipment**

Property and equipment are stated at cost. Property and equipment under capital lease obligations are stated at the lower of the present value of minimum lease payments at the beginning of the lease term or fair value of the leased assets at the inception of the lease. Repairs and maintenance are charged to expense when incurred.

Depreciation on property and equipment is calculated using the straight-line method over the estimated useful lives of the assets, generally two to seven years. Leasehold improvements are amortized by the straight-line method over the shorter of the estimated useful life or the lease term.

| September 30,<br>2011 | December 31,<br>2010 |
|-----------------------|----------------------|
|-----------------------|----------------------|

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|  |    |         |    |         |
|--|----|---------|----|---------|
| Office furniture fixtures                      | \$ | 376     | \$ | 294     |
| Equipment                                      |    | 1,842   |    | 1,365   |
| Leasehold improvements                         |    | 1,039   |    | 986     |
|  |    | 3,257   |    | 2,645   |
| Less accumulated depreciation and amortization |    | (1,789) |    | (1,315) |
|  | \$ | 1,468   | \$ | 1,330   |

**Table of Contents****8. Intangible Assets Purchased and Capitalized Patent Costs**

Intangible assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable.

|                               | September 30,<br>2011 | December 31,<br>2010 |
|-------------------------------|-----------------------|----------------------|
| Gross intangible assets       | \$ 2,863              | \$ 2,290             |
| Accumulated amortization      | (202)                 | (116)                |
| <b>Intangible assets, net</b> | <b>\$ 2,661</b>       | <b>\$ 2,174</b>      |

**9. Joint Venture and Related Party Transactions**

On June 11, 2009 the Company entered into two joint venture agreements with Nielsen to launch two new companies. The two joint venture agreements and a revised patent license agreement expanded and replaced the previous license and services agreement between the Company and Nielsen that had been in operation since late 2007. Under the 2009 new agreements, the Company and Nielsen are working together to develop new products and services, including the expansion and deployment of those products and services that were in development under the prior agreement.

Under the terms of the patent license agreement, Nielsen agreed to pay Digimarc \$18,750 during the period from July 2009 through January 2014, and Digimarc granted to Nielsen a non-exclusive license to Digimarc's patents for use within Nielsen's business. Unless earlier terminated in accordance with the agreement, the license will continue until the expiration of the last to expire of the licensed patents. The payment terms extend beyond the Company's normal 30 to 60 day payment terms, thus the license revenue is recognized when the installments are due.

Joint Venture I, TVaura LLC, is engaged in the development of copyright filtering solutions, royalty/audit solutions for online video and audio rights organizations, guilds or other organizations involved in the reconciliation of royalties, residuals and other payments, and other related products. Each of the Company and Nielsen are making initial cash contributions aggregating \$3,900 payable quarterly from July 2009 through October 2011.

Joint Venture II, TVaura Mobile LLC, is engaged in the development of certain enhanced television offerings, and other related products. Each of the Company and Nielsen are making initial cash contributions aggregating \$2,800 payable quarterly from July 2009 through October 2011.

The Company will provide technical and development services to TVaura LLC's business for minimum service fees, subject to adjustment for any development service fees paid to the Company by TVaura Mobile LLC, totaling \$6,670 during the period 2009 through 2011. Service revenue will be recognized as the services are performed.

Pursuant to the terms of the agreements and ASC 810 *Consolidation*, the joint ventures are not consolidated with the Company because the minority shareholder of each joint venture has substantive participation rights, or veto rights, such that no shareholder has majority control.

*Related Party Transactions*

|                           | Three<br>Months<br>Ended<br>September 30,<br>2011 | Three<br>Months<br>Ended<br>September 30,<br>2010 | Nine<br>Months<br>Ended<br>September 30,<br>2011 | Nine<br>Months<br>Ended<br>September 30,<br>2010 |
|---------------------------|---|---|--|--|
| <b>TVaura LLC:</b>        |   |   |  |  |
| Capital contributions     | \$ 400  | \$ 400  | \$ 1,200   | \$ 1,200   |
| Revenue(1)                | \$ 622  | \$ 652  | \$ 2,033   | \$ 2,026   |
| <b>TVaura Mobile LLC:</b> |   |   |  |  |

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|                       |        |        |          |          |
|-----------------------|--------|--------|----------|----------|
| Capital contributions | \$ 300 | \$ 300 | \$ 900   | \$ 900   |
| Total:                |        |        |          |          |
| Capital contributions | \$ 700 | \$ 700 | \$ 2,100 | \$ 2,100 |
| Revenue(1)            | \$ 622 | \$ 652 | \$ 2,033 | \$ 2,026 |

(1) Technical and development services

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|                     | September 30, 2011 | December 31, 2010 |
|---------------------|--------------------|-------------------|
| <b>TVaura LLC:</b>  |                    |                   |
| Accounts receivable | \$ 189             | \$ 255            |

Summarized financial data for TVaura LLC are as follows:

|                        | September 30, 2011 | December 31, 2010 |
|------------------------|--------------------|-------------------|
| Current assets         | \$ 1,040           | \$ 777            |
| Noncurrent assets      | \$ 25              | \$ 31             |
| Current liabilities    | \$ 189             | \$ 255            |
| Noncurrent liabilities | \$                 | \$                |

|                                       | Three<br>Months<br>Ended<br>September 30,<br>2011 | Three<br>Months<br>Ended<br>September 30,<br>2010 | Nine<br>Months<br>Ended<br>September 30,<br>2011 | Nine<br>Months<br>Ended<br>September 30,<br>2010 |
|---------------------------------------|---|---|--|--|
| Revenue                               | \$  | \$  | \$   | \$   |
| Gross profit                          | \$  | \$  | \$   | \$   |
| Operating expenses                    | \$ 628  | \$ 656  | \$ 2,078   | \$ 2,126   |
| Net loss from continuing operations   | \$ (628)  | \$ (656)  | \$ (2,077)                                       | \$ (2,125)                                       |
| The Company's pro-rata share net loss | \$ (320)  | \$ (335)  | \$ (1,059)                                       | \$ (1,084)                                       |

Summarized financial data for TVaura Mobile LLC are as follows:

|                        | September 30, 2011 | December 31, 2010 |
|------------------------|--------------------|-------------------|
| Current assets         | \$ 1,908           | \$ 1,831          |
| Noncurrent assets      | \$                 | \$                |
| Current liabilities    | \$ 334             | \$ 279            |
| Noncurrent liabilities | \$                 | \$                |

|                                       | Three<br>Months<br>Ended<br>September 30,<br>2011 | Three<br>Months<br>Ended<br>September 30,<br>2010 | Nine<br>Months<br>Ended<br>September 30,<br>2011 | Nine<br>Months<br>Ended<br>September 30,<br>2010 |
|---------------------------------------|---|---|--|--|
| Revenue                               | \$  | \$  | \$ 50  | \$   |
| Gross loss                            | \$  | \$  | \$ (27)  | \$   |
| Operating expenses                    | \$ 766  | \$ 456  | \$ 1,751   | \$ 1,005   |
| Net loss from continuing operations   | \$ (766)  | \$ (456)  | \$ (1,778)                                       | \$ (1,005)                                       |
| The Company's pro-rata share net loss | \$ (375)  | \$ (223)  | \$ (871)   | \$ (492)   |

**10. Income Taxes**

The Company's income tax provision for the three- and nine-months ended September 30, 2011 was an expense of \$134 and a tax benefit of \$1,796, respectively. The tax benefit includes \$2,581 deferred tax benefit from the valuation allowance release as well as benefits from federal and state research credits. During the three-months ended June 30, 2011, the Company concluded, based on projections of future income, that it is more likely than not that the Company's deferred tax assets will be realized.

The reconciliation of the statutory federal income tax rate to the Company's effective income tax rate for the nine-months ended September 30, 2011 is as follows:

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|  | Nine-Months<br>Ended<br>September 30,<br>2011 | %            |
|--|---|--------------|
| Income taxes computed at statutory rates               | \$ 1,158                                      | 34%          |
| Increases (decreases) resulting from:                  |   |              |
| State income taxes, net of federal tax benefit         | 175   | 5%           |
| Change in valuation allowance                          | (2,581)                                       | (76)%        |
| Federal and state research and experimentation credits | (726)   | (21)%        |
| Other, net   | 178   | 5%           |
| <b>Total</b>   | <b>\$ (1,796)</b>                             | <b>(53)%</b> |

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The provision for income taxes for the three- and nine-month periods ended September 30, 2010 reflects estimated U.S. alternative minimum tax expense and withholding tax expense in various foreign jurisdictions. Withholding taxes are computed by the Company's customers and paid to foreign jurisdictions on its behalf. Other than the U.S. alternative minimum taxes and foreign withholding tax expense, there was no provision for current income taxes related to net income because the computation of regular taxable income is fully offset by available net operating loss carry-forwards and tax credits previously offset by a full valuation allowance.

**11. Commitments and Contingencies**

Certain of the Company's product license and services agreements include an indemnification provision for claims from third parties relating to the Company's intellectual property. Such indemnification provisions are accounted for in accordance with ASC 450 *Contingencies*. To date, there have been no claims made under such indemnification provisions.

Verance Corporation, a Digimarc licensee, filed a declaratory judgment action against Digimarc in the United States District Court in Delaware on September 30, 2010, alleging the invalidity and non-infringement of 22 patents held by Digimarc. Verance Corp. v. Digimarc Corp., 1:10-cv-00831-UNA. The District Court dismissed Verance's action. On September 9, 2011 Verance filed a Notice of Appeal with the Court of Appeals for the Federal Circuit.

On December 6, 2010, Digimarc filed suit against Verance Corporation in the District of Oregon. Digimarc is seeking payment for breach of contract by Verance related to Verance's failure to make payments under the licensing agreement between Digimarc and Verance. Digimarc Corp. v. Verance Corp., CV 10-1489 JE. On April 29, 2011, the Magistrate Judge denied Verance's motion to dismiss or stay the action, and to compel arbitration. The case is pending.

Digimarc was named as one of several defendants in a complaint filed by Walker Digital, LLC (Walker), in the U.S. District Court for the District of Delaware on April 22, 2011, case number 11-cv-00363-UNA, alleging patent infringement. The case was settled in early October 2011 with a negotiated patent license arrangement between TVaura Mobile LLC and Walker.

The Company is subject from time to time to other legal proceedings and claims arising in the ordinary course of business. Although the ultimate outcome of these matters cannot be determined, management believes that, as of October 26, 2011, the final disposition of these proceedings will not have a material adverse effect on the financial position, results of operations, or liquidity of the Company. In accordance with ASC 450, no accrual has been recorded because the amounts are not probable or reasonably estimatable, and a range of possible outcomes is not determinable.

**12. Stock Repurchases**

Summary of common stock shares repurchased:

|  | Three<br>Months<br>Ended<br>September 30,<br>2011 | Three<br>Months<br>Ended<br>September 30,<br>2010 | Nine<br>Months<br>Ended<br>September 30,<br>2011 | Nine<br>Months<br>Ended<br>September 30,<br>2010 |
|--|---|---|--|--|
| Private transaction                              |   |   | 552,536  |  |
| Repurchase program                               | 63,500  |   | 104,577  |  |
| Exercise of stock options                        | 20,776  |   | 44,875   |  |
| Tax withholding obligations on stock options     | 26,363  |   | 44,116   |  |
| Tax withholding obligations on restricted shares | 2,979   | 822   | 13,994   | 2,117  |
| Total  | 113,618   | 822   | 760,098  | 2,117  |



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Value of common stock shares repurchased:

|  | Three<br>Months<br>Ended<br>September 30,<br>2011 | Three<br>Months<br>Ended<br>September 30,<br>2010 | Nine<br>Months<br>Ended<br>September 30,<br>2011 | Nine<br>Months<br>Ended<br>September 30,<br>2010 |
|--|---|---|--|--|
| Private transaction                              | \$  | \$  | \$ 14,927  | \$   |
| Repurchase program                               | 1,977   |   | 3,098  |  |
| Exercise of stock options                        | 822   |   | 1,555  |  |
| Tax withholding obligations on stock options     | 1,055   |   | 1,596  |  |
| Tax withholding obligations on restricted shares | 93  | 15  | 418  | 40   |
| Total  | \$ 3,947  | \$ 15   | \$ 21,594  | \$ 40  |

On January 26, 2011, the Company repurchased 552,536 shares of its common stock from Koninklijke Philips Electronics, N.V., in a privately negotiated transaction. The shares were purchased for an aggregate price of approximately \$14,927, including transaction fees. To facilitate the repurchase, the Company sold \$10,752 and \$2,996 of short- and long-term marketable securities, respectively, prior to their maturity date at an immaterial gain.

In April 2009, the Board of Directors approved a stock repurchase program authorizing the purchase, at the discretion of management, of up to \$5,000 of the Company's common stock through either periodic open-market or private transactions at then prevailing market prices through April 30, 2010. In both April 2010 and April 2011, the Board of Directors approved an extension of the stock repurchase program for one year periods. As of September 30, 2011, the Company had repurchased 216,244 shares under this program at an aggregate purchase price of \$4,659.

As part of the Company's 2008 Stock Incentive Plan, stock options are granted to certain employees and restricted stock shares are awarded to certain employees.

Pursuant to the terms of the stock option grants, the Company purchased a number of whole shares of common stock having a fair market value (as determined by the Company as of the date of exercise) equal to the amount of the total value of the aggregate exercise price of the options exercised. In addition, the Company withheld (purchased) from shares issued from upon exercise of the stock options a number of whole shares of common stock having a fair market value (as determined by the Company as of the date of vesting) equal to the amount of tax required to be withheld by law, in order to satisfy the tax withholding obligations of the Company in connection with the exercise of such options.

Pursuant to the terms of the restricted stock award agreement, the Company withheld (purchased) from fully vested shares of common stock otherwise deliverable to any employee, a number of whole shares of common stock having a fair market value (as determined by the Company as of the date of vesting) equal to the amount of tax required to be withheld by law, in order to satisfy the tax withholding obligations of the Company in connection with the vesting of such shares.

**13. Subsequent Events**

In accordance with ASC 855 *Subsequent Events*, the Company has evaluated subsequent events.

**14. Quarterly Financial Information**

| Quarter ended:<br>2011           | March 31 | June 30  | September 30 |
|----------------------------------|----------|----------|--------------|
| Service revenue                  | \$ 3,069 | \$ 3,165 | \$ 3,108     |
| License and subscription revenue | 6,022    | 6,308    | 5,442        |
| Total revenue                    | 9,091    | 9,473    | 8,550        |

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|  |         |         |         |
|--|---------|---------|---------|
| Total cost of revenue                                  | 1,649   | 1,690   | 1,742   |
| Gross profit   | 7,442   | 7,783   | 6,808   |
| Gross profit percent, service revenue                  | 48%     | 49%     | 46%     |
| Gross profit percent, license and subscription revenue | 99%     | 99%     | 99%     |
| Gross profit percent, total                            | 82%     | 82%     | 80%     |
| Sales and marketing                                    | 1,102   | 1,017   | 1,166   |
| Research, development and engineering                  | 1,775   | 1,884   | 1,958   |
| General and administrative                             | 2,847   | 2,270   | 2,000   |
| Intellectual property                                  | 301     | 266     | 259     |
| Operating income                                       | 1,417   | 2,346   | 1,425   |
| Net income   | 938     | 3,626   | 639     |
| Earnings per share:                                    |         |         |         |
| Net income per share basic                             | \$ 0.14 | \$ 0.54 | \$ 0.10 |
| Net income per share diluted                           | \$ 0.12 | \$ 0.50 | \$ 0.09 |
| Weighted average shares outstanding basic              | 6,864   | 6,696   | 6,706   |
| Weighted average shares outstanding diluted            | 7,505   | 7,245   | 7,344   |

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| <b>Quarter ended:</b>                                  | <b>March 31</b> | <b>June 30</b> | <b>September 30</b> | <b>December 31</b> |
|--|-----------------|----------------|---------------------|--------------------|
| <b>2010</b>  |                 |                |                     |                    |
| Service revenue  | \$ 3,514        | \$ 2,918       | \$ 2,761            | \$ 3,131           |
| License and subscription revenue                       | 6,678           | 2,330          | 2,476               | 7,342              |
| Total revenue  | 10,192          | 5,248          | 5,237               | 10,473             |
| Total cost of revenue                                  | 1,857           | 1,540          | 1,469               | 1,834              |
| Gross profit   | 8,335           | 3,708          | 3,768               | 8,639              |
| Gross profit percent, service revenue                  | 49%             | 49%            | 49%                 | 43%                |
| Gross profit percent, license and subscription revenue | 99%             | 98%            | 98%                 | 99%                |
| Gross profit percent, total                            | 82%             | 71%            | 72%                 | 82%                |
| Sales and marketing                                    | 741             | 759            | 953                 | 1,092              |
| Research, development and engineering                  | 1,259           | 1,321          | 1,471               | 1,636              |
| General and administrative                             | 1,885           | 1,687          | 1,842               | 2,450              |
| Intellectual property                                  | 257             | 319            | 315                 | 312                |
| Operating income (loss)                                | 4,193           | (378)          | (813)               | 3,149              |
| Net income (loss)                                      | 3,776           | (896)          | (1,460)             | 2,754              |
| Earnings (loss) per share:                             |                 |                |                     |                    |
| Net earnings (loss) per share basic                    | \$ 0.53         | \$ (0.13)      | \$ (0.21)           | \$ 0.38            |
| Net earnings (loss) per share diluted                  | \$ 0.51         | \$ (0.13)      | \$ (0.21)           | \$ 0.35            |
| Weighted average shares outstanding basic              | 7,096           | 7,097          | 7,098               | 7,190              |
| Weighted average shares outstanding diluted            | 7,387           | 7,097          | 7,098               | 7,859              |

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**Item 2. 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 relating to future events or the future financial performance of Digimarc, that involve risks and uncertainties. Our actual results could differ materially from those anticipated in these forward-looking statements. Please see the discussion regarding forward-looking statements included in this Quarterly Report on Form 10-Q under the caption "Safe Harbor Statement under the Private Securities Litigation Reform Act of 1995."*

*The following discussion should be read in conjunction with our financial statements and the related notes and other financial information appearing elsewhere in this Quarterly Report on Form 10-Q. Readers are also urged to carefully review and consider the disclosures made in Part II, Item 1A (Risk Factors) of this Quarterly Report on Form 10-Q and our Annual Report on Form 10-K for the year ended December 31, 2010 filed on March 3, 2011 (the "2010 Annual Report") and in the audited financial statements and related notes included in our 2010 Annual Report, and other reports and filings made with the Securities and Exchange Commission ("SEC").*

*Unless the context otherwise requires, references in this Quarterly Report on Form 10-Q to Digimarc, we, our and us refer to Digimarc Corporation.*

*All dollar amounts are in thousands, unless otherwise noted.*

**Overview**

Digimarc Corporation enables governments and enterprises around the world to give digital identities to media and objects that computers can sense and recognize and to which they can react. Our technology provides the means to infuse persistent digital information, perceptible only to computers and digital devices, into all forms of media content. The unique digital identifier placed in media generally persists with it regardless of the distribution path and whether it is copied, manipulated or converted to a different format, and does not affect the quality of the content or the enjoyment or other traditional uses of it. Our technology permits computers and digital devices to quickly identify relevant data from vast amounts of media content.

Our technologies, and those of our licensees, span a range of media content, enabling our customers and those of our partners to:

Quickly identify and effectively manage music, movies, television programming, digital images, documents and other printed materials, especially in light of new non-linear distribution over the internet;

Deter counterfeiting of money, media and goods, and piracy of movies and music;

Support new digital media distribution models and methods to monetize media content;

Leverage the power of ubiquitous computing to instantly link consumers to a wealth of information and/or interactive experiences related to the media and objects they encounter each day;

Provide consumers with more choice and access to media content when, where and how they want it;

Enhance imagery and video by associating metadata or authenticating media content for government and commercial uses; and

Better secure identity documents to enhance national security and combat identity theft and fraud.

At the core of our intellectual property is a signal processing technology innovation known as "digital watermarking" which allows imperceptible digital information to be embedded in all forms of digitally designed, produced or distributed media content and some physical objects, including photographs, movies, music, television, personal identification documents, financial instruments, industrial parts and product

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packages. The digital information can be detected and read by a wide range of computers, mobile phones, and other digital devices.

We provide technology-based solutions directly and through our licensees. Our proprietary technology has proven to be a powerful element of document security, giving rise to our long-term relationship with a consortium of central banks, which we refer to as the Central Banks, and many leading companies in the information technology industry. We and our licensees have successfully propagated digital watermarking in music, movies, television broadcasts, images and printed materials. Digital watermarks have been used in these applications to improve media rights and asset management, reduce piracy and counterfeiting losses, improve marketing programs, permit more efficient and effective distribution of valuable media content and enhance consumer entertainment and commercial experiences.

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Our patent portfolio contains a number of innovations in digital watermarking, pattern recognition (sometimes referred to as fingerprinting), digital rights management and related fields. To protect our significant efforts in creating our technology, we have implemented an extensive intellectual property protection program that relies on a combination of patent, copyright, trademark and trade secret laws, and nondisclosure agreements and other contracts. As a result, we believe we have one of the world's most extensive patent portfolios in digital watermarking and related fields, with approximately 1,100 granted and pending U.S. and foreign filings as of September 30, 2011. Separately, we own registered trademarks in both the United States and other countries and have applied for additional trademarks. We continue to develop and broaden our portfolio of patented technology in the fields of media identification and management technology and related applications and systems. We devote significant resources to developing and protecting our technology and continuously seek to identify and evaluate potential licensees for our patents. Most of these patents are subject to an exclusive patent licensing arrangement as described further below.

For a discussion of activities and costs related to our research and development, please read the sections entitled "Research, development and engineering" under Item 2, "Management's Discussion and Analysis of Financial Condition and Results of Operations."

As part of our intellectual property marketing initiative and patent monetization strategy, on October 5, 2010 we entered into a patent licensing arrangement with IV Digital Multimedia Inventions, LLC, a Delaware limited liability company affiliated with Intellectual Ventures (IV), pursuant to which we granted an exclusive license to sublicense, subject to pre-existing encumbrances and a grant-back license, an aggregate of approximately 900, of the 1,100 noted above, patents and applications held by us.

We believe recent intellectual property licensing initiatives we have commenced represent substantial opportunities for us to grow our license and subscription revenues, as well as our service revenues. These initiatives, however, may require additional investment in our intellectual property enforcement program and research and development.

## **Critical Accounting Policies and Estimates**

Detailed information on our critical accounting policies and estimates are set forth in our 2010 Annual Report in Part II, Item 7 thereof ("Management's Discussion and Analysis of Financial Condition and Results of Operations"), under the caption "Critical Accounting Policies and Estimates," which is incorporated by reference into this Quarterly Report on Form 10-Q.

**Table of Contents****Results of Operations**

The following table presents statements of operations data for the periods indicated as a percentage of total revenue. Unless otherwise indicated, all references in this Management's Discussion and Analysis of Financial Condition and Results of Operations to the three- and nine-month periods relate to the three- and nine-month periods ended September 30, 2011 and all changes discussed with respect to those periods reflect changes compared to the three- and nine-month periods ended September 30, 2010.

|  | Three<br>Months<br>Ended<br>September 30,<br>2011 | Three<br>Months<br>Ended<br>September 30,<br>2010 | Nine<br>Months<br>Ended<br>September 30,<br>2011 | Nine<br>Months<br>Ended<br>September 30,<br>2010 |
|--|---|---|--|--|
| <b>Revenue:</b>  |   |   |  |  |
| Service  | 36%   | 53%   | 34%  | 44%  |
| License and subscription                               | 64  | 47  | 66   | 56   |
| <b>Total revenue</b>                                   | <b>100</b>  | <b>100</b>  | <b>100</b>                                       | <b>100</b>                                       |
| <b>Cost of revenue:</b>                                |   |   |  |  |
| Service  | 19  | 27  | 18   | 23   |
| License and subscription                               | 1   | 1   | 1  | 1  |
| <b>Total cost of revenue</b>                           | <b>20</b>   | <b>28</b>   | <b>19</b>  | <b>24</b>  |
| <b>Gross profit</b>                                    | <b>80</b>   | <b>72</b>   | <b>81</b>  | <b>76</b>  |
| <b>Operating expenses:</b>                             |   |   |  |  |
| Sales and marketing                                    | 14  | 18  | 12   | 12   |
| Research, development and engineering                  | 23  | 28  | 21   | 20   |
| General and administrative                             | 23  | 35  | 26   | 26   |
| Intellectual property                                  | 3   | 6   | 3  | 4  |
| <b>Total operating expenses</b>                        | <b>63</b>   | <b>87</b>   | <b>62</b>  | <b>62</b>  |
| <b>Operating income (loss)</b>                         | <b>17</b>   | <b>(15)</b>                                       | <b>19</b>  | <b>14</b>  |
| <b>Net loss from joint ventures</b>                    | <b>(8)</b>  | <b>(11)</b>                                       | <b>(7)</b>                                       | <b>(7)</b>                                       |
| Interest income, net                                   |   | 1   | 1  | 1  |
| <b>Income (loss) before provision for income taxes</b> | <b>9</b>  | <b>(25)</b>                                       | <b>13</b>  | <b>8</b>   |
| (Provision) benefit for income taxes                   | (2)   | (3)   | 6  | (1)  |
| <b>Net income (loss)</b>                               | <b>7%</b>   | <b>(28)%</b>                                      | <b>19%</b>                                       | <b>7%</b>  |

Our revenue for the three- and nine-month periods ended September 30, 2011 increased 63% to \$8.5 million from \$5.2 million and 31% to \$27.1 million from \$20.1 million, respectively, from the prior periods primarily as a result of revenue derived from our relationship with IV and Verance, a long-term licensee. Our revenue for the nine-month period ended September 30, 2010 included a one-time payment of license fees of \$4.5 million from Arbitron in the first quarter of the prior period. Throughout the three- and nine-month periods ended September 30, 2011, we continued to invest in the development and marketing of Digimarc Discover, an application designed for digital devices to hear, see and react to their surroundings, in developing additional intellectual property and in our strategic initiatives. We also continued to incur legal expenses in the three- and nine-month periods ended September 30, 2011 in connection with our litigation matter with Verance.

Notwithstanding the reversal of our valuation allowance in the second quarter of 2011, we continued to achieve pre-tax income from continuing operations for the three- and nine-month periods ended September 30, 2011 by improving operational leverage through controlling the operating costs of increased revenues.





**Table of Contents***Revenue*

|   | Three<br>Months<br>Ended<br>September 30,<br>2011 | Three<br>Months<br>Ended<br>September 30,<br>2010 | Dollar<br>Increase | Percent<br>Increase | Nine<br>Months<br>Ended<br>September 30,<br>2011 | Nine<br>Months<br>Ended<br>September 30,<br>2010 | Dollar<br>Increase | Percent<br>Increase |
|---|---|---|--------------------|---------------------|--|--|--------------------|---------------------|
| <b>Revenue:</b>                         |   |   |                    |                     |  |  |                    |                     |
| Service                                 | \$ 3,108  | \$ 2,761  | \$ 347             | 13%                 | \$ 9,342   | \$ 9,193   | \$ 149             | 2%                  |
| License and subscription                | 5,442   | 2,476   | 2,966              | 120%                | 17,772   | 11,484   | 6,288              | 55%                 |
| <b>Total</b>                            | <b>\$ 8,550</b>                                   | <b>\$ 5,237</b>                                   | <b>\$ 3,313</b>    | <b>63%</b>          | <b>\$ 27,114</b>                                 | <b>\$ 20,677</b>                                 | <b>\$ 6,437</b>    | <b>31%</b>          |
| <b>Revenue (as % of total revenue):</b> |   |   |                    |                     |  |  |                    |                     |
| Service                                 | 36%   | 53%   |                    |                     | 34%  | 44%  |                    |                     |
| License and subscription                | 64%   | 47%   |                    |                     | 66%  | 56%  |                    |                     |
| <b>Total</b>                            | <b>100%</b>                                       | <b>100%</b>                                       |                    |                     | <b>100%</b>                                      | <b>100%</b>                                      |                    |                     |

We derive our revenue primarily from:

- 1) development services provided to government and commercial customers and
- 2) licensing our patents.

*Service.* Service revenue consists primarily of software development and consulting services. The majority of service revenue arrangements are structured as time and materials consulting agreements, or fixed price consulting agreements. The majority of our services revenue is derived from contracts with the Central Banks, Nielsen, the joint venture TVaura LLC, government agencies and IV. The agreements range from several months to several years in length, and our longer term contracts are subject to work plans that are reviewed and agreed upon at least annually. These contracts generally provide for billing hours worked at predetermined rates and, to a lesser extent, for cost reimbursement for third party costs and services. Increases or decreases in the services provided under these contracts are generally subject to both volume and price changes. The volume of work is generally negotiated at least annually and can be modified as the customer's needs change. We also have provisions in our longer term contracts that allow for specific hourly rate price increases on an annual basis to account for cost of living variables. Contracts with other government agencies are generally shorter term in nature, less linear in billings and less predictable than our longer terms contracts because the contracts with other government agencies are subject to government budgets and funding.

The increases in service revenue for the three-month period ended September 30, 2011, compared to the corresponding three month period ended September 30, 2010, were primarily due to increased program work related to the Central Banks and our relationship with IV.

The increases in service revenue for the nine-month period ended September 30, 2011, compared to the corresponding and nine-month period ended September 30, 2010, were primarily due to increased revenue from our relationship with IV, offset by decreased revenue from government customers.

*License and subscription.* License revenue originates primarily from licensing our technology and patents where we receive royalties as our income stream. Subscription revenue consists primarily of royalty revenue from the sale of our web-based subscriptions related to various software products, which are more recurring in nature. Revenues from our licensed products have minimal associated direct costs, and thus are highly profitable.

The increases in license and subscription revenue for the three- and nine-month periods ended September 30, 2011, compared to the corresponding three- and nine-month periods ended September 30, 2010, were primarily attributed to revenue derived from the IV relationship

and increased royalty revenue from Verance.

**Table of Contents***Revenue by Geography*

|   | Three<br>Months<br>Ended<br>September 30,<br>2011 | Three<br>Months<br>Ended<br>September 30,<br>2010 | Dollar<br>Increase<br>(Decrease) | Percent<br>Increase<br>(Decrease) | Nine<br>Months<br>Ended<br>September 30,<br>2011 | Nine<br>Months<br>Ended<br>September 30,<br>2010 | Dollar<br>Increase | Percent<br>Increase |
|---|---|---|----------------------------------|-----------------------------------|--|--|--------------------|---------------------|
| <b>Revenue by geography:</b>            |   |   |                                  |                                   |  |  |                    |                     |
| Domestic                                | \$ 5,221  | \$ 1,868  | \$ 3,353                         | 180%                              | \$ 17,321  | \$ 11,211  | \$ 6,110           | 55%                 |
| International                           | 3,329   | 3,369   | (40)                             | (1)%                              | 9,793  | 9,466  | 327                | 3%                  |
| Total                                   | \$ 8,550  | \$ 5,237  | \$ 3,313                         | 63%                               | \$ 27,114  | \$ 20,677  | \$ 6,437           | 31%                 |
| <b>Revenue (as % of total revenue):</b> |   |   |                                  |                                   |  |  |                    |                     |
| Domestic                                | 61%   | 36%   |                                  |                                   | 64%  | 54%  |                    |                     |
| International                           | 39%   | 64%   |                                  |                                   | 36%  | 46%  |                    |                     |
| Total                                   | 100%  | 100%  |                                  |                                   | 100%   | 100%   |                    |                     |

Domestic revenue increased for the three- and nine-month periods ended September 30, 2011, compared to the corresponding three- and nine-month periods ended September 30, 2010, primarily as a result of increased revenue derived from the IV relationship and increased royalty revenue from Verance, offset by the one-time payment of license fees from Arbitron in the first quarter of the prior period.

International revenue for the three- and nine-month periods ended September 30, 2011, compared to the corresponding three- and nine-month periods ended September 30, 2010, remained relatively constant.

We anticipate revenue will be lower for the remainder of 2011, compared to the same period in 2010, primarily as a result of one scheduled payment from IV in the fourth quarter of 2011 compared to two license payments received from IV in the fourth quarter of 2010.

*Cost of Revenue*

*Service.* Cost of service revenue primarily includes costs that are allocated from research, development, engineering and sales and marketing that relate directly to performing services under our customer contracts, and, to a lesser extent, direct costs of program delivery for both personnel and operating expenses. Allocated costs include:

salaries, a payroll tax and benefit factor, incentive compensation and related costs of our software developers, quality assurance personnel, product managers, business development managers and other personnel where we bill our customers for time and materials costs;

payments to outside contractors that are billed to customers;

charges for equipment directly used by the customer;

depreciation charges for machinery, equipment and software;

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travel costs directly attributable to service and development contracts; and

charges for infrastructure and centralized costs of facilities and information technology.

*License and subscription.* Cost of license and subscription revenue primarily includes:

patent or software license costs for any patents licensed from third parties where the party receives a portion of royalties or license revenue received by Digimarc;

internet service provider connectivity charges and image search data fees to support the services offered to our subscription customers; and, to a lesser extent,

amortization of capitalized patent costs.

**Table of Contents***Gross Profit*

|                          | Three<br>Months<br>Ended<br>September 30,<br>2011 | Three<br>Months<br>Ended<br>September 30,<br>2010 | Dollar<br>Increase | Percent<br>Increase | Nine<br>Months<br>Ended<br>September 30,<br>2011 | Nine<br>Months<br>Ended<br>September 30,<br>2010 | Dollar<br>Increase<br>(Decrease) | Percent<br>Increase<br>(Decrease) |
|--------------------------|---|---|--------------------|---------------------|--|--|----------------------------------|-----------------------------------|
| <b>Gross Profit:</b>     |   |   |                    |                     |  |  |                                  |                                   |
| Service                  | \$ 1,443  | \$ 1,351  | \$ 92              | 7%                  | \$ 4,479   | \$ 4,500   | \$ (21)                          | <(1)%                             |
| License and subscription | 5,365   | 2,417   | 2,948              | 122%                | 17,554   | 11,311   | 6,243                            | 55%                               |
| Total                    | \$ 6,808  | \$ 3,768  | \$ 3,040           | 81%                 | \$ 22,033  | \$ 15,811  | \$ 6,222                         | 39%                               |

**Gross Profit (as % of related revenue components):**

|                          |     |     |     |     |
|--------------------------|-----|-----|-----|-----|
| Service                  | 46% | 49% | 48% | 49% |
| License and subscription | 99% | 98% | 99% | 98% |
| Total                    | 80% | 72% | 81% | 76% |

The increases in gross profit for the three- and nine-month periods ended September 30, 2011, compared to the corresponding three- and nine-month periods ended September 30, 2010, were primarily the result of increased license and royalty revenues from IV and Verance, offset by the one-time payment of license fees from Arbitron in the first quarter of the prior period.

The increases in gross profit as a percentage of revenue for the three- and nine-month periods ended September 30, 2011, compared to the corresponding three- and nine-month periods ended September 30, 2010, were due primarily to changes in revenue mix resulting in higher license revenue which carries a higher margin than service revenue, as a percent of total revenue. The decrease in service gross profit as a percentage of revenue for the three-month period resulted from a change in mix for both labor resources and for labor and non-labor billings.

*Operating Expenses**Sales and marketing*

|   | Three<br>Months<br>Ended<br>September 30,<br>2011 | Three<br>Months<br>Ended<br>September 30,<br>2010 | Dollar<br>Increase | Percent<br>Increase | Nine<br>Months<br>Ended<br>September 30,<br>2011 | Nine<br>Months<br>Ended<br>September 30,<br>2010 | Dollar<br>Increase | Percent<br>Increase |
|---|---|---|--------------------|---------------------|--|--|--------------------|---------------------|
| Sales and marketing                         | \$ 1,166  | \$ 953  | \$ 213             | 22%                 | \$ 3,285   | \$ 2,453   | \$ 832             | 34%                 |
| Sales and marketing (as % of total revenue) | 14%   | 18%   |                    |                     | 12%  | 12%  |                    |                     |

Sales and marketing expenses consist primarily of:

compensation, benefits and related costs of sales and marketing employees and product managers;

travel and market research costs, and costs associated with marketing programs, such as trade shows, public relations and new product launches;

professional services and outside contractors for product and marketing initiatives;

incentive compensation in the form of stock-based compensation expense; and

charges for infrastructure and centralized costs of facilities and information technology.

We allocate certain costs of sales and marketing to cost of service revenue when they relate directly to our service contracts. For direct billable labor hours, we allocate to cost of service revenue:

salaries;

a payroll tax and benefits factor; and

incentive compensation related to our stock compensation plans.

We record all remaining, or residual, costs as sales and marketing costs.

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The increase in sales and marketing expense for the three-month period ended September 30, 2011, compared to the corresponding three-month period ended September 30, 2010, resulted primarily from:

increased headcount and compensation-related expenses of \$0.1 million from hiring additional sales and marketing support for our mobile device market initiatives; and

increased marketing and professional fees of \$0.1 million related to a number of sales initiatives, including our Digimarc Discover Platform.

The increase in sales and marketing expense for the nine-month period ended September 30, 2011, compared to the corresponding nine-month period ended September 30, 2010, resulted primarily from:

increased headcount and compensation-related expenses of \$0.4 million from hiring additional sales and marketing support for our mobile device market initiatives; and

increased marketing and professional fees of \$0.3 million related to a number of sales initiatives, including our Digimarc Discover Platform.

We anticipate that we will continue to incur sales and marketing costs at existing levels to support ongoing sales initiatives.

*Research, development and engineering*

|   | <b>Three<br/>Months<br/>Ended<br/>September 30,<br/>2011</b> | <b>Three<br/>Months<br/>Ended<br/>September 30,<br/>2010</b> | <b>Dollar<br/>Increase</b> | <b>Percent<br/>Increase</b> | <b>Nine<br/>Months<br/>Ended<br/>September 30,<br/>2011</b> | <b>Nine<br/>Months<br/>Ended<br/>September 30,<br/>2010</b> | <b>Dollar<br/>Increase</b> | <b>Percent<br/>Increase</b> |
|---|--|--|----------------------------|-----------------------------|---|---|----------------------------|-----------------------------|
| Research, development and engineering                         | \$ 1,958   | \$ 1,471   | \$ 487                     | 33%                         | \$ 5,617  | \$ 4,051  | \$ 1,566                   | 39%                         |
| Research, development and engineering (as % of total revenue) | 23%  | 28%  |                            |                             | 21%   | 20%   |                            |                             |

Research, development and engineering expenses arise primarily from three areas that support our business model:

Fundamental Research:

investigation of new watermarking algorithms to increase robustness and/or computational efficiency;

mobile device usage models and imaging sub-systems in camera-phones;

industry conference participation and authorship of papers for industry journals;

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survey and study of human and computer interaction models with a focus on mobile devices and modeling of intent;

development of new intellectual property, including documentation of claims and production of supporting diagrams and materials; and

research in fingerprinting and other content identification technologies.

### Platform Development:

tuning and optimization of implementation models to improve resistance to non-malicious attacks and routine transformations, such as JPEG, cropping and printing; and

mobile platform creation to leverage device specific capabilities (e.g. instruction sets and Graphics Processing Units ( GPUs )).

### Product Development:

creation of Online Services Portal to provide campaign management and routing services for the Digimarc Discover platform;

implementation of web-hosted image watermark embedder in support of Digimarc Discover platform; and

iterative development and release of the Digimarc Discover application for the iTunes and Android marketplace.

Research, development and engineering expenses consist primarily of:

compensation, benefits, recruiting and related costs of software and hardware developers and quality assurance personnel;



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payments to outside contractors;

the purchase of materials and services for product development;

incentive compensation in the form of stock-based compensation expense; and

charges for infrastructure and centralized costs of facilities and information technology.

We allocate certain costs of research, development and engineering to cost of service revenue when they relate directly to our service contracts. For direct billable labor hours, we allocate to cost of service revenue:

salaries;

a payroll tax and benefits factor; and

incentive compensation related to our stock compensation plans.

We record all remaining, or residual, costs as research, development and engineering costs.

The increase in research, development and engineering expense for the three-month period ended September 30, 2011, compared to the corresponding three-month period ended September 30, 2010, resulted primarily from:

increased headcount and compensation-related expenses of \$0.5 million from hiring engineers and scientists to facilitate growth in our product and service offerings, including increased investments primarily related to the mobile device market.

Research, development and engineering expense for the nine-month period ended September 30, 2011, compared to the corresponding nine-month period ended September 30, 2010, resulted primarily from:

increased headcount and compensation-related expenses of \$1.2 million from hiring engineers and scientists to facilitate growth in our product and service offerings, including increased investments primarily related to the mobile device market; and

increased professional fees and contract labor of \$0.2 million related to our mobile device market initiatives.

We anticipate that we will continue to invest in research, development and engineering expenses at higher levels to support our ongoing research and product initiatives.

*General and administrative*

| Three Months Ended September 30, 2011 | Three Months Ended September 30, 2010 | Dollar Increase | Percent Increase | Nine Months Ended September 30, 2011 | Nine Months Ended September 30, 2010 | Dollar Increase | Percent Increase |
|---------------------------------------|---------------------------------------|-----------------|------------------|--------------------------------------|--------------------------------------|-----------------|------------------|
|---------------------------------------|---------------------------------------|-----------------|------------------|--------------------------------------|--------------------------------------|-----------------|------------------|

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|   |          |          |        |    |          |          |          |     |
|---|----------|----------|--------|----|----------|----------|----------|-----|
| General and administrative                            | \$ 2,000 | \$ 1,842 | \$ 158 | 9% | \$ 7,117 | \$ 5,414 | \$ 1,703 | 31% |
| General and administrative<br>(as % of total revenue) | 23%      | 35%      |        |    | 26%      | 26%      |          |     |

We incur general and administrative costs in the functional areas of finance, legal, human resources, executive and board of directors. Costs for facilities and information technology are also managed as part of the general and administrative processes and are allocated to this area as well as each of the areas in costs of services, sales and marketing, and research, development and engineering.

General and administrative expenses consist primarily of:

compensation, benefits and related costs;

third party and professional fees associated with legal, accounting, human resources and costs associated with being a public company;

incentive compensation in the form of stock-based compensation expense; and

charges for infrastructure and centralized costs of facilities and information technology.

The increases in general and administrative expenses for the three-month period ended September 30, 2011, compared to the corresponding three-month period ended September 30, 2010, resulted primarily from:

increased legal fees of \$0.2 million primarily related to legal fees incurred in connection with the litigation matter with Verance.

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The increases in general and administrative expenses for the nine-month period ended September 30, 2011, compared to the corresponding nine-month period ended September 30, 2010, resulted primarily from:

increased legal fees of \$1.1 million primarily related to the litigation matter with Verance;

increased compensation-related expenses of \$0.5 million primarily related to an additional layer of stock-based awards and payroll taxes related to stock option exercises; and

increased accounting fees of \$0.2 million related to the transition to our new auditors that we engaged in late 2010 for the 2010 audit. We anticipate that we will continue to incur general and administrative expenses at higher levels in the near term, particularly for legal fees related to our current litigation matters, while continuing to examine means to reduce general and administrative expenses as a percentage of revenue in the longer term.

*Intellectual property*

|   | Three<br>Months<br>Ended<br>September 30,<br>2011 | Three<br>Months<br>Ended<br>September 30,<br>2010 | Dollar<br>Decrease | Percent<br>Decrease | Nine<br>Months<br>Ended<br>September 30,<br>2011 | Nine<br>Months<br>Ended<br>September 30,<br>2010 | Dollar<br>Decrease | Percent<br>Decrease |
|---|---|---|--------------------|---------------------|--|--|--------------------|---------------------|
| Intellectual property                         | \$ 259  | \$ 315  | \$ 56              | 18%                 | \$ 826   | \$ 891   | \$ 65              | 7%                  |
| Intellectual property (as % of total revenue) | 3%  | 6%  |                    |                     | 3%   | 4%   |                    |                     |

We incur intellectual property expenses that arise primarily from costs associated with documenting, applying for, and maintaining domestic and international patents and trademarks.

Gross expenditures for intellectual property costs, before reflecting the effect of capitalized patent costs, primarily consist of:

compensation, benefits and related costs of attorneys and legal assistants;

third party costs including filing and governmental regulatory fees and fees for outside legal counsel and translation costs, each incurred in the patent process;

incentive compensation in the form of stock-based compensation expense; and

charges for infrastructure and centralized costs of facilities and information technology.

We allocate certain costs of intellectual property to cost of service revenue when they relate directly to our service contracts, primarily for support services provided to IV. For direct billable labor hours, we allocate to cost of service revenue:

salaries;

a payroll tax and benefits factor; and

incentive compensation related to our stock compensation plans.

Intellectual property expenses can vary from period to period based on:

the level of capitalized patent activity, and

prosecution costs and direct labor hours (salaries, payroll taxes and benefits factor and incentive compensation related to our stock compensation plans) related to the patents that were exclusively licensed to IV that are allocated to cost of revenue.

Intellectual property expenses for the three- and nine-month periods ended September 30, 2011, compared to the corresponding three- and nine-month periods ended September 30, 2010, decreased slightly, and reflect the variable spending levels described in the preceding paragraph.

We anticipate that we will continue to invest in intellectual property expenses at existing levels.

**Table of Contents***Stock-based compensation*

|                                       | Three<br>Months<br>Ended<br>September 30,<br>2011 | Three<br>Months<br>Ended<br>September 30,<br>2010 | Dollar<br>Increase | Percent<br>Increase | Nine<br>Months<br>Ended<br>September 30,<br>2011 | Nine<br>Months<br>Ended<br>September 30,<br>2010 | Dollar<br>Increase | Percent<br>Increase |
|---------------------------------------|---|---|--------------------|---------------------|--|--|--------------------|---------------------|
| Cost of revenue                       | \$ 158  | \$ 84   | \$ 74              | 88%                 | \$ 446   | \$ 272   | \$ 174             | 64%                 |
| Sales and marketing                   | 87  | 50  | 37                 | 74%                 | 248  | 141  | 107                | 76%                 |
| Research, development and engineering | 174   | 79  | 95                 | 120%                | 440  | 225  | 215                | 96%                 |
| General and administrative            | 590   | 542   | 48                 | 9%                  | 1,761  | 1,576  | 185                | 12%                 |
| Intellectual property                 | 48  | 27  | 21                 | 78%                 | 143  | 73   | 70                 | 96%                 |
| Total                                 | \$ 1,057  | \$ 782  | \$ 275             | 35%                 | \$ 3,038   | \$ 2,287   | \$ 751             | 33%                 |

The increases in stock-based compensation expense for the three- and nine-month periods ended September 30, 2011, compared to the corresponding three- and nine-month periods ended September 30, 2010, were primarily due to an additional layer of stock-based awards. We anticipate incurring an additional \$7,795 in stock-based compensation expense through September 2015 for awards outstanding as of September 30, 2011.

*Net loss from joint ventures*

|  | Three<br>Months<br>Ended<br>September 30,<br>2011 | Three<br>Months<br>Ended<br>September 30,<br>2010 | Dollar<br>Increase | Percent<br>Increase | Nine<br>Months<br>Ended<br>September 30,<br>2011 | Nine<br>Months<br>Ended<br>September 30,<br>2010 | Dollar<br>Increase | Percent<br>Increase |
|--|---|---|--------------------|---------------------|--|--|--------------------|---------------------|
| Net loss from joint ventures                           | \$ (695)  | \$ (558)  | \$ 137             | 25 %                | \$ (1,930)                                       | \$ (1,576)                                       | \$ 354             | 22 %                |
| Net loss from joint venture<br>(as % of total revenue) | 8%  | 11%   |                    |                     | 7%   | 7%   |                    |                     |

The increases in the net loss from joint ventures for the three- and nine-month periods ended September 30, 2011, compared to the corresponding three- and nine-month periods ended September 30, 2010, resulted primarily from increased litigation costs in connection with the legal matter with Walker Digital, and increased research, development and engineering costs for product development.

*Interest income, net*

|   | Three<br>Months<br>Ended<br>September 30,<br>2011 | Three<br>Months<br>Ended<br>September 30,<br>2010 | Dollar<br>Decrease | Percent<br>Decrease | Nine<br>Months<br>Ended<br>September 30,<br>2011 | Nine<br>Months<br>Ended<br>September 30,<br>2010 | Dollar<br>Decrease | Percent<br>Decrease |
|---|---|---|--------------------|---------------------|--|--|--------------------|---------------------|
| Interest income, net                            | \$ 43   | \$ 62   | 19                 | 31%                 | \$ 149   | \$ 184   | 35                 | 19%                 |
| Interest income, net (as % of<br>total revenue) | 0%  | 1%  |                    |                     | 1%   | 1%   |                    |                     |

The decreases in interest income, net for the three- and nine-month periods ended September 30, 2011, compared to the corresponding three- and nine-month periods ended September 30, 2010, was primarily due to a combination of lower balances and lower interest earned on cash and investment balances. The lower balances primarily resulted from cash expended for stock repurchases, net of cash provided from operations and the lower interest rates reflect continued monetary policy set by the federal government.

*Provision for Income Taxes*

Our income tax provision for the three- and nine-month periods ended September 30, 2011 were a tax expense of \$0.1 million and a tax benefit of \$1.8 million, respectively. The tax benefit includes a \$2.6 million deferred tax benefit resulting from the valuation allowance release. During the second quarter of 2011 we concluded, based on projections of future income, that it is more likely than not that our deferred tax assets will be realized.

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There were no provisions for income taxes, other than estimated U.S. alternative minimum taxes and foreign withholding taxes, for the three- and nine-month periods ended September 30, 2010.

On a quarterly basis, we estimate what our effective tax rate will be for the full fiscal year and record a quarterly income tax provision based on the anticipated rate. As the year progresses, we refine our estimate based on the facts and circumstances of each tax jurisdiction.

**Liquidity and Capital Resources**

|   | September 30,<br>2011 | December 31,<br>2010 |
|---|-----------------------|----------------------|
| Working capital   | \$ 27,880             | \$ 35,526            |
| Current (liquidity) ratio(1)                                | 8.8:1                 | 9.7:1                |
| Cash, cash equivalents and short-term marketable securities | \$ 26,533             | \$ 34,781            |
| Long-term marketable securities                             | \$ 4,683              | \$ 11,163            |
| Total cash, cash equivalents and all marketable securities  | \$ 31,216             | \$ 45,944            |

(1) The current (liquidity) ratio is calculated by dividing total current assets by total current liabilities.

The \$14.7 million decrease in cash, cash equivalents and all marketable securities, and the largest contributor to the \$7.6 million decrease in working capital, resulted primarily from:

the purchase of common stock from a shareholder, Koninklijke Philips Electronics N.V, in a privately negotiated transaction;

purchases of common stock related to the vesting of restricted stock and exercise of stock options in satisfaction of required withholding tax liability, and repurchases made under our stock repurchase program; and

cash contributions to the joint ventures with Nielsen.

*Operating Cash Flow.* The components of operating cash flows were:

|   | Nine<br>Months<br>Ended<br>September 30,<br>2011 | Nine<br>Months<br>Ended<br>September 30,<br>2010 | Dollar<br>Increase<br>(Decrease) | Percent<br>Increase<br>(Decrease) |
|---|--|--|----------------------------------|-----------------------------------|
| Net income                                  | \$ 5,203   | \$ 1,420   | \$ 3,783                         | 266%                              |
| Non-cash items                              | 2,896  | 4,347  | (1,451)                          | (33)%                             |
| Changes in operating assets and liabilities | (343)  | 80   | (423)                            | (529)%                            |
| Net cash provided by operating activities   | \$ 7,756   | \$ 5,847   | \$ 1,909                         | 33%                               |

**Net income.**

The increase in operating results for the nine-month period ended September 30, 2011, compared to the corresponding nine-month period ended September 30, 2010, reflects higher license revenues primarily related to IV and Verance, offset by increased operating expenses related to our mobile device market initiatives and the litigation matter with Verance and a one-time licensing payment of \$4.5 million from Arbitron in the prior period. In addition, we reversed the valuation allowance on our deferred tax assets in the second quarter of 2011 and recorded the tax assets

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in the financial statements which resulted in a recognized tax benefit of \$2.6 million valuation allowance release, offset by the \$0.8 million current income tax provision.

### *Non-cash items.*

The decrease in non-cash items for the nine-month period ended September 30, 2011, compared to the corresponding nine-month period ended September 30, 2010, was primarily the result of the deferred income tax benefit that resulted from the reversal of the valuation allowance on our deferred tax assets in the second quarter of 2011, offset by the net losses from the joint ventures, an additional layer of stock-based awards and the tax benefits from stock-based awards.

### *Operating assets and liabilities.*

The primary changes in the operating assets and liabilities for the nine-month period ended September 30, 2011 related to:

amortization of deferred revenue; offset by

reimbursement from our landlord for the tenant improvement allowance.



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The primary changes in the operating assets and liabilities for the nine-month period ended September 30, 2010 relate to:

collection of advanced billings, as provided in our contracts with customers; and

a decrease in compensation related liabilities related to accrued bonuses at year-end in 2009 that were paid compared to none accrued in 2010.

***Cash flows from investing activities.***

The cash flows from investing activities for the nine-month period ended September 30, 2011 and the same period in the prior year related to:

investments made in property and equipment, primarily in our information technology area for computer systems and related equipment used to operate our business;

investments made in the patent application and granting process;

investments made in joint ventures; and

net activity from investing our short- and long-term marketable securities.

***Cash flows from financing activities.***

The cash flows from financing activities for the nine-month period ended September 30, 2011 related to the increase in purchases of common stock for the following:

purchase of common stock from a shareholder in a privately negotiated transaction;

purchases of common stock as part of our stock repurchase program;

purchases of common stock for the withholding of shares upon the vesting of restricted stock to satisfy tax withholding obligations; offset by

the exercise of stock options; and

the excess tax benefit from stock-based awards.

The cash flows from financing activities for the nine-month period ended September 30, 2010, were the result of purchases of common stock for the withholding of shares upon vesting of restricted stock to satisfy tax withholding obligations, partially offset by the exercise of stock options.

***Future Cash Expectations.***

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Since the inception of our stock repurchase program in April 2009, through September 30, 2011, our Board of Directors has authorized the repurchase of \$5.0 million of our common stock. As of September 30, 2011, we had repurchased 216,244 shares under this program at an aggregate purchase price of \$4.7 million. Shares of our common stock may be purchased in the open market or through privately negotiated transactions, subject to market conditions. This repurchase program does not obligate us to acquire any specific number of shares or to acquire shares over any specified period of time.

In connection with the IV arrangement, our cash flow has improved, and we believe it will continue to improve, with the:

payment of the license issue fee in increasing quarterly installments over three years,

consulting fees payable over five years, and

additional cost savings resulted from IV's assumption of the prosecution and maintenance costs related to the patents and patent applications that were licensed to IV that were previously borne by us.

We believe that our current cash, cash equivalents, and short-term marketable securities balances will satisfy our projected working capital and capital expenditure requirements for at least the next 12 months. Thereafter, we anticipate continuing to use cash, cash equivalents and marketable securities balances to satisfy our projected working capital and capital expenditure requirements.

We may use cash resources to repurchase stock under our stock repurchase program and fund acquisitions or investments in complementary businesses, technologies or product lines. In order to take advantage of certain opportunities, we may find it necessary to obtain additional equity financing, debt financing, or credit facilities. We do not believe at this time, however, that our long-term working capital and capital expenditures would require us to take steps to remedy any potential deficiencies. If it were necessary to obtain additional financing or credit facilities, we may not be able to do so, or if these funds are available, they may not be available on satisfactory terms.

**Table of Contents****Contractual Obligations**

Pursuant to the terms of the joint venture agreements with Nielsen, we are obligated to contribute an aggregate of \$6.7 million to the joint ventures payable in quarterly installments from July 2009 through October 2011, of which \$0.7 million remained to be contributed as of September 30, 2011.

In May 2010 we entered into an amendment with the landlord of our corporate offices to extend the length of our facilities lease through August 2016 for rent payments totaling \$5.3 million.

Our obligations under non-cancelable operating leases for our facilities and various equipment leases totaled \$4.2 million as of September 30, 2011, and are payable in monthly installments through August 2016.

|                                   | Total           | Payment Due by Period |                 |                 | More than<br>5 years |
|-----------------------------------|-----------------|-----------------------|-----------------|-----------------|----------------------|
|                                   |                 | Less than<br>1 year   | 1-3 years       | 3-5 years       |                      |
| Total joint venture obligations   | \$ 700          | \$ 700                | \$              | \$              | \$                   |
| Total operating lease obligations | 4,230           | 817                   | 1,701           | 1,712           |                      |
| <b>Total obligations</b>          | <b>\$ 4,930</b> | <b>\$ 1,517</b>       | <b>\$ 1,701</b> | <b>\$ 1,712</b> | <b>\$</b>            |

Other than as described above, as of September 30, 2011 there have been no material changes in the contractual obligations disclosed in our 2010 Annual Report.

**Off-Balance Sheet Arrangements**

We do not have any off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on our financial condition, changes in financial condition, revenue or expenses, results of operations, liquidity, capital expenditures or capital resources that are material to our business.

**Safe Harbor Statement under the Private Securities Litigation Reform Act of 1995**

This Quarterly Report on Form 10-Q includes forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934 and Section 27A of the Securities Act of 1933. Words such as may, plan, should, could, expect, anticipate, intend, believe, forecast, estimate, continue, variations of such terms or similar expressions are intended to identify such forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These forward-looking statements, or other statements made by us, are made based on our expectations and beliefs concerning future events impacting us, and are subject to uncertainties and factors (including those specified below), which are difficult to predict and, in many instances, are beyond our control. As a result, our actual results could differ materially from those expressed in or implied by any such forward-looking statements, and investors are cautioned not to place undue reliance on such statements. Forward-looking statements include but are not limited to statements relating to:

concentration of revenues with few customers comprising a large majority of the revenues;

trends and expectations in revenue levels;

our future level of investment in our business and the joint ventures in which we have invested, including investment in research, development and engineering of products and technology, development of our intellectual property, the acquisition of new customers and development of new market opportunities;

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our ability to improve margins;

anticipated expenses, costs, margins, provision for income taxes and investment activities in the foreseeable future, including estimated increases in stock-based compensation expenses through September 2015;

anticipated revenue to be generated from current contracts and as a result of new programs;

variability of contracted arrangements;

our profitability in future periods;

business opportunities that could require that we seek additional financing;

the size and growth of our markets;

the existence of international growth opportunities and our future investment in such opportunities;

the source of our future revenue;

our expected short-term and long-term liquidity positions;

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our capital expenditure and working capital requirements and our ability to fund our capital expenditure and working capital needs through;

capital market conditions, including the recent economic crisis, interest rate volatility and other limitations on the availability of capital, which could have an impact on our cost of capital and our ability to access the capital markets;

our use of cash, cash equivalents and marketable securities in upcoming quarters;

anticipated levels of backlog in future periods;

the success of our arrangements with Intellectual Ventures;

protection, development and monetization of our intellectual property portfolio; and

other risks detailed in our filings with the Securities and Exchange Commission, including the risk factors set forth in Part I, Item 1A of our 2010 Annual Report.

We believe that the risk factors contained in Part I, Item 1A of our 2010 Annual Report could affect our future performance and the liquidity and value of our securities and cause our actual results to differ materially from those expressed or implied by forward-looking statements made by us or on our behalf. Investors should understand that it is not possible to predict or identify all risk factors and that there may be other factors that may cause our actual results to differ materially from the forward-looking statements. All forward-looking statements made by us or by persons acting on our behalf apply only as of the date of this Quarterly Report on Form 10-Q. We do not undertake any obligation to publicly update or revise any forward-looking statements to reflect future events, information or circumstances that arise after the date of the filing of this Quarterly Report on Form 10-Q.

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

The market risk disclosures as set forth in Part II, Item 7A of our 2010 Annual Report have not changed materially.

**Item 4. Controls and Procedures.**

**Evaluation of Disclosure Controls and Procedures**

We conducted an evaluation (pursuant to Rule 13a-15(b) of the Securities Exchange Act of 1934 (the Exchange Act)), under the supervision and with the participation of management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e)) as of the end of the period covered by this Form 10-Q. These disclosure controls and procedures are designed to ensure that information required to be disclosed in our reports that are filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. Our disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that this information is accumulated and communicated to management, including the principal executive and principal financial officers, or persons performing similar functions, as appropriate, to allow timely decisions regarding required disclosure. Based on the evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that these disclosure controls and procedures were effective as of the end of the period covered by this Form 10-Q.

**Changes in Controls**

There was no change in our internal control over financial reporting (as defined in Rule 13a-15(f) and 15d-15(f) of the Exchange Act of 1934) that occurred during the fiscal quarter ended September 30, 2011 that has materially affected, or is reasonably likely to materially affect, our

internal control over financial reporting.

**Table of Contents****PART II. OTHER INFORMATION.****Item 1. Legal Proceedings.**

Verance Corporation, a Digimarc licensee, filed a declaratory judgment action against Digimarc in the United States District Court in Delaware on September 30, 2010, alleging the invalidity and non infringement of 22 patents held by Digimarc. Verance Corp. v. Digimarc Corp., 1:10-cv-00831-UNA. The District Court dismissed Verance's action. On September 9, 2011 Verance filed a Notice of Appeal with the Court of Appeals for the Federal Circuit.

On December 6, 2010, Digimarc filed suit against Verance Corporation in the District of Oregon. Digimarc is seeking payment for breach of contract by Verance related to Verance's failure to make payments under the licensing agreement between Digimarc and Verance. Digimarc Corp. v. Verance Corp., CV 10-1489 JE. On April 29, 2011, the Magistrate Judge denied Verance's motion to dismiss or stay the action, and to compel arbitration on April 29, 2011. The case is pending.

Digimarc was named as one of several defendants in a complaint filed by Walker Digital, LLC ( Walker ), in the U.S. District Court for the District of Delaware on April 22, 2011, case number 11-cv-00363-UNA, alleging patent infringement. The case was settled in early October 2011 with a negotiated patent license arrangement between TVaura Mobile LLC and Walker.

**Item 1A. Risk Factors**

Detailed information about risk factors that may affect Digimarc's actual results are set forth in Part I, Item 1A of our 2010 Annual Report.

Our business, financial condition, results of operations and cash flows may be affected by a number of factors, including the factors set forth in our 2010 Annual Report. The risks and uncertainties described in our 2010 Annual Report are those risks of which we are aware and that we consider to be material to our business. If any of the risks and uncertainties develops into actual events, our business, financial condition, results of operations, or cash flows could be materially adversely affected. In that case, the trading price of our common stock could decline.

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

In April 2009, the Board of Directors approved a stock repurchase program authorizing the purchase, at the discretion of management, of up to \$5.0 million in shares of our common stock through either periodic open-market or private transactions at then-prevailing market prices through April 30, 2010. In both April 2010 and April 2011, the Board of Directors approved an extension of the stock repurchase program for additional one year periods. We have paid \$4.7 million to repurchase 216,244 shares of outstanding common stock under this program since the program's inception and \$0.3 million remains available to repurchase common stock under the stock repurchase program.

In addition to the stock repurchase program described above, and the withholding (repurchase) of shares of common stock in connection with the vesting of restricted shares, described below, from time to time we repurchase shares in connection with stock option exercises, to cover exercise price and taxes.

The following table sets forth information regarding purchases of our equity securities during the three-month period ended September 30, 2011:

| Period | (a)<br>Total number of<br>shares<br>purchased (1) | (b)<br>Average price<br>paid per<br>share (1) | (c)<br>Total number of<br>shares (or<br>units)<br>purchased as<br>part of<br>publicly<br>announced plans<br>or programs | (d)<br>Maximum number<br>(or approximate<br>dollar value) of<br>shares (or units)<br>that may yet<br>be purchased<br>under the plans<br>or programs |
|--------|---|---|---|---|
|        |   |   |   |   |

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|   |               |           |              |                       |
|---|---------------|-----------|--------------|-----------------------|
| <b>Month 1</b>                          |               |           |              |                       |
| July 1, 2011 to July 31, 2011           | 21,282        | \$        | 41.01        | \$ 2.3 million        |
| <b>Month 2</b>                          |               |           |              |                       |
| August 1, 2011 to August 31, 2011       | 3,371         | \$        | 38.61        | 43,500 \$ 0.8 million |
| <b>Month 3</b>                          |               |           |              |                       |
| September 1, 2011 to September 30, 2011 | 4,689         | \$        | 30.93        | 20,000 \$ 0.3 million |
| <b>Total</b>                            | <b>29,342</b> | <b>\$</b> | <b>39.13</b> | <b>63,500</b>         |

- (1) Includes stock option shares and fully vested restricted stock shares of common stock withheld (purchased) by us in satisfaction of required withholding tax liability.



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**Item 6. Exhibits.**

| <b>Exhibit Number</b> | <b>Exhibit Description</b>  |
|-----------------------|---|
| 31.1                  | Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer |
| 31.2                  | Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer |
| 32.1                  | Section 1350 Certification of Chief Executive Officer             |
| 32.2                  | Section 1350 Certification of Chief Financial Officer             |
| 101.INS               | XBRL Instance Document  |
| 101.SCH               | XBRL Taxonomy Extension Schema Document                           |
| 101.CAL               | XBRL Taxonomy Extension Calculation Linkbase Document             |
| 101.DEF               | XBRL Taxonomy Extension Definition Linkbase Document              |
| 101.LAB               | XBRL Taxonomy Extension Label Linkbase Document                   |
| 101.PRE               | XBRL Taxonomy Extension Label Linkbase Document                   |

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**SIGNATURES**

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

Date: October 26, 2011

DIGIMARC CORPORATION

By:

/s/ MICHAEL McCONNELL  
Michael McConnell

*Chief Financial Officer and Treasurer*

*(Duly Authorized Officer*

*and Principal Financial and Accounting Officer)*

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