

Digimarc CORP
Form 10-Q
April 29, 2011
Table of Contents

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

For the quarterly period ended March 31, 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)

Edgar Filing: Digimarc CORP - Form 10-Q

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 April 25, 2011, there were 6,963,950 shares of the registrant's common stock, par value \$0.001 per share, outstanding.

Table of Contents

Table of Contents

PART I FINANCIAL INFORMATION

| | | |
|---------|---|----|
| Item 1. | <u>Financial Statements (Unaudited):</u> | 3 |
| | <u>Balance Sheets as of March 31, 2011 and December 31, 2010</u> | 3 |
| | <u>Statements of Operations for the three-months ended March 31, 2011 and 2010</u> | 4 |
| | <u>Statements of Shareholders' Equity as of the period ended March 31, 2011 and December 31, 2010</u> | 5 |
| | <u>Statements of Cash Flows for the three-months ended March 31, 2011 and 2010</u> | 6 |
| | <u>Notes to Financial Statements</u> | 7 |
| Item 2. | <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 21 |
| Item 3. | <u>Quantitative and Qualitative Disclosures About Market Risk</u> | 32 |
| Item 4. | <u>Controls and Procedures</u> | 32 |

PART II OTHER INFORMATION

| | | |
|----------|--|----|
| Item 1. | <u>Legal Proceedings</u> | 33 |
| Item 1A. | <u>Risk Factors</u> | 33 |
| Item 2. | <u>Unregistered Sales of Equity Securities and Use of Proceeds</u> | 33 |
| Item 6. | <u>Exhibits</u> | 34 |
| | <u>SIGNATURES</u> | 35 |

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

| | March 31, 2011 | December 31, 2010(1) |
|--|-------------------|-------------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 7,423 | \$ 6,340 |
| Marketable securities | 21,421 | 28,441 |
| Trade accounts receivable, net | 2,725 | 3,481 |
| Other current assets | 812 | 1,345 |
| Total current assets | 32,381 | 39,607 |
| Marketable securities | 4,264 | 11,163 |
| Property and equipment, net | 1,342 | 1,330 |
| Intangibles, net | 2,288 | 2,174 |
| Investments in joint ventures | 1,192 | 1,029 |
| Other assets, net | 408 | 462 |
| Total assets | \$ 41,875 | \$ 55,765 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable and other accrued liabilities | \$ 1,652 | \$ 1,519 |
| Deferred revenue | 2,324 | 2,562 |
| Total current liabilities | 3,976 | 4,081 |
| Long-term liabilities | 510 | 525 |
| Total liabilities | 4,486 | 4,606 |
| Commitments and contingencies (Note 11) | | |
| Shareholders' equity: | | |
| Preferred stock (10,000 shares issued and outstanding at March 31, 2011 and December 31, 2010) | 50 | 50 |
| Common stock (6,964,345 and 7,443,450 shares issued and outstanding at March 31, 2011 and December 31, 2010, respectively) | 7 | 7 |
| Additional paid-in capital | 34,901 | 49,609 |
| Retained earnings | 2,431 | 1,493 |
| Total shareholders' equity | 37,389 | 51,159 |
| Total liabilities and shareholders' equity | \$ 41,875 | \$ 55,765 |

Edgar Filing: Digimarc CORP - Form 10-Q

- (1) Derived from the Company's December 31, 2010 audited financial statements
See Notes to Unaudited Financial Statements.

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

| | Three Months Ended March 31, 2011 | Three Months Ended March 31, 2010 |
|---|--|--|
| Revenue: | | |
| Service | \$ 3,069 | \$ 3,514 |
| License and subscription | 6,022 | 6,678 |
| Total revenue | 9,091 | 10,192 |
| Cost of revenue: | | |
| Service | 1,584 | 1,800 |
| License and subscription | 65 | 57 |
| Total cost of revenue | 1,649 | 1,857 |
| Gross profit | 7,442 | 8,335 |
| Operating expenses: | | |
| Sales and marketing | 1,102 | 741 |
| Research, development and engineering | 1,775 | 1,259 |
| General and administrative | 2,847 | 1,885 |
| Intellectual property | 301 | 257 |
| Total operating expenses | 6,025 | 4,142 |
| Operating income | 1,417 | 4,193 |
| Net loss from joint ventures | (537) | (457) |
| Interest income, net | 58 | 61 |
| Income before provision for income taxes | 938 | 3,797 |
| Provision for income taxes | | (21) |
| Net income | \$ 938 | \$ 3,776 |
| Earnings per share: | | |
| Net income per share basic | \$ 0.14 | \$ 0.53 |
| Net income per share diluted | \$ 0.12 | \$ 0.51 |
| Weighted average shares outstanding basic | 6,864 | 7,096 |
| Weighted average shares outstanding diluted | 7,505 | 7,387 |

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 paid-in capital | Retained Earnings (Accumulated Deficit) | Total shareholders equity |
|---|-----------------|--------|--------------|--------|----------------------------------|--|---------------------------------|
| | Shares | Amount | Shares | Amount | | | |
| BALANCE AT DECEMBER 31, 2009 | 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 |
| BALANCE AT DECEMBER 31, 2010 | 10,000 | \$ 50 | 7,443,450 | \$ 7 | \$ 49,609 | \$ 1,493 | \$ 51,159 |
| Exercise of stock options | | | | | | | |
| Issuance of restricted common stock | | | 101,180 | | | | |
| Purchase and retirement of common stock | | | (580,285) | | (15,705) | | (15,705) |
| Stock-based compensation | | | | | 997 | | 997 |
| Net income | | | | | | 938 | 938 |
| BALANCE AT MARCH 31, 2011 | 10,000 | \$ 50 | 6,964,345 | \$ 7 | \$ 34,901 | \$ 2,431 | \$ 37,389 |

See Notes to Unaudited Financial Statements.

Table of Contents

DIGIMARC CORPORATION
STATEMENTS OF CASH FLOWS

(In thousands)

(UNAUDITED)

| | Three Months Ended March 31, 2011 | Three Months Ended March 31, 2010 |
|---|---|---|
| Cash flows from operating activities: | | |
| Net income | \$ 938 | \$ 3,776 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization, property and equipment | 153 | 153 |
| Amortization, intangibles | 26 | 13 |
| Stock-based compensation | 986 | 740 |
| Net loss from joint ventures | 537 | 457 |
| Changes in operating assets and liabilities: | | |
| Trade accounts receivable, net | 756 | 720 |
| Other current assets | 533 | 132 |
| Other assets, net | 54 | 14 |
| Accounts payable and other accrued liabilities | 119 | (431) |
| Deferred revenue | (239) | (193) |
| Net cash provided by operating activities | 3,863 | 5,381 |
| Cash flows from investing activities: | | |
| Purchase of property and equipment | (165) | (71) |
| Capitalized patent costs | (129) | (236) |
| Investments in joint ventures | (700) | (700) |
| Sale or maturity of marketable securities | 42,234 | 17,756 |
| Purchase of marketable securities | (28,315) | (18,743) |
| Net cash provided by (used in) investing activities | 12,925 | (1,994) |
| Cash flows from financing activities: | | |
| Issuance of common stock | | 8 |
| Purchase of common stock | (15,705) | (22) |
| Net cash used in financing activities | (15,705) | (14) |
| Net increase in cash and cash equivalents | 1,083 | 3,373 |
| Cash and cash equivalents at beginning of period | 6,340 | 8,884 |
| Cash and cash equivalents at end of period | \$ 7,423 | \$ 12,257 |
| Supplemental disclosure of cash flow information: | | |
| Cash paid for income taxes | \$ | \$ 21 |
| Supplemental schedule of non-cash investing activities: | | |
| Stock-based compensation capitalized to patent costs | \$ 11 | \$ 11 |

See Notes to Unaudited Financial Statements.

Table of Contents

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 were provided a share 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 \$7,405 and \$6,036 at March 31, 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.

Table of Contents

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.

| | March 31, 2011 | December 31, 2010 |
|--|-----------------------|--------------------------|
| Marketable securities, at amortized cost | \$ 31,161 | \$ 43,898 |
| Cash equivalents, included above | \$ 5,476 | \$ 4,294 |
| Money market funds | \$ 1,929 | \$ 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.

Table of Contents

Equity Method Investments

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.

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 March 31, 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.

Edgar Filing: Digimarc CORP - Form 10-Q

The Company uses the Black-Scholes option pricing model as its method of valuation for stock-based awards. The Company's determination of the fair value of stock-based 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

Table of Contents

exercise behaviors. Although the fair value of stock-based 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 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.

2. Recent Accounting Standards Update

In April 2010, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (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. The Company does not expect this standard to have a material effect on the financial condition or results of operations in periods after the initial adoption.

3. Revenue Recognition

We derive our revenue primarily from development services and licensing of our 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.

Table of Contents

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.

Pursuant to the relative selling price method, the Company did not note any changes from the residual method for the following:

units of accounting;

how the consideration is allocated to the various units of accounting; and

the pattern and timing of revenue recognition.

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.

License revenue is recognized when amounts owed to the Company have been earned, are fixed or determinable (within our normal 30 to 60 day payment terms), and collection is probable. If the payment terms extend beyond our 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.

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.

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

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

As noted above, the Company's standard payment terms for license arrangements are 30 to 60 days. Extended payment terms increase the likelihood we 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 our patent licensing business. As such, revenue on license arrangements with extended payment terms are recognized as fees become fixed and determinable.

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

Edgar Filing: Digimarc CORP - Form 10-Q

customers. The Company markets its products in the U.S. and in non-U.S. countries through its sales personnel.

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

| | Three Months Ended March 31, 2011 | Three Months Ended March 31, 2010 |
|---------------|--|--|
| Domestic | \$ 6,070 | \$ 7,240 |
| International | 3,021 | 2,952 |
| Total | \$ 9,091 | \$ 10,192 |

Table of Contents*Major Customers*

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

| | Three Months Ended March 31, 2011 | Three Months Ended March 31, 2010 |
|-----------------------|--|--|
| Intellectual Ventures | 33% | |
| Central Banks | 26% | 24% |
| Verance | 13% | * |
| The Nielsen Company | 11% | * |
| Arbitron | | 44% |

* Less than 10%

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 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. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model.

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.

Edgar Filing: Digimarc CORP - Form 10-Q

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.

Table of Contents

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

| | 2011 | 2010 |
|--------------------------|-------------|-------------|
| 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% |

| | Three Months Ended March 31, 2011 | Three Months Ended March 31, 2010 |
|-------------------------------------|--|--|
| Fair value of stock options granted | \$ 954 | \$ 893 |

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.

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. 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 Months Ended March 31, 2011 | Three Months Ended March 31, 2010 |
|---------------------------------------|--|--|
| Stock-based compensation: | | |
| Cost of revenue | \$ 110 | \$ 97 |
| Sales and marketing | 85 | 42 |
| Research, development and engineering | 158 | 70 |
| General and administrative | 585 | 507 |
| Intellectual property | 48 | 24 |
| Stock-based compensation expense | 986 | 740 |
| Capitalized to patent costs | 11 | 11 |
| Total stock-based compensation | \$ 997 | \$ 751 |

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

Edgar Filing: Digimarc CORP - Form 10-Q

| | As of March 31, 2011 | As of December 31, 2010 |
|---------------------------------|----------------------------|-------------------------------|
| Unrecognized compensation costs | \$ 9,206 | \$ 6,212 |

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

Table of Contents

The Company expects to recognize this compensation cost for stock options and restricted stock over a weighted average period through March 2015:

| | Stock Options | Restricted Stock |
|-------------------------|---------------|------------------|
| Weighted average period | 1.14 years | 2.00 years |

Stock Option Activity

As of March 31, 2011, under all of the Company's stock-based compensation plans, options to purchase an additional 929,530 shares were authorized for future grants under the plans. The Company issues new shares upon option exercises.

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

| | Options | Weighted Average Exercise Price | Weighted Average Grant Date Fair Value | Aggregate Intrinsic Value |
|---|-----------|---------------------------------|--|---------------------------|
| Three-months ended March 31, 2011: | | | | |
| Outstanding at December 31, 2010 | 993,491 | \$ 10.47 | \$ 6.55 | |
| Options granted | 75,000 | \$ 30.01 | \$ 12.72 | |
| Options exercised | | | | |
| Options canceled or expired | | | | |
| Outstanding at March 31, 2011 | 1,068,491 | \$ 11.84 | \$ 6.98 | \$ 18,307 |
| Exercisable at March 31, 2011 | 491,080 | \$ 10.56 | | \$ 9,008 |
| Unvested at March 31, 2011 | 577,411 | \$ 12.93 | | \$ 9,299 |

The aggregate intrinsic value is based on the closing price of \$28.90 per share of Digimarc common stock on March 31, 2011, which would have been received by the optionees had all of the options with exercise prices less than \$28.90 per share been exercised on that date.

The following table summarizes information about stock options outstanding at March 31, 2011:

| Range of Exercise Prices | Options Outstanding | | | Options Exercisable | | |
|--------------------------|---------------------|------------------------------------|------------------------|---------------------|------------------------------------|------------------------|
| | Number Outstanding | Remaining Contractual Life (Years) | Weighted Average Price | Number Exercisable | Remaining Contractual Life (Years) | Weighted Average Price |
| \$9.64 | 827,241 | 7.58 | \$ 9.64 | 402,120 | 7.58 | \$ 9.64 |
| \$9.91 | 30,000 | 8.08 | \$ 9.91 | 30,000 | 8.08 | \$ 9.91 |
| \$14.99 | 106,250 | 8.76 | \$ 14.99 | 28,335 | 8.76 | \$ 14.99 |
| \$18.01 | 30,000 | 9.08 | \$ 18.01 | 27,500 | 9.08 | \$ 18.01 |
| \$30.01 | 75,000 | 9.76 | \$ 30.01 | 3,125 | 9.76 | \$ 30.01 |
| \$9.64 - \$30.01 | 1,068,491 | 7.91 | \$ 11.84 | 491,080 | 7.78 | \$ 10.56 |

Table of Contents*Restricted Stock Activity*

The following table reconciles the unvested balance of restricted stock:

| | Number of Shares | Weighted Average Grant Date Fair Value |
|---|---------------------|---|
| Three-months ended March 31, 2011: | | |
| Unvested balance, December 31, 2010 | 197,760 | \$ 14.25 |
| Granted | 101,180 | \$ 30.01 |
| Vested | (27,335) | \$ 14.51 |
| Canceled | | |
| Unvested balance, March 31, 2011 | 271,605 | \$ 20.09 |

6. Trade Accounts Receivable*Trade Accounts Receivable*

Trade accounts receivable are recorded at the invoiced amount.

| | March 31, 2011 | December 31, 2010 |
|--|-------------------|----------------------|
| Trade accounts receivable | \$ 2,725 | \$ 3,481 |
| Allowance for doubtful accounts | | |
| Trade accounts receivable, net | \$ 2,725 | \$ 3,481 |
| Unpaid deferred revenues included in accounts receivable | \$ 1,168 | \$ 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 nor deferred revenue accounts.

Major customers

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

Edgar Filing: Digimarc CORP - Form 10-Q

| | March 31, 2011 | December 31, 2010 |
|---------------------|-------------------|----------------------|
| The Nielsen Company | 37% | 29% |
| Central Banks | 27% | 43% |
| Civolution | 15% | 11% |
| TVaura LLC | 10% | * |

* Less than 10%

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.

Table of Contents

| | March 31, 2011 | December 31, 2010 |
|--|-------------------|----------------------|
| Office furniture fixtures | \$ 294 | \$ 294 |
| Equipment | 1,530 | 1,365 |
| Leasehold improvements | 986 | 986 |
| | 2,810 | 2,645 |
| Less accumulated depreciation and amortization | (1,468) | (1,315) |
| | \$ 1,342 | \$ 1,330 |

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.

| | March 31, 2011 | December 31, 2010 |
|--------------------------|-------------------|----------------------|
| Gross intangible assets | \$ 2,430 | \$ 2,290 |
| Accumulated amortization | (142) | (116) |
| Intangible assets, net | \$ 2,288 | \$ 2,174 |

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. The Company will provide technical and development services to TVaura LLC's business of 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.

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.

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

Related Party Transactions

Edgar Filing: Digimarc CORP - Form 10-Q

| | Three Months Ended March 31, 2011 | Three Months Ended March 31, 2010 |
|-----------------------|---|---|
| TVaura LLC: | | |
| Capital contributions | \$ 400 | \$ 400 |
| Revenue(1) | \$ 691 | \$ 692 |
| TVaura Mobile LLC: | | |
| Capital contributions | \$ 300 | \$ 300 |
| Total: | | |
| Capital contributions | \$ 700 | \$ 700 |
| Revenue(1) | \$ 691 | \$ 692 |

(1) Technical and development services

Table of Contents

| | March 31, 2011 | December 31, 2010 |
|---------------------|----------------|-------------------|
| TVaura LLC: | | |
| Accounts receivable | \$ 283 | \$ 255 |

Summarized financial data for TVaura LLC:

| | March 31, 2011 | December 31, 2010 |
|------------------------|----------------|-------------------|
| Current assets | \$ 892 | \$ 777 |
| Noncurrent assets | \$ 29 | \$ 31 |
| Current liabilities | \$ 284 | \$ 255 |
| Noncurrent liabilities | \$ | \$ |

| | Three Months Ended March 31, 2011 | Three Months Ended March 31, 2010 |
|---------------------------------------|---|---|
| Revenue | \$ | \$ |
| Gross profit | \$ | \$ |
| Operating expenses | \$ 717 | \$ 740 |
| Net loss from continuing operations | \$ (716) | \$ (740) |
| The Company's pro-rata share net loss | \$ (365) | \$ (377) |

Summarized financial data for TVaura Mobile LLC:

| | March 31, 2011 | December 31, 2010 |
|------------------------|----------------|-------------------|
| Current assets | \$ 1,893 | \$ 1,831 |
| Noncurrent assets | \$ | \$ |
| Current liabilities | \$ 91 | \$ 279 |
| Noncurrent liabilities | \$ | \$ |

| | Three Months Ended March 31, 2011 | Three Months Ended March 31, 2010 |
|---------------------------------------|---|---|
| Revenue | \$ | \$ |
| Gross profit | \$ | \$ |
| Operating expenses | \$ 350 | \$ 164 |
| Net loss from continuing operations | \$ (350) | \$ (164) |
| The Company's pro-rata share net loss | \$ (172) | \$ (80) |

10. Income Taxes

There was no provision for the period ended March 31, 2011. 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 was fully offset by available net operating loss carry-forwards and tax credits previously offset by a full valuation allowance.

The provision for income taxes for the period ended March 31, 2010 reflects withholding tax expense in various foreign jurisdictions. Withholding taxes are computed by the Company's customers and paid to foreign jurisdictions on its behalf.

Table of Contents**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. Digimarc responded by filing a motion to dismiss the action, the parties filed briefs on this issue, and a hearing was held on April 13, 2011.

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. Verance responded by filing a motion to dismiss or stay the action, and to compel arbitration. The parties filed briefs on the issue, and a hearing was held on April 27, 2011.

Digimarc has been named as one of several defendants in a complaint filed by Walker Digital, LLC, 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 plaintiff is seeking a declaratory judgment, injunctive relief and damages. Digimarc has not yet been served with the complaint.

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 March 31, 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

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 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 one year periods.

| | Three Months Ended March 31, 2011 | Three Months Ended March 31, 2010 | Since Inception (April 2009) |
|------------------|--|--|---|
| Shares purchased | 16,873 | | 128,540 |
| Purchases | \$ 455 | \$ | \$ 2,016 |

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. During the three-month periods ended March 31, 2011 and 2010, there were no purchases of shares related to stock option exercises.

Edgar Filing: Digimarc CORP - Form 10-Q

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.

Table of Contents

| | Three Months Ended March 31, 2011 | Three Months Ended March 31, 2010 |
|--|--|--|
| Restricted shares withheld (purchased) for tax | 10,876 | 1,149 |
| Tax withholding obligations | \$ 322 | \$ 22 |

13. Subsequent Events

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

14. Quarterly Financial Information

| Quarter ended: 2011 | March 31 |
|--|-----------------|
| Service revenue | \$ 3,069 |
| License and subscription revenue | 6,022 |
| Total revenue | 9,091 |
| Total cost of revenue | 1,649 |
| Gross profit | 7,442 |
| Gross profit percent, service revenue | 48% |
| Gross profit percent, license and subscription revenue | 99% |
| Gross profit percent, total | 82% |
| Sales and marketing | 1,102 |
| Research, development and engineering | 1,775 |
| General and administrative | 2,847 |
| Intellectual property | 301 |
| Operating income | 1,417 |
| Net income | 938 |
| Earnings per share: | |
| Net income per share basic | \$ 0.14 |
| Net income per share diluted | \$ 0.12 |
| Weighted average shares outstanding basic | 6,864 |
| Weighted average shares outstanding diluted | 7,505 |

Table of Contents

| Quarter ended: 2010 | March 31 | June 30 | September 30 | December 31 |
|--|-----------------|----------------|---------------------|--------------------|
| 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 |

Table of Contents

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, which 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

Edgar Filing: Digimarc CORP - Form 10-Q

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.

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

Table of Contents

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 nearly 1,100 granted and pending U.S. and foreign filings as of March 31, 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 titled "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 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-month period relate to the three-month period ended March 31, 2011 and all changes discussed with respect to such period reflect changes compared to the three-month period ended March 31, 2010.

| | Three Months Ended March 31, 2011 | Three Months Ended March 31, 2010 |
|---|--|--|
| Revenue: | | |
| Service | 34% | 34% |
| License and subscription | 66 | 66 |
| Total revenue | 100 | 100 |
| Cost of revenue: | | |
| Service | 17 | 17 |
| License and subscription | 1 | 1 |
| Total cost of revenue | 18 | 18 |
| Gross profit | 82 | 82 |
| Operating expenses: | | |
| Sales and marketing | 12 | 7 |
| Research, development and engineering | 20 | 12 |
| General and administrative | 32 | 19 |
| Intellectual property | 3 | 3 |
| Total operating expenses | 67 | 41 |
| Operating income | 15 | 41 |
| Net loss from joint ventures | (6) | (5) |
| Interest income, net | 1 | 1 |
| Income before provision for income taxes | 10 | 37 |
| Provision for income taxes | | |
| Net income | 10% | 37% |

Continuing with the success in our licensing and service activities, revenues from our largest six customers grew more than \$4 million compared to the prior year, including a \$3 million revenue contribution of our newest relationship, Intellectual Ventures, with whom we entered a long term collaborative relationship in the fourth quarter of 2010. Although our total revenue for the three-month period in 2011 decreased 11% to \$9.1 million compared to the same period in the prior year, the prior year included a one-time payment of license fees of \$4.5 million from Arbitron and we generated revenues from some non-linear government services contracts during that period. In 2011, we continued to invest in our strategic initiatives, including the marketing of our intellectual property, our joint ventures with Nielsen, development of additional intellectual property, and development and marketing of Digimarc Discover; all centered on our vision of enhancing computers, networks and other digital devices to see, hear, understand and respond to their surroundings. In addition, we incurred legal expenses in connection with our litigation with Verance. Notwithstanding the decreased revenues and increased investments in executing our strategy, we achieved profitability and positive cash flow from operations for the three-months ended March 31, 2011.

Revenue

Edgar Filing: Digimarc CORP - Form 10-Q

| | Three Months Ended March 31, 2011 | Three Months Ended March 31, 2010 | Dollar Decrease | Percent Decrease |
|---|--|--|----------------------------|-----------------------------|
| Revenue: | | | | |
| Service | \$ 3,069 | \$ 3,514 | \$ (445) | (13)% |
| License and subscription | 6,022 | 6,678 | (656) | (10)% |
| Total | \$ 9,091 | \$ 10,192 | \$ (1,101) | (11)% |
| Revenue (as % of total revenue): | | | | |
| Service | 34% | 34% | | |
| License and subscription | 66% | 66% | | |
| Total | 100% | 100% | | |

Table of Contents

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, are 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 decrease in service revenue for the three-month period was due primarily to the fact that in the prior period we completed a number of government contracts for which revenue was earned upon completion. Excluding the revenue earned upon completion of these government contracts in the prior period, service revenue for the three-month period increased primarily by the revenue earned for the support services rendered to IV in support of IV's efforts to monetize the licensed patents.

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 decrease in license and subscription revenue for the three-month period was due primarily to the fact that the prior period included a one-time licensing payment of \$4.5 million from Arbitron. Excluding this payment in the prior period, license and subscription revenue for the three-month period increased primarily by \$2.8 million from IV and, to a lesser extent, by increased license and royalty revenues received from other customers in the three-month period.

Revenue by Geography

| | Three Months Ended March 31, 2011 | Three Months Ended March 31, 2010 | Dollar Increase (Decrease) | Percent Increase (Decrease) |
|---|--|--|---|--|
| Revenue by geography: | | | | |
| Domestic | \$ 6,070 | \$ 7,240 | \$ (1,170) | (16)% |
| International | 3,021 | 2,952 | 69 | 2% |
| Total | \$ 9,091 | \$ 10,192 | \$ (1,101) | 11% |
| Revenue (as % of total revenue): | | | | |
| Domestic | 67% | 71% | | |
| International | 33% | 29% | | |
| Total | 100% | 100% | | |

Edgar Filing: Digimarc CORP - Form 10-Q

The decrease in domestic revenue decreased for the three-month period was due primarily to the fact that the prior period included a one-time licensing payment of \$4.5 million from Arbitron. Excluding this payment in the prior period, domestic revenue for the three-month period reflects increased license and service revenues of \$3.0 million from IV and, to a lesser extent, increased license and royalty revenues received from other customers in the three-month period. International revenue remained relatively consistent for the three-month period.

Table of Contents

We anticipate revenue growth for the remainder of 2011, compared to the same period in 2010, from our existing customers and from new customers as we continue expand the marketing and monetization of our intellectual property portfolio.

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;

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.

Gross Profit

| | Three Months Ended March 31, 2011 | Three Months Ended March 31, 2010 | Dollar Decrease | Percent Decrease |
|---------------|--|--|----------------------------|-----------------------------|
| Gross Profit: | | | | |
| Service | \$ 1,485 | \$ 1,714 | \$ (229) | (13)% |

Edgar Filing: Digimarc CORP - Form 10-Q

| | | | | |
|--------------------------|----------|----------|----------|-------|
| License and subscription | 5,957 | 6,621 | (664) | (10)% |
| Total | \$ 7,442 | \$ 8,335 | \$ (893) | (11)% |

Gross Profit (as % of related revenue components):

| | | |
|--------------------------|-----|-----|
| Service | 48% | 49% |
| License and subscription | 99% | 99% |
| Total | 82% | 82% |

The decrease in gross profit for the three-month period primarily reflected the fact that in the prior period we completed a number of government contracts for which a significant amount of the revenue was earned upon completion, and received a one-time licensing payment in the amount of \$4.5 million from Arbitron. Excluding the revenue earned upon completion of these government contracts and the Arbitron licensing payment in the prior period, gross profit for the three-month period increased as a result of the licensing revenue earned from IV and other licensees. Gross profit as a percentage of revenue for the three-month period remained relatively consistent.

Operating Expenses

Sales and marketing

Table of Contents

| | Three Months Ended March 31, 2011 | Three Months Ended March 31, 2010 | Dollar Increase | Percent Increase |
|--|--|--|----------------------------|-----------------------------|
| Sales and marketing | \$ 1,102 | \$ 741 | \$ 361 | 49% |
| Sales and marketing (as % of total revenue) | 12% | 7% | | |
| 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.

The increase in sales and marketing expense for the three-month period resulted primarily from:

increased headcount and compensation-related expenses of \$0.2 million from hiring additional sales 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.

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

Research, development and engineering

Edgar Filing: Digimarc CORP - Form 10-Q

| | Three Months Ended March 31, 2011 | Three Months Ended March 31, 2010 | Dollar Increase | Percent Increase |
|---|--|--|----------------------------|-----------------------------|
| Research, development and engineering | \$ 1,775 | \$ 1,259 | \$ 516 | 41% |
| Research, development and engineering (as % of total revenue) | 20% | 12% | | |

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;

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 GPUs).

Table of Contents

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 and related costs of software developers and quality assurance personnel;

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 resulted primarily from:

increased headcount and compensation-related expenses of \$0.3 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 of \$0.1 million related to the mobile device market.

Edgar Filing: Digimarc CORP - Form 10-Q

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

General and administrative

| | Three Months Ended March 31, 2011 | Three Months Ended March 31, 2010 | Dollar Increase | Percent Increase |
|--|--|--|----------------------------|-----------------------------|
| General and administrative | \$ 2,848 | \$ 1,885 | \$ 963 | 51% |
| General and administrative (as % of total revenue) | 32% | 19% | | |

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 resulted primarily from:

increased legal fees of \$0.6 million related to the litigation matter with Verance, 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.

Table of Contents

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 Months Ended March 31, 2011 | Three Months Ended March 31, 2010 | Dollar Increase | Percent Increase |
|---|--|--|----------------------------|-----------------------------|
| Intellectual property | \$ 301 | \$ 257 | \$ 44 | 17% |
| Intellectual property (as % of total revenue) | 3% | 3% | | |

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 for the three-month period remained relatively constant. Intellectual property expenses, however, can vary from period to period based on:

the level of capitalized patent activity, and

Edgar Filing: Digimarc CORP - Form 10-Q

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.

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

Stock-based compensation

| | Three Months Ended March 31, 2011 | Three Months Ended March 31, 2010 | Dollar Increase | Percent Increase |
|---------------------------------------|--|--|----------------------------|-----------------------------|
| Cost of revenue | \$ 110 | \$ 97 | \$ 13 | 13% |
| Sales and marketing | 85 | 42 | 43 | 102% |
| Research, development and engineering | 158 | 70 | 88 | 126% |
| General and administrative | 585 | 507 | 78 | 15% |
| Intellectual property | 48 | 24 | 24 | 100% |
| Total | \$ 986 | \$ 740 | \$ 246 | 33% |

The increase in stock-based compensation expense for the three-month period was primarily due to an additional layer of stock-based awards. We anticipate incurring an additional \$9,206 in stock-based compensation expense through March 2015 for awards outstanding as of March 31, 2011. Our tax accounting may also be affected by actual exercise behavior and the relative market price of our common stock at exercise of the awards.

Table of Contents*Net loss from joint ventures*

| | Three Months Ended March 31, 2011 | Three Months Ended March 31, 2010 | Dollar Increase | Percent Increase |
|--|--|--|----------------------------|-----------------------------|
| Net loss from joint ventures | \$ (537) | \$ (457) | \$ 80 | 18% |
| Net loss from joint ventures (as % of total revenue) | (6)% | (5)% | | |

The increase in the net loss from joint ventures for the three-month period resulted primarily from increased research, development and engineering work in product development.

Interest income, net

| | Three Months Ended March 31, 2011 | Three Months Ended March 31, 2010 | Dollar Decrease | Percent Decrease |
|--|--|--|----------------------------|-----------------------------|
| Interest income, net | 58 | 61 | (3) | (5)% |
| Interest income, net (as % of total revenue) | 1% | 1% | | |

The decrease in interest income, net was primarily due to a combination of lower balances and lower interest earned on cash and investment balances, reflecting lower interest rates paid on these balances.

Provision for Income Taxes.

There was no provision for the period ended March 31, 2011.

There was no provision for income taxes, other than foreign withholding taxes, for the three-month period ended March 31, 2010 since the estimated effective tax rate for the period ending December 31, 2010 was expected to be zero, with the exception of foreign withholding tax.

We continually assess the applicability of a valuation allowance. Based upon the positive and negative evidence available as of March 31, 2011, we concluded that it is not more likely than not that net deferred tax assets will be utilized. Consequently, a valuation allowance continues to offset our net deferred tax assets.

Liquidity and Capital Resources

| | March 31, 2011 | December 31, 2010 |
|---|---------------------------|------------------------------|
| Working capital | \$ 28,405 | \$ 35,526 |
| Current (liquidity) ratio(1) | 8.1:1 | 9.7:1 |
| Cash, cash equivalents and short-term marketable securities | \$ 28,844 | \$ 34,781 |
| Long-term marketable securities | \$ 4,264 | \$ 11,163 |
| Total cash, cash equivalents and all marketable securities | \$ 33,108 | \$ 45,944 |

(1) The current (liquidity) ratio is calculated by dividing total current assets by total current liabilities. The \$12.8 million decrease in cash, cash equivalents and all marketable securities resulted primarily from:

Edgar Filing: Digimarc CORP - Form 10-Q

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 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:

Table of Contents

| | Three Months Ended March 31, 2011 | Three Months Ended March 31, 2010 | Dollar Increase (Decrease) | Percent Increase (Decrease) |
|---|---|---|----------------------------------|-----------------------------------|
| Net income | \$ 938 | \$ 3,776 | \$ (2,838) | (75)% |
| Non-cash items | 1,702 | 1,363 | 339 | 25% |
| Changes in operating assets and liabilities | 1,223 | 242 | 981 | 405% |
| Net cash provided by operating activities | \$ 3,863 | \$ 5,381 | \$ (1,518) | (28)% |

Net income.

The decrease in operating results for the three-month period reflects lower revenues primarily related to the fact that the prior period included a one-time licensing payment of \$4.5 million from Arbitron, and increased operating expenses related to our mobile device market initiatives and the litigation matter with Verance incurred in the first quarter of 2011.

Non-cash items.

The increase in non-cash items for the three-month period was primarily the result of 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 three-month period related to:

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

reimbursement from our landlord for the tenant improvement allowance.

The primary changes in the operating assets and liabilities for the prior year period 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 three-month period 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;

Edgar Filing: Digimarc CORP - Form 10-Q

investments made in joint ventures; and

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

Cash flows from financing activities.

The cash flows from financing activities for the three-month period 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; and

purchases of common stock for the withholding of shares upon the vesting of restricted stock to satisfy tax withholding obligations.

The cash flows from financing activities for the same period in the prior year 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.

As part of our stock repurchase program, of the \$5.0 million that was authorized, \$3.0 million remained available, as of March 31, 2011, to purchase our common stock in the open market or private transactions through April 30, 2012.

Table of Contents

In connection with the IV arrangement, we anticipate our cash flow will improve with:

- 1) payment of the license issue fee in increasing quarterly installments over three years,
- 2) consulting fees payable over five years, and
- 3) 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 fund acquisitions or investments in complementary businesses, technologies or product lines. In order to take advantage of 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.

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 \$2.1 million remained to be contributed as of March 31, 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 \$4.6 million as of March 31, 2011, and are payable in monthly installments through August 2016.

Contractual Obligations

| | Total | Payment Due by Period | | | |
|-----------------------------------|-----------------|-----------------------|-----------------|-----------------|----------------------|
| | | Less than 1 year | 1-3 years | 3-5 years | More than 5 years |
| Total joint venture obligations | \$ 2,100 | \$ 2,100 | \$ | \$ | \$ |
| Total operating lease obligations | 4,629 | 803 | 1,682 | 1,762 | 382 |
| Total obligations | \$ 6,729 | \$ 2,903 | \$ 1,682 | \$ 1,762 | \$ 382 |

Other than as described above, as of March 31, 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 growth;

Table of Contents

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;

our ability to improve margins;

anticipated expenses, costs, margins and investment activities in the foreseeable future;

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;

our ability to fund our working capital needs through cash flow from operations;

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 in upcoming quarters;

anticipated levels of backlog in future periods;

the success of our arrangements with Intellectual Ventures;

protection 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 Officers, 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 March 31, 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. Digimarc responded by filing a motion to dismiss the action, the parties filed briefs on this issue, and a hearing was held on April 13, 2011.

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. Verance responded by filing a motion to dismiss or stay the action, and to compel arbitration. The parties filed briefs on the issue, and a hearing was held on April 27, 2011.

Digimarc has been named as one of several defendants in a complaint filed by Walker Digital, LLC, 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 plaintiff is seeking a declaratory judgment, injunctive relief and damages. Digimarc has not yet been served with the complaint.

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 \$2.0 million to repurchase 128,540 shares of outstanding common stock under this program since the program's inception and \$3.0 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. No stock repurchases were made in connection with stock option exercises during the three-month period ended March 31, 2011.

The following table sets forth information regarding purchases of our equity securities during the three-month period ended March 31, 2011:

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

Edgar Filing: Digimarc CORP - Form 10-Q

| | | | | or programs |
|---------------------------------------|---------------------------|----------------------------|---------------|--------------------|
| Month 1 | | | | |
| January 1, 2011 to January 31, 2011 | 562,136 ⁽¹⁾⁽²⁾ | \$ 27.07 ⁽¹⁾⁽²⁾ | | \$ 3.4 million |
| Month 2 | | | | |
| February 1, 2011 to February 28, 2011 | | | | \$ 3.4 million |
| Month 3 | | | | |
| March 1, 2011 to March 31, 2011 | 1,276 ⁽¹⁾ | \$ 26.42 ⁽¹⁾ | 16,873 | \$ 3.0 million |
| Total | 563,412 | \$ 27.07 | 16,873 | |

- (1) Includes fully vested shares of common stock withheld (purchased) by us in satisfaction of required withholding tax liability.
- (2) Includes 552,536 shares of our common stock purchased from Koninklijke Philips Electronics, N.V., in a privately negotiated transaction. The shares were purchased for an aggregate purchase price of approximately \$14.9 million, including transaction fees, from cash on hand and was made separate from the \$5.0 million stock repurchase program.

Table of Contents

Item 6. Exhibits.

| Exhibit Number | Exhibit Description |
|-----------------------|---|
| 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 |

Table of Contents

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: April 29, 2011

DIGIMARC CORPORATION

By:

/s/ MICHAEL McCONNELL
Michael McConnell

Chief Financial Officer and Treasurer

(Duly Authorized Officer

and Principal Financial and Accounting Officer)

35