

DIGIMARC CORP  
Form 10-Q  
May 02, 2008

[QuickLinks](#) -- Click here to rapidly navigate through this document

**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, 2008**

**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: 000-28317**

**DIGIMARC CORPORATION**

(Exact name of registrant as specified in its charter)

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

**94-3342784**  
(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)

Securities registered pursuant to Section 12(b) of the Act:

<b>Title of Each Class</b>	<b>Name of Each Exchange on Which Registered</b>
Common Stock, \$0.001 Par Value Per Share	The Nasdaq Global Market
Securities registered pursuant to Section 12(g) of the Act:	
<b>NONE</b>	

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

Edgar Filing: DIGIMARC CORP - Form 10-Q

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

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

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 30, 2008, there were 22,183,532 shares of the registrant's common stock, par value \$0.001 per share, outstanding.

---

---

---

**Table of Contents**

**PART I FINANCIAL INFORMATION**

Item 1.	Financial Statements:	3
	Consolidated Balance Sheets as of March 31, 2008 and December 31, 2007 (Unaudited)	3
	Consolidated Statements of Operations for the three-months ended March 31, 2008 and 2007 (Unaudited)	4
	Consolidated Statements of Stockholders' Equity as of March 31, 2008 and December 31, 2007 (Unaudited)	5
	Consolidated Statements of Cash Flows for the three-months ended March 31, 2008 and 2007 (Unaudited)	6
	Notes to Consolidated Financial Statements (Unaudited)	7
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	24
Item 3.	Quantitative and Qualitative Disclosures About Market Risk	45
Item 4.	Controls and Procedures	45

**PART II OTHER INFORMATION**

Item 1.	Legal Proceedings	46
Item 1A.	Risk Factors	47
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	60
Item 6.	Exhibits	60

<b>SIGNATURES</b>		61
-------------------	--	----

## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements.

**DIGIMARC CORPORATION**  
**CONSOLIDATED BALANCE SHEETS**

(In thousands, except share data)

(UNAUDITED)

	March 31, 2008	December 31, 2007(1)
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 24,228	\$ 19,582
Restricted cash	1,470	205
Short-term investments	3,849	3,568
Trade accounts receivable, net	15,068	18,498
Inventory, net	6,120	7,316
Other current assets	2,487	2,628
	<u>53,222</u>	<u>51,797</u>
Total current assets	53,222	51,797
Restricted cash	7,888	9,358
Property and equipment, net	66,055	66,277
Intangibles, net	13,041	13,462
Other assets, net	1,280	1,129
	<u>141,486</u>	<u>142,023</u>
Total assets	\$ 141,486	\$ 142,023
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 5,777	\$ 6,092
Accrued payroll and related costs	2,550	1,952
Deferred revenue	5,660	6,239
Other current liabilities	2,098	1,955
	<u>16,085</u>	<u>16,238</u>
Total current liabilities	16,085	16,238
Long-term deferred revenue, net of current portion	6,904	7,007
Other long-term liabilities	1,319	1,455
	<u>24,308</u>	<u>24,700</u>
Total liabilities	24,308	24,700
Commitments and contingencies (Note 11)		
Stockholders' equity:		
Common stock (22,180,764 and 21,838,375 shares issued and outstanding at March 31, 2008 and December 31, 2007, respectively)	22	22
Additional paid-in capital	218,557	217,341
Accumulated deficit	(101,401)	(100,040)
	<u>117,178</u>	<u>117,323</u>
Total stockholders' equity	117,178	117,323
Total liabilities and stockholders' equity	\$ 141,486	\$ 142,023

Edgar Filing: DIGIMARC CORP - Form 10-Q

March 31, 2008	December 31, 2007(1)
<hr/>	<hr/>
<hr/>	<hr/>

---

(1)

Derived from the Company's December 31, 2007 audited consolidated financial statements

See Notes to Unaudited Consolidated Financial Statements.

## DIGIMARC CORPORATION

## CONSOLIDATED BALANCE SHEETS

(In thousands, except share data)

(UNAUDITED)

## DIGIMARC CORPORATION

## CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share data)

(UNAUDITED)

	Three Months Ended March 31,	
	2008	2007
Revenue:		
Service	\$ 24,674	\$ 21,299
Product and subscription	5,896	5,547
Total revenue	30,570	26,846
Cost of revenue:		
Service	16,203	14,715
Product and subscription	2,420	2,100
Total cost of revenue	18,623	16,815
Gross profit	11,947	10,031
Operating expenses:		
Sales and marketing	4,623	4,277
Research, development and engineering	2,278	2,042
General and administrative	4,584	4,098
Amortization of intangibles	420	500
Intellectual property	545	499
Acquisition related costs	1,089	
Total operating expenses	13,539	11,416
Operating income (loss)	(1,592)	(1,385)
Other income (expense), net	353	382
Income (loss) before provision for income taxes	(1,239)	(1,003)
(Provision) benefit for income taxes	(122)	(19)
Net income (loss)	\$ (1,361)	\$ (1,022)
Net income (loss) per share basic	\$ (0.06)	\$ (0.05)
Net income (loss) per share diluted	\$ (0.06)	\$ (0.05)
Weighted average shares outstanding basic	21,342	20,797
Weighted average shares outstanding diluted	21,342	20,797

See Notes to Unaudited Consolidated Financial Statements.



## DIGIMARC CORPORATION

## CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

(In thousands, except share data)

	Common stock		Additional paid-in capital	Accumulated deficit	Total stockholders' equity
	Shares	Amount			
<b>BALANCE AT DECEMBER 31, 2006</b>	21,191,918	\$ 22	\$ 211,209	\$ (99,740)	\$ 111,491
Initial adjustment to adopt FIN 48				145	145
Exercise of stock options	325,709		1,624		1,624
Issuance of employee stock purchase plan shares	119,143		920		920
Issuance of restricted common stock	309,490				
Purchase and retirement of common stock	(107,885)		(357)		(357)
Stock-based compensation expense			3,945		3,945
Net loss				(445)	(445)
<b>BALANCE AT DECEMBER 31, 2007</b>	21,838,375	22	217,341	(100,040)	117,323
Exercise of stock options	21,169		136		136
Issuance of employee stock purchase plan shares	33,914		259		259
Issuance of restricted common stock	323,280				
Purchase and retirement of common stock	(35,974)		(293)		(293)
Stock-based compensation expense			1,114		1,114
Net loss				(1,361)	(1,361)
<b>BALANCE AT MARCH 31, 2008</b>	22,180,764	\$ 22	\$ 218,557	\$ (101,401)	\$ 117,178

See Notes to Unaudited Consolidated Financial Statements.



## DIGIMARC CORPORATION

## CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY (Continued)

(In thousands, except share data)

## DIGIMARC CORPORATION

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(UNAUDITED)

	Three Months Ended	
	March 31, 2008	March 31, 2007
<b>Cash flows from operating activities:</b>		
Net loss	\$ (1,361)	\$ (1,022)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	4,249	3,921
Stock-based compensation expense	1,114	1,005
Other non-cash charges	30	(28)
Changes in operating assets and liabilities:		
Restricted cash	205	378
Trade and unbilled accounts receivable	3,430	313
Inventory, net	1,196	(530)
Other current assets	141	234
Other assets, net	(151)	(77)
Accounts payable	(315)	936
Accrued payroll and related costs	598	(2,196)
Deferred revenue	(682)	2,451
Other liabilities	101	24
Net cash provided by (used in) operating activities	8,555	5,409
<b>Cash flows from investing activities:</b>		
Purchase of property and equipment and capitalized labor costs	(3,585)	(6,897)
Sale or maturity of short-term investments	41,534	38,355
Purchase of short-term investments	(41,815)	(38,355)
Net cash provided by (used in) investing activities	(3,866)	(6,897)
<b>Cash flows from financing activities:</b>		
Issuance of common stock	395	582
Purchase of common stock	(293)	(140)
Principal payments under capital lease obligations	(145)	(144)
Net cash provided by (used in) financing activities	(43)	298
Net increase (decrease) in cash and cash equivalents	4,646	(1,190)
Cash and cash equivalents at beginning of period	19,582	23,135
Cash and cash equivalents at end of period	\$ 24,228	\$ 21,945
<b>Supplemental disclosure of cash flow information:</b>		
Cash paid for interest	\$ 48	\$ 19
Cash paid for income taxes	\$ 111	\$ 12

Edgar Filing: DIGIMARC CORP - Form 10-Q

Three Months Ended

---

Summary of non-cash investing and financing activities:

Equipment acquired or exchanged under capital lease obligations	\$	51	\$
---	----	----	----

See Notes to Unaudited Consolidated Financial Statements.

**DIGIMARC CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(In thousands, except share and per share data)**

**(UNAUDITED)**

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

*Description of Business*

Digimarc Corporation ("Digimarc" or "the Company") is a supplier of secure identity solutions and advanced technologies for use in media identification and management. The Company's solutions enable governments and businesses around the world to deter counterfeiting and piracy, enhance traffic safety and national security, combat identity theft and fraud, facilitate the effectiveness of voter identification programs, improve the management of media content, and support new digital media distribution models that provide consumers with more choice and access to media content.

*Pending Acquisition of Digimarc and Spin-Off of Digital Watermarking Business*

On March 23, 2008, the Company entered into a definitive agreement with L-1 Identity Solutions, Inc. (NYSE: L-1) ("L-1") pursuant to which a subsidiary of L-1 will be merged with and into the Company (the "merger"), with the Company continuing after the merger as a wholly-owned subsidiary of L-1. Immediately prior to the merger, the Company will contribute all of the assets and liabilities related to the Company's digital watermarking business, together with all of the Company's cash, to a wholly-owned subsidiary of the Company, the shares of which will be distributed to the Company's stockholders in a taxable spin-off transaction.

At the effective time of the merger, each issued and outstanding share of the Company's common stock will be converted into the right to receive (i) the stockholder's pro rata share of \$120.0 million in cash, without interest, and (ii) a fractional interest in a share of L-1 common stock based on an exchange ratio calculated in accordance with the terms of the merger agreement. In addition, all outstanding options to purchase shares of the Company's common stock will vest and become fully exercisable immediately prior to the record date for the spin-off, and each holder of an option to purchase shares of the Company's common stock will be entitled to exercise such holder's options immediately prior to the record date for the spin-off, conditioned upon the occurrence of the spin-off. After the completion of the merger and spin-off, L-1 will purchase stock in the new digital watermarking company, in the aggregate amount of \$5.0 million.

The completion of the merger is subject to approval of the merger agreement by the Company's stockholders, expiration or termination of any applicable waiting period under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, completion of the spin-off and other customary closing conditions. The transaction is not subject to any financing condition. There can be no assurance that the merger and spin-off will be consummated in a timely manner, if at all.

In connection with the proposed merger, L-1 will file with the Securities and Exchange Commission (the "SEC") a Registration Statement on Form S-4 that will include a proxy statement of the Company that also constitutes a prospectus of L-1, in addition to other relevant materials related to the merger and spin-off. The proxy statement/prospectus will include a detailed description of the terms of the merger agreement, as well as other important information about the proposed transactions.

DIGIMARC CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(UNAUDITED)

**1. Description of Business and Summary of Significant Accounting Policies (Continued)**

*Principles of Consolidation*

The consolidated financial statements include the accounts of Digimarc and its wholly-owned subsidiaries. All significant intercompany transactions and balances have been eliminated.

*Interim Financial Statements*

The accompanying consolidated 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 for the periods presented. Certain information and footnote 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 under the rules and regulations of the SEC.

These consolidated financial statements should be read in conjunction with the audited consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2007, which was filed with the SEC on February 29, 2008. The results of operations for the interim periods presented in these consolidated financial statements are not necessarily indicative of the results for the full year.

*Use of Estimates*

The preparation of consolidated 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 service contracts, impairments and estimation of useful lives of long-lived assets, inventory valuation, reserves for uncollectible accounts receivable, valuation allowance for deferred tax assets, contingencies and litigation and stock-based compensation. Digimarc bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under 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.

*Investments*

The Company considers all investments with original maturities over 90 days that mature in less than one year to be short-term investments. Investments with maturities beyond one year may be classified as short-term based on their highly liquid nature and because such marketable securities represent the investment of cash that is available for current operations. Short-term investments include federal agency notes, company notes, and commercial paper. The Company's marketable securities are generally classified as held-to-maturity as of the balance sheet date and are reported at amortized cost, which approximates market. The book value of these investments approximates fair market value and, accordingly, no amounts have been recorded to other comprehensive income.

DIGIMARC CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(UNAUDITED)

**1. Description of Business and Summary of Significant Accounting Policies (Continued)**

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 to 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 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. Dividend and interest income are recognized when earned.

*Fair Value of Financial Instruments*

The carrying amounts of cash and cash equivalents, short-term investments, trade accounts receivable, accounts payable and accrued payroll approximate fair value due to the short-term nature of these instruments. The carrying amounts of capital leases approximate fair value as the stated interest rates approximate current market rates. Fair value estimates are made at a specific point in time, based on relevant market information about the financial instrument when available. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and, therefore, cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

*Impairment of Long-Lived Assets*

The Company accounts for long-lived assets in accordance with the provisions of Statement of Financial Accounting Standards ("SFAS") No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. 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.

*Software Development Costs*

Under SFAS No. 86, *Accounting for the Cost of Computer Software to Be Sold, Leased, or Otherwise Marketed*, 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

DIGIMARC CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(UNAUDITED)

**1. Description of Business and Summary of Significant Accounting Policies (Continued)**

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.

Internal use software development costs are accounted for in accordance with AICPA SOP No. 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*. Costs incurred in the preliminary project stage are expensed as incurred and costs incurred in the application development stage, which meet the capitalization criteria, are capitalized and amortized on a straight-line basis over the estimated useful life of the asset, generally three to five years. Costs incurred in the post-implementation stage are expensed as incurred. Internal use software development projects that have been capitalized to date relate to card manufacturing and control systems software.

**2. Recent Accounting Pronouncements**

In September 2006, the Financial Accounting Standards Board ("FASB") issued SFAS No. 157, *Fair Value Measurements*, which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value. This statement does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. SFAS No. 157 is effective the first fiscal year beginning after November 15, 2007. The Company has applied the provisions of this standard regarding the framework of measuring fair value and noted no material effect on the current financial statements.

In February 2007, the FASB issued SFAS No. 159, *The Fair Option for the Financial Assets and Financial Liabilities*, which permits entities to choose to measure certain financial assets and liabilities at fair value. SFAS No. 159 is effective the first fiscal year beginning after November 15, 2007. The Company has elected not to measure certain financial assets and liabilities at fair value as permitted by SFAS No. 159.

**3. Revenue Recognition**

Certain customer arrangements encompass multiple deliverables, such as software, hardware sales, consumables sales, maintenance fees, and software development fees. The Company accounts for these arrangements in accordance with EITF Issue No. 00-21. If the deliverables meet the criteria in EITF Issue No. 00-21, the deliverables are divided into separate units of accounting and revenue is allocated to the deliverables based on their relative fair values. The criteria specified in EITF Issue No. 00-21 are as follows (i) the delivered item has value to the customer on a stand-alone basis, (ii) there is objective and reliable evidence of the fair value of the undelivered item, and (iii) if the arrangement includes a general right of return relative to the delivered item, delivery or performance of the undelivered item is considered probable and substantially in the control of the vendor. For our purposes, fair value is generally defined as the price at which a customer could purchase each of the elements independently from other vendors or as the price that the Company has sold the element separately to another customer. Management applies judgment to ensure appropriate application of EITF Issue No. 00-21, including value allocation among multiple deliverables, determination of whether undelivered elements are essential to the functionality of delivered elements and timing of revenue recognition, among

**DIGIMARC CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(In thousands, except share and per share data)**

**(UNAUDITED)**

**3. Revenue Recognition (Continued)**

others. Revenue is recognized in accordance with SAB 104 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.

AICPA SOP No. 98-9 requires that revenue be recognized using the "residual method" in circumstances when vendor specific objective evidence ("VSOE") exists only for undelivered elements. Under the residual method, revenue is recognized as follows: (1) the total fair value of undelivered elements, as indicated by vendor specific objective evidence, is deferred and subsequently recognized in accordance with the relevant sections of AICPA SOP No. 97-2, and (2) the difference between the total arrangement fee and the amount deferred for the undelivered elements is recognized as revenue related to the delivered elements.

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

Revenue from the Company's government-issued credential systems is generally billed and recognized on a per card produced basis. The Company recognizes revenue on these contracts based on the actual monthly production, if available, and in limited situations on estimated volume information. When actual production information becomes available, typically within one month, the Company bills the customer accordingly and any differences from the estimates are recognized in the month the billing occurs. Differences to date have not been significant.

Revenue related to an enhancement of, or upgrade to, an existing system is deferred and recognized over the remaining life of the contract, unless VSOE can be established for the delivered items, title passes to those items and all obligations are completed in which case we recognize revenue at acceptance.

Revenue for sales of consumables and equipment not related to a driver license production contract is recognized when the products have been shipped, ownership has been transferred, evidence of an arrangement exists, the sales price is fixed and determinable, and collectibility is reasonably assured. When significant obligations remain after products are delivered, such as for system integration or customer acceptance, revenue and related costs are deferred until such obligations are fulfilled.

Revenue from professional service arrangements is generally determined based on time and material or a cost plus a profit margin measure. Revenue for professional services is recognized as the services are performed. Progress towards completion is measured using costs incurred compared to the budgeted amounts contained in the contract. Losses on contracts, if any, are provided for in the period in which the loss becomes determinable. Billing for services rendered generally occurs within one month following when the services are provided.

Maintenance revenue is recognized when the maintenance amounts owed to the Company have been earned, are determinable, and collection is probable. Maintenance contracts are, at times, paid in advance and revenue is recognized ratably on a straight-line basis over the term of the service period.

DIGIMARC CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(UNAUDITED)

**3. Revenue Recognition (Continued)**

Royalty revenue is recognized when the royalty amounts owed to the Company have been earned, are determinable, and collection is probable. Subscriptions are paid in advance and revenue is recognized ratably over the term of the subscription. These revenues include the licensing of digital watermarking products and services for use in authenticating documents, detecting fraudulent documents and deterring unauthorized duplication or alteration of high-value documents, for use in communicating copyright, asset management and business-to-business image commerce solutions, and for use in connecting analog media to a digital environment.

Software revenue is recognized in accordance with AICPA SOP No. 97-2, as amended by AICPA SOP No. 98-9. Revenue for licenses of the Company's software products is recognized upon the Company meeting the following criteria: persuasive evidence of an arrangement exists; delivery has occurred; the vendor's fee is fixed or determinable; and collectibility is probable. Software revenue is recognized over the term of the license or upon delivery and acceptance if the Company grants a perpetual license with no further obligations.

The Company records revenue from certain customers upon cash receipt as a result of collectibility not being reasonably assured.

Revenue earned which has not been invoiced is classified as unbilled trade receivables, which is included in the balance of trade accounts receivable, net in the consolidated balance sheets.

Deferred revenue consists of payments received in advance for professional services, subscriptions and hardware for which revenue has not been earned.

**4. Segment Information**

*Geographic Information*

The Company derives its revenue from a single reporting segment: secure identification and media management solutions. Revenue is generated in this segment through licensing and subscription of its various products and the delivery of contracted and consulting services related to these products. The Company markets its products in the United States and in non-U.S. countries through its sales personnel and its subsidiaries. The Company's management evaluates resource allocation decisions and the performance of the Company based upon revenue by the geographic regions of the segment and does not receive discrete financial information about asset allocation and expense allocation on a disaggregated basis.



## DIGIMARC CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(UNAUDITED)

**4. Segment Information (Continued)**

Revenue by geographic areas is as follows:

	Three Months Ended March 31,	
	2008	2007
United States	\$ 24,422	\$ 20,520
International	6,148	6,326
<b>Total</b>	<b>\$ 30,570</b>	<b>\$ 26,846</b>

*Major Customers*

No single customer accounted for more than 10% of the Company's revenues for the three-month period ended March 31, 2008. One customer accounted for slightly over 10% of the Company's revenues for the three-month period ended March 31, 2007.

**5. Stock-Based Compensation**

Stock-based compensation includes expense charges for all stock-based awards to employees and directors. Such awards include option grants, restricted stock awards, and shares expected to be purchased under an employee stock purchase plan.

Stock-based compensation recognized in the Company's consolidated financial statements in the three-months ended March 31, 2008 and 2007 is based on the value of the portion of the stock-based award that vested during the period, adjusted for expected forfeitures for stock-based awards granted prior to, but not fully vested as of, December 31, 2005 and stock-based awards granted subsequent to December 31, 2005. The compensation cost for awards granted prior to January 1, 2006 is based on the grant date fair value estimated in accordance with the pro forma provisions of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, while awards granted on or after January 1, 2006 follow the provisions of SFAS 123(R) to determine the grant date fair value and compensation cost. Compensation cost for all stock-based awards is recognized using the straight-line method.

***Determining Fair Value Under SFAS 123(R)****Stock Options*

*Valuation and Amortization Method.* The Company estimates the fair value of stock-based awards granted using the Black-Scholes option pricing 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.

*Expected Life.* The expected life of awards granted represents the period of time that they are expected to be outstanding. 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. Stock options granted during the three-months ended March 31, 2008 and 2007 generally vest over four years and have contractual terms of ten years.

## DIGIMARC CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(UNAUDITED)

**5. Stock-Based Compensation (Continued)**

*Expected Volatility.* The Company estimates the volatility of its common stock at the date of grant based on the historical volatility of its common stock using the Black-Scholes option pricing model based on historical stock prices over the most recent period commensurate with the estimated expected life of the award. This historical period excludes portions of time when unusual transactions occurred, such as a significant acquisition.

*Risk-Free Interest Rate.* The Company bases the risk-free interest rate used in the Black-Scholes option pricing model on the implied yield currently available on U.S. Treasury zero-coupon issues with an equivalent remaining term approximately equal to the expected life of the award.

*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 pricing model.

*Expected Forfeitures.* The Company uses relevant historical data to estimate pre-vesting option forfeitures. The Company records stock-based compensation only for those awards that are expected to vest.

A summary of the weighted average assumptions and results for options granted during the periods presented is as follows:

	Three Months Ended March 31,	
	2008	2007
Expected life (in years)	5.7	5.8
Expected volatility	44%	44%
Risk-free interest rate	2.5%	4.7%
Expected dividend yield	0%	0%
Expected forfeiture rate	16%	16%
Fair value	\$ 3.65	\$ 4.27

*Employee Stock Purchase Plans*

The Company also recognizes stock-based compensation in connection with its 1999 Employee Stock Purchase Plan. The plan, as amended on November 2, 2006, allows employees to purchase shares of Digimarc common stock through payroll deductions of up to 15% of their base compensation during each three-month plan period, up to a maximum deduction of \$5.3 for each plan period, not to exceed \$21 per year. The three-month plan periods begin December 1, March 1, June 1 and September 1. The price an employee pays for the shares is 85% of the lower of (i) the fair market value of Digimarc common stock at the beginning of the plan period or (ii) the fair market value at the end of the plan period. There were 33,914 and 25,377 shares purchased under the Company's stock purchase plan during the three-months ended March 31, 2008 and 2007, respectively.

DIGIMARC CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(UNAUDITED)

**5. Stock-Based Compensation (Continued)**

*Restricted Stock and Market or Performance Based Vesting Shares*

The Compensation Committee of the Board of Directors (the "Board") awarded restricted stock shares under the Company's 1999 Stock Incentive Plan, as amended, to certain officers, employees and directors. The shares subject to the restricted stock awards vest over a certain period, usually one to four years, following the date of the grant.

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.

In addition to restricted stock shares that vest over time, the Compensation Committee awarded restricted stock that vests upon satisfaction of either market based or employee performance based conditions under the 1999 Stock Incentive Plan, as amended.

The fair value of restricted stock awards that vest upon the satisfaction of market based conditions is calculated using a Monte Carlo valuation model that results in a discount factor applied to the fair market value of the Company's common stock on the date of the grant (measurement date). Compensation cost is recognized over the derived service period, which is shorter than the performance period, using the straight-line method. If the market condition is met prior to completion of the derived service period, all remaining expense is immediately recognized in the period the awards vest. Expense for market based awards is recognized if the employee completes the derived service period, regardless of whether the market condition is met. If the market condition is not met, the shares will be forfeited.

The fair value of restricted stock awards that vest upon the satisfaction of employee performance conditions is based on the fair market value of the Company's common stock on the date of grant (measurement date). Management has determined it is probable that all performance conditions can be achieved; therefore, compensation cost is recognized on a straight line basis over the explicit service period. If the performance condition is satisfied early, all remaining compensation cost will be recognized in the period the condition is satisfied. If the performance vesting condition is not met by the end of the explicit service condition, all previously recognized compensation cost will be reversed and the shares will be forfeited.

Specific terms of the restricted stock awards (including market or performance based vesting share awards) are governed by restricted stock agreements between the Company and the award recipients.

## DIGIMARC CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(UNAUDITED)

## 5. Stock-Based Compensation (Continued)

*Stock-based Compensation Under FAS 123(R)*

The following table summarizes stock-based compensation expense related to stock-based awards under SFAS 123(R) for the three months ended March 31, 2008 and 2007, which was incurred as follows:

	Three Months Ended March 31,	
	2008	2007
Stock-based compensation:		
Cost of revenue	\$ 114	\$ 106
Sales and marketing	168	207
Research, development and engineering	113	72
General and administrative	702	608
Intellectual property	17	12
<b>Total stock-based compensation</b>	<b>\$ 1,114</b>	<b>\$ 1,005</b>

At March 31, 2008, the Company had 1.4 million non-vested stock options that had a weighted average grant date price of \$7.59. As of March 31, 2008, the Company had \$10,181 of total unrecognized compensation cost related to non-vested stock-based awards granted under all equity compensation plans, including options, restricted stock, and employee stock purchase plan. Total unrecognized compensation cost will be adjusted for any future changes in estimated forfeitures. The Company expects to recognize this cost over a weighted average period of 1.44 years.

*Stock Option Activity*

As of March 31, 2008, under all of the Company's stock-based compensation plans, options to purchase an aggregate of 6.9 million shares were outstanding, and options to purchase an additional 7.0 million shares were authorized for future grants under the plans. The Company issues new shares upon option exercises.

## DIGIMARC CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(UNAUDITED)

## 5. Stock-Based Compensation (Continued)

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

Three-months ended March 31, 2008:	Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life
Outstanding at December 31, 2007	6,691,725	\$ 13.61	
Options granted	345,750	8.22	
Options exercised	(21,169)	6.38	
Options canceled	(83,964)	10.83	
Options expired			
Outstanding at March 31, 2008	6,932,342	\$ 13.40	5.66 years
Exercisable at March 31, 2008	5,534,456	\$ 14.87	4.91 years

The following table summarizes information about stock options outstanding at March 31, 2008:

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Number Outstanding	Remaining Contractual Life (Years)	Weighted Average Price	Number Exercisable	Weighted Average Price
\$ 0.50 - \$ 5.96	668,823	7.24	\$ 5.50	442,940	\$ 5.31
\$ 6.00 - \$ 6.46	608,692	7.49	\$ 6.10	365,390	\$ 6.09
\$ 6.52 - \$ 8.29	720,303	8.73	\$ 7.56	235,845	\$ 7.12
\$ 8.46 - \$ 9.49	752,773	7.89	\$ 8.84	368,226	\$ 8.81
\$ 9.50 - \$11.98	765,409	6.22	\$ 11.15	705,713	\$ 11.23
\$12.07 - \$13.87	587,200	4.73	\$ 12.92	587,200	\$ 12.92
\$14.02 - \$14.95	751,200	3.08	\$ 14.16	751,200	\$ 14.16
\$15.06 - \$15.71	745,108	4.93	\$ 15.43	745,108	\$ 15.43
\$16.00 - \$19.93	729,084	3.88	\$ 17.94	729,084	\$ 17.94
\$20.00 - \$53.94	603,750	2.06	\$ 36.57	603,750	\$ 36.57
\$ 0.50 - \$53.94	6,932,342	5.66	\$ 13.40	5,534,456	\$ 14.87

At December 31, 2007, 5,454,008 options were exercisable at a weighted average price of \$15.04.

At March 31, 2008, the aggregate intrinsic value of outstanding and exercisable stock options was \$8,020 and \$4,641, respectively. The aggregate intrinsic value is based on our closing price of \$9.99 per share on March 31, 2008, which would have been received by the optionees had all of the options with exercise prices less than \$9.99 per share been exercised on that date.

## DIGIMARC CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(UNAUDITED)

## 5. Stock-Based Compensation (Continued)

*Restricted Stock and Market or Performance Based Vesting Shares Activity*

The following table reconciles the unvested balance of restricted and performance shares:

Three-months ended March 31, 2008:	Number of Shares
Unvested balance, December 31, 2007	554,953
Granted	323,280
Vested	(87,869)
Canceled	(1,705)
Unvested balance, March 31, 2008	788,659

## 6. Net Income (Loss) Per Share Computation

Net income (loss) per share (or earnings per share ("EPS")) is calculated in accordance with SFAS No. 128, *Earnings per Share*, which provides that basic and diluted net income (loss) per share for all periods presented are to be computed using the weighted average number of common shares outstanding during each period, with diluted net income (loss) per share including the effect of potentially dilutive common shares.

The following table shows the reconciliation of weighted average basic shares to weighted average diluted shares outstanding.

	Three Months Ended March 31,	
	2008	2007
	Shares (in 000'S)	
<b>Basic EPSs</b>		
Weighted average shares outstanding	21,342	20,797
<b>Effect of Dilutive Securities</b>		
Options		
Restricted stock and performance vesting shares		
<b>Diluted EPS</b>		
Weighted average shares outstanding	21,342	20,797

Common stock equivalents related to stock options of 4,916 and 4,393 were excluded from diluted net loss per share calculations for the three-month periods ended March 31, 2008 and 2007, respectively, as their exercise price was higher than the average market price of the underlying common stock for the period and therefore their impact would be anti-dilutive. In addition, common stock equivalents related to stock options and restricted stock of 151 and 688 for the three-month periods ended March 31, 2008 and 2007, respectively, were excluded from diluted net loss per share as the Company was in a loss position and the inclusion would be anti-dilutive.



## DIGIMARC CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(UNAUDITED)

**7. Trade Accounts Receivable***Trade Accounts Receivable*

Trade accounts receivable are recorded at the invoiced amount and do not bear interest. Revenue earned which has not been invoiced as of the balance sheet date, and generally billed the following month, is classified as unbilled trade receivables in the consolidated balance sheets.

	March 31, 2008	December 31, 2007
Billed trade receivables, net	\$ 8,118	\$ 12,396
Unbilled trade receivables	6,950	6,102
<b>Trade accounts receivable, net</b>	<b>\$ 15,068</b>	<b>\$ 18,498</b>

Trade accounts receivable, net includes \$1,778 and \$3,060 at March 31, 2008 and at December 31, 2007, respectively, of deferred revenue, billed in accordance with the provisions of the contracts with the Company's customers.

*Allowance for doubtful accounts*

The allowance for doubtful accounts was \$95 and \$187 at March 31, 2008 and at December 31, 2007, respectively, and 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.

*Major Customers*

No single customer accounted for more than 10% of the Company's trade and unbilled accounts receivable, net at March 31, 2008 and at December 31, 2007.

**8. Inventory***Inventory*

Inventory consists primarily of the consumable materials used to manufacture identification cards, such as inks, laminates, and adhesives (considered raw material), equipment held for sale (considered finished goods) and deferred contract costs (considered either finished goods or in-process). Inventories are valued on a first-in, first-out basis at the lower of cost or market value (net realizable value).

	March 31, 2008	December 31, 2007
Equipment and deferred contract costs	\$ 655	\$ 1,213
Consumable materials, net	5,465	6,103
<b>Inventory, net</b>	<b>\$ 6,120</b>	<b>\$ 7,316</b>





## DIGIMARC CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(UNAUDITED)

**8. Inventory (Continued)***Reserve for slow moving and obsolete inventory*

The Company records a provision for excess and obsolete inventory based on changes in market conditions, sales orders, expected sales volumes, and technology advances. The provision was recorded in the period the circumstances occurred or were identified.

The reserve for slow moving and obsolete consumable materials was \$101 and \$138 at March 31, 2008 and at December 31, 2007, respectively. While the Company does not currently expect to be able to sell or otherwise use the reserved inventory it has on hand based upon its forecast and backlog, it is possible that one or more customers will decide in the future to purchase a portion of the reserved inventory.

**9. Other Income (Expense), Net**

Other income (expense), net consists primarily of interest received and paid and foreign currency translation gain or loss.

	Three Months Ended March 31,	
	2008	2007
Other income (expense):		
Interest income	\$ 318	\$ 412
Interest expense	(48)	(19)
Foreign currency and other	83	(11)
	<u>          </u>	<u>          </u>
Total other income (expense), net	\$ 353	\$ 382
	<u>          </u>	<u>          </u>

**10. Income Taxes**

*Provision for Income Taxes.* The provision for income taxes reflects expected tax expense in certain foreign jurisdictions. The Company has recorded a full valuation allowance against the Company's net deferred tax assets at March 31, 2008 due to the uncertainty of realization of the Company's net operating losses. The Company will continue to evaluate the realizability of the Company's domestic and other foreign net deferred tax assets and may record additional benefits in future earnings if the Company determines the realization of these assets is more likely than not.

**11. Commitments and Contingencies***Litigation*

In 2004, three purported class action lawsuits were filed in the U.S. District Court for the District of Oregon against the Company and certain of its current and former directors and officers on behalf of purchasers of the Company's securities during the period April 17, 2002 to July 28, 2004. These lawsuits were later consolidated into one action for all purposes. The amended complaint, which sought unspecified damages, asserted claims under the federal securities laws relating to the Company's restatement of its financial statements for 2003 and the first two quarters of 2004 and alleged that the

**DIGIMARC CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(In thousands, except share and per share data)**

**(UNAUDITED)**

**11. Commitments and Contingencies (Continued)**

Company issued false and misleading financial statements and issued misleading public statements about the Company's operations and prospects. On August 4, 2006, the court granted the Company's motion to dismiss the lawsuit with prejudice and entered judgment in the Company's favor. Plaintiffs appealed to the Ninth Circuit Court of Appeals. The appeal has been fully briefed but not yet scheduled for oral argument. Due to the inherent uncertainties of litigation, the Company cannot accurately predict the ultimate timing of a decision in or the outcome of this matter.

On or about October 19, 2004, two purported shareholder derivative lawsuits were filed against certain of the Company's officers and directors, naming the Company as a nominal defendant, in the Superior Court of the State of California for the County of San Luis Obispo. These lawsuits were consolidated into one action for all purposes on March 14, 2005. This suit claims that certain of these officers and directors breached their fiduciary duties to the Company's stockholders and to the Company. The complaint is derivative in nature and does not seek relief from the Company. The Board appointed an independent committee to investigate the claims asserted in this derivative lawsuit. On July 19, 2005, the court granted the Company's motion to dismiss these consolidated actions in favor of a shareholder derivative action to be filed by plaintiffs in the Circuit Court of the State of Oregon for the County of Washington. On August 25, 2005, the California plaintiffs filed two new derivative lawsuits in the United States District Court for the District of Oregon. On October 17, 2005, the defendants filed a motion to dismiss these complaints for lack of subject matter jurisdiction and failure to state a claim. In May of 2006, the Board committee, after completing its investigation, concluded that pursuit of the allegations would not be in the best interests of the Company or its stockholders. On August 24, 2006, the court granted the defendants' motion and dismissed the lawsuit with prejudice. Plaintiffs filed a notice of appeal on September 22, 2006. The briefs to the Ninth Circuit were completed in June 2007, and the Company anticipates oral argument and a decision in 2008. However, due to the inherent uncertainties of litigation, the Company cannot accurately predict the ultimate timing or outcome of the matter.

On or about April 6, 2005, another purported shareholder derivative lawsuit was filed against certain of the Company's officers and directors, and also naming the Company as a nominal defendant, in the Circuit Court for the State of Oregon for the County of Washington containing similar allegations to the complaints discussed above. That case was stayed pending the report of the Board committee referenced above, and was ultimately dismissed following the Board committee's investigation.

Beginning in May 2001, a number of substantially identical class action complaints alleging violations of the federal securities laws were filed in the United States District Court for the Southern District of New York naming approximately 300 companies, including the Company, and their officers and directors and underwriters as defendants in connection with the initial public offerings of these companies. The plaintiffs allege that the defendants fraudulently inflated the share prices of these companies during and after their initial public offerings through an elaborate scheme characterized by tie-in agreements, undisclosed compensation and analyst conflicts. The plaintiffs also allege that the underwriter defendants required some substantial investors who requested allocations in the initial public offerings to participate in the scheme. Some of the Company's officers and directors are named in the amended complaint pursuant to Section 11 of the Securities Act of 1933 and Section 10(b) and

DIGIMARC CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(UNAUDITED)

**11. Commitments and Contingencies (Continued)**

Rule 10b-5 of the Securities Exchange Act of 1934 on the basis of an alleged failure to disclose the underwriters' alleged compensation arrangements and manipulative practices. The complaint seeks unspecified damages. The individual officer and director defendants entered into tolling agreements and, pursuant to a court order dated October 9, 2002, were dismissed from the litigation without prejudice. The plaintiffs have continued to litigate their claims primarily against the underwriter defendants. The district court directed that the litigation proceed within a number of "focus cases" rather than in all of the 309 cases that have now been consolidated. The Company's case is not one of these focus cases. On December 5, 2006, the Court of Appeals for the Second Circuit reversed the district court's class certification decision for these six focus cases. In response to that ruling, the plaintiffs amended their master allegations and the focus case complaints, and the defendants moved to dismiss those amended complaints. The court issued an opinion and order on March 26, 2008, essentially denying the motion to dismiss and allowing the case to continue. New motions for class certification in the six focus cases are in the briefing process which is expected to be completed in May of 2008. Due to the inherent uncertainties of litigation, the Company cannot accurately predict the ultimate outcome of the matter.

On October 10, 2007, a stockholder of the Company filed a lawsuit in the United States District Court for the Western District of Washington against several companies that acted as lead underwriters on the initial public offering of the Company. The complaint, which also named the Company as a nominal defendant but did not assert any claims against the Company, asserted claims against the underwriters under Section 16(b) of the Securities Exchange Act of 1934 for recovery of alleged short-swing profits on trades of the Company's stock. On February 28, 2008, an amended complaint was filed, with the Company still named only as a nominal defendant. Similar complaints have been filed by this same plaintiff against a number of other issuers in connection with their initial public offerings, and the factual allegations are closely related to the allegations in the litigation pending in the United States District Court for the Southern District of New York which is described above in this Form 10-Q.

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 SFAS No. 5, *Accounting for Contingencies*. To date, there have been no claims made under such indemnification provisions.

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, 2008, the final disposition of these proceedings will not have a material adverse effect on the consolidated financial position, results of operations, or liquidity of the Company. No accrual has been recorded because the amounts are not probable or reasonably estimatable in accordance with SFAS No. 5, *Accounting for Contingencies*.

*Performance Bonds*

Some governmental authorities require performance bonds that we are obligated to maintain during the life of the contract. Often, the terms of these bonds require that we obtain letters of credit to secure our obligations under the bonds. The letters of credit may in turn require us to maintain

## DIGIMARC CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(UNAUDITED)

**11. Commitments and Contingencies (Continued)**

large restricted cash reserves as security, reducing our ability to use these funds for our other business purposes. Even with the availability of such cash reserve guarantees, we may not be able to obtain such performance bond underwriting at a favorable rate or at all. Our failure to be able to provide such performance bonds may preclude us from bidding on new government contracts or maintaining our existing contracts for their full terms. In addition, these performance bonds may provide for security interests covering our receivables or other assets, which could cause additional financing to be more difficult or more expensive to obtain. The size, nature and purpose of, and the risks and uncertainties associated with, public sector contracts can potentially cause our results to fluctuate and anticipated revenue to decrease significantly.

**12. Quarterly Financial Information**

Quarter ended:	March 31	June 30	September 30	December 31
<b>2008</b>				
Total revenue	\$ 30,570			
Total cost of revenue	18,623			
Gross profit	11,947			
Sales and marketing	4,623			
Research, development and engineering	2,278			
General and administrative	4,584			
Amortization of intangibles	420			
Intellectual property	545			
Acquisition related costs	1,089			
Operating income (loss)	(1,592)			
Net income (loss)	(1,361)			
Net income (loss) per share basic	(0.06)			
Net income (loss) per share diluted	(0.06)			
<b>2007</b>				
Total revenue	\$ 26,846	\$ 27,364	\$ 27,132	\$ 28,422
Total cost of revenue	16,815	17,077	16,367	17,769
Gross profit	10,031	10,287	10,765	10,653
Sales and marketing	4,277	4,365	4,103	3,870
Research, development and engineering	2,042	1,883	1,691	1,707
General and administrative	4,098	3,809	3,724	3,978
Amortization of intangibles	500	509	451	532
Intellectual property	499	476	429	432
Operating income (loss)	(1,385)	(755)	367	134
Net income (loss)	(1,022)	(495)	772	300
Net income (loss) per share basic	(0.05)	(0.02)	0.04	0.01
Net income (loss) per share diluted	(0.05)	(0.02)	0.04	0.01

**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 consolidated financial statements and the related notes and other financial information appearing elsewhere in this Form 10-Q. Readers are also urged to carefully review and consider the various disclosures made by us which attempt to advise interested parties of the factors which affect our business, including without limitation the disclosures made in Part II, Item 1A (Risk Factors) of this Form 10-Q and in the audited consolidated financial statements and related notes included in our Annual Report on Form 10-K for the year ended December 31, 2007 filed on February 29, 2008, and other reports and filings made with the Securities and Exchange Commission ("SEC").*

**Pending Acquisition of Digimarc and Spin-Off of Digital Watermarking Business**

On March 23, 2008, we entered into a definitive agreement with L-1 Identity Solutions, Inc. (NYSE: L-1) ("L-1") pursuant to which a subsidiary of L-1 will be merged with and into Digimarc (the "merger"), with Digimarc continuing after the merger as a wholly-owned subsidiary of L-1. Immediately prior to the merger, we will contribute all of the assets and liabilities related to our digital watermarking business, together with all of our cash, to our wholly-owned subsidiary, the shares of which will be distributed to our stockholders in a taxable spin-off transaction.

At the effective time of the merger, each issued and outstanding share of our common stock will be converted into the right to receive (i) the stockholder's pro rata share of \$120.0 million in cash, without interest, and (ii) a fractional interest in a share of L-1 common stock based on an exchange ratio calculated in accordance with the terms of the merger agreement. In addition, all outstanding options to purchase shares of our common stock will vest and become fully exercisable immediately prior to the record date for the spin-off, and each holder of an option to purchase shares of our common stock will be entitled to exercise such holder's options immediately prior to the record date for the spin-off, conditioned upon the occurrence of the spin-off. After the completion of the merger and spin-off, L-1 will purchase stock in the new digital watermarking company, in the aggregate amount of \$5.0 million.

The completion of the merger is subject to approval of the merger agreement by our stockholders, expiration or termination of any applicable waiting period under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, completion of the spin-off and other customary closing conditions. The transaction is not subject to any financing condition. There can be no assurance that the merger and spin-off will be consummated in a timely manner, if at all.

In connection with the proposed merger, L-1 will file with the SEC a Registration Statement on Form S-4 that will include a proxy statement of Digimarc that also constitutes a prospectus of L-1, in addition to other relevant materials related to the merger and spin-off. The proxy statement/prospectus will include a detailed description of the terms of the merger agreement, as well as other important information about the proposed transactions.

## Edgar Filing: DIGIMARC CORP - Form 10-Q

**We urge investors and security holders to read the proxy statement/prospectus regarding the proposed merger when it becomes available because it will contain important information.**

Our company, our directors, and certain of our executive officers may be deemed to be participants in the solicitation of proxies from our stockholders with respect of the proposed transaction. Our stockholders may obtain information regarding the names, affiliations and interests of such individuals in the proxy statement.

All forward-looking statements in this Quarterly Report on Form 10-Q, including those in the Management's Discussion and Analysis of Financial Condition, Results of Operations and Risk Factors, are based on management's plans for future operations without consideration given to the pending transaction.

### Overview

Digimarc Corporation ("Digimarc," "our" or "we") is a leading supplier of secure identity solutions and solutions for use in media identification and management. Our solutions enable governments and businesses around the world to enhance traffic safety and national security, combat identity theft and fraud, facilitate the effectiveness of voter identification programs, improve the management of media content, deter counterfeiting and piracy and support new digital media distribution models that provide consumers with more choice and access to media content. Our mission is two-fold:

Foster large-scale adoption of media identification and management solutions licensed under Digimarc's intellectual property; and

Be the most desired profitable supplier of driver license issuance systems.

We issue more than 60 million identification documents ("IDs") annually and are the leading supplier of government-issued citizen IDs in North America, including supplying systems that produce more than two-thirds of all driver licenses issued in the U.S. We are also a pioneer and leading owner of intellectual property in 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, including personal identification documents, financial instruments, photographs, movies, music, television, and product packages. The embedded data within various types of media content can be detected and read by software or hardware detectors in personal computers and other digital devices.

Digital watermarking is a strategic component of nearly all of our product offerings. We provide media identification and management solutions based on this and related technologies directly and through our licensees. Digital watermarking has already proven to be a powerful element of document security, giving rise to our long-term relationship with a consortium of Central Banks and many leading companies in the information technology industry. We are working to achieve a similar success in secure identity management systems. We anticipate that by the middle of 2008 more than one out of two driver licenses being produced in the U.S. will carry digital watermarks as a means to provide cross-jurisdictional machine authentication. In addition, Digimarc and its licensees have successfully propagated digital watermarking in music, movies, television broadcasts, images and printed materials. Digital watermarks have been used in these applications to provide improved 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 experiences.

Our principal administrative, marketing, research, and intellectual property development facility is located in Beaverton, Oregon. Our secure ID systems business is headquartered in Burlington, Massachusetts, and our logistics center is in Fort Wayne, Indiana.

## Edgar Filing: DIGIMARC CORP - Form 10-Q

Our ID systems revenue is primarily generated pursuant to long-term contracts with government ID issuers primarily U.S. State government agencies responsible for driver license issuance and national governments of a number of countries. These customers rely on our systems design, integration and materials science expertise, and proprietary technologies such as digital watermarking, to implement issuance systems and processes that improve the security of identity documents and banknotes.

Our media identification and management revenue is generated through commercial and government applications of our digital watermarking and related media identification and management technologies, primarily from patent and technology license fees paid by business partners and our contracts with a consortium of Central Banks and with The Nielsen Company. Our licensing program, which is a core part of our media identification and management business, is built upon our extensive patent portfolio, which contains over 370 issued U.S. patents, and numerous foreign patents, as of March 31, 2008. Private sector media and entertainment industry customers use secure media identification and management solutions from our business partners and us to identify, track, manage and protect content as it is distributed and consumed either digitally or physically and to enable new consumer applications to improve access to networks and information from personal computers and mobile devices. We expect that patent and technology licensing will continue to contribute most of our revenues from non-government customers for the foreseeable future.

### *Secure ID Systems*

We issue more than 60 million IDs annually and are the leading supplier of government-issued citizen IDs in North America, producing more than two-thirds of all driver licenses issued in the U.S. We have also provided secure ID solutions to approximately 25 foreign governments.

In North America, we generate most of our revenue through the issuance of State driver licenses and other IDs on a fixed price per credential issued basis. In North America, we are generally a prime contractor, providing full issuance systems to Federal, State, and provincial departments of motor vehicles or other government issuing authorities. These systems typically include hardware (including specialized cameras, printers, personal computers and servers), software, consumable supplies (such as ribbons, blank or preprinted card materials and laminated and related consumables) and ongoing support services. These systems may also involve software and/or hardware development, integration services, and implementation services. When we provide a full issuance system to a customer, we generally retain title to all equipment, software and consumables associated with the system and are responsible for maintaining the system over the contractual period.

Our strategy regarding the anticipated opportunities relating to the REAL ID Act, federal legislation passed in May 2005, is to provide solutions that address the requirements of the REAL ID Act: identity verification; document scanning and archiving; individual background checking; data and image sharing; and migration to and production of REAL ID Act compliant driver license documents. These solutions are available to customers as upgrades or complete issuance systems. Digimarc is currently offering the States program management assistance to safely migrate to REAL ID Act compliance.

In markets outside of North America, we generally provide driver license, national identification and voter identification systems, services, and components in partnership with local card producers, security printers, system integrators and others. In these markets, we may serve as prime contractor or sub-contractor, depending on the circumstances. As a sub-contractor, we generally are responsible for delivering hardware, software, or consumables, and some degree of integration services to the prime contractor; whereas as a prime contractor, we are responsible for integrating all components of the system to the customer's specifications.



## Edgar Filing: DIGIMARC CORP - Form 10-Q

Outside of North America, our revenues are typically generated from sales of equipment, software and/or consumables to government agencies or their prime contractors. These sales may occur at irregular intervals, can carry relatively low margins and cause variations in quarterly revenue and gross profit trends. We enter into low margin contracts and transactions from time to time to maintain market presence and build relationships with customers and business partners, and often transition to more profitable digital technologies over time. Due to the nature of such international programs and customers, the timing of these sales is less predictable than our service revenues provided by domestic customers and, consequently, international sales can occur unevenly during the course of a year.

### *Media Identification and Management*

We license our technology and patents and otherwise foster development of the market for media identification and management solutions, including our digital watermarking technologies, through our participation in industry activities and events for commercial as well as governmental uses. Our licenses primarily involve use of our technology and patents in the media and entertainment area, but also support industrial and commercial enterprise applications as well as applications supporting Federal programs. We also have a multi-year contract with an international consortium of Central Banks pursuant to which we have been, since 1997, developing, deploying, supporting and continuing to enhance a system to deter digital counterfeiting of currency using personal computers and digital reprographics.

Commercial customers use secure media solutions from our business partners and us to identify, track, manage and protect content as it is distributed and consumed either digitally or physically and to enable new consumer applications to access networks and information from personal computers and mobile devices. Many movie studios, record labels, broadcasters, creative professionals and other customers rely on digital watermarking as a cost-effective means to:

deter piracy and illegal use of movies, music and images;

protect entertainment content from copyright infringement;

track and monitor entertainment content for rights usage and licensing compliance;

monitor advertisements to verify ad placement and measure return on investment;

enhance information access, search and marketing capabilities related to media content; and

enable fair and legitimate use of content by consumers.

Our business partners and customers include AquaMobile, Cinea, Inc., a subsidiary of Dolby Laboratories, Inc., GCS Research LLC, MediaGrid, Microsoft Corporation, Mobile Data Systems, Inc., The Nielsen Company, Royal Philips, Signum Technologies Limited, Thomson Multimedia, S.A., USA Video, Verance Corporation, Verimatrix, Inc. and VCP (an affiliate of VEIL Interactive Technologies). Although each partner or customer addresses particular needs, as a whole these partners and customers are propagating digital watermarking in music, movies, images and television as a means to improve media rights and asset management, reduce piracy losses, improve marketing programs, and provide more efficient and effective distribution of valuable media content.

*Seasonality.* We have observed seasonality in our U.S. driver license issuance revenues, with larger revenues in the second and third quarter of the year, and generally lower revenues in the first and fourth quarters. The fourth quarter is usually the seasonally lowest quarter each year. We use the straight line method of depreciation and amortization for program-related assets. The combination of the seasonality of our revenues and straight line depreciation and amortization can cause significant variations in quarterly gross margin trends, generally increasing margins in the second and third quarters when our issuance revenues are higher and decreasing margins in the first and fourth quarters when our issuance revenues are typically lower, while having a neutral effect on a yearly basis.

## Edgar Filing: DIGIMARC CORP - Form 10-Q

*Variability of Capitalized and Deferred Costs.* Our driver license and ID issuance programs generally require that we incur significant costs in developing, building and deploying new systems which may be sold outright upon completion or used in generating recurring revenue in the future. Certain labor and other costs relating to these new systems may be deferred and expensed upon completion, or capitalized and amortized over the life of the relevant contract, rather than expensed in the quarter in which they are incurred. We may experience variability in our operating income, depending on the extent to which we are able to capitalize or defer these costs. If we are able to win new business, our capitalized or deferred costs and operating income may increase as a result of an increased allocation of labor resources to capitalized or deferred items. On the other hand, if we experience delays or reductions in new business, our capitalized or deferred costs may decrease, which may result in an increase in operating expenses for the relevant quarter and a decrease in operating income.

*Depreciation.* Our policy for depreciating fixed assets that are specifically used to provide services under long-term contracts to the shorter of the original contract term plus 2.75 years or estimated useful life. Historically, 95% of contracts were extended beyond the original contract term, that the average contract had at least two contract extensions during its life and that these extensions added on average 2.75 years to the length of the contracts' original terms.

Since contract-specific program assets are tracked on a contract basis, the finding that contracts are routinely extended beyond the original term and that these extensions are not generally accompanied by significant incremental capital investment indicates that the useful life of contract-related assets is generally longer than the original term of the contract. Given these findings, we concluded that it was appropriate to change the estimated useful lives of these assets for purposes of depreciation. In addition, the change in useful lives achieves a better matching of the utility of these assets with the resulting revenues. For the year ended December 31, 2007, we performed an updated analysis on contract specific assets which resulted in no change to our previous conclusions. We will continue to analyze the useful lives of contract specific assets in future periods. The financial impact of this change is discussed below under the "Cost of Revenue" heading.

### *Backlog.*

	<b>Total</b>	<b>Revenue to be Recognized for the Remainder of 2008</b>
	(in millions)	
<b>Backlog by source:</b>		
Media identification and management	\$ 65	\$ 13
Identification	215	55
Total	\$ 280	\$ 68

Based on projected government-issued credential production volumes and other commitments we have for the periods under contract with our respective customers, we anticipate our current contracts as of March 31, 2008 will generate approximately \$280 million in revenue during the contractual terms of such contracts, currently up to seven years. We expect more than \$68 million of this amount to be recognized as revenue during the remainder of 2008. This amount includes production volumes reasonably expected to be achieved under currently effective contracts and government orders that are firm but not yet funded, and government contracts awarded but not yet signed. Backlog as of December 31, 2007 was approximately \$225 million. The increase in backlog reflects factors noted below.

## Edgar Filing: DIGIMARC CORP - Form 10-Q

Some factors that lead to increased backlog are:

competitive bid wins,

renewals with current customers,

add-on sales to current customers, and

contracts with longer contractual periods replacing contracts with shorter contractual periods.

Some factors that lead to decreased backlog are:

recognition of revenue associated with backlog currently in place,

low bid and award activity,

contracts with shorter contractual periods replacing contracts with longer contractual periods, and

the revenue model utilized for a particular customer (e.g., a "price-per-card" model with a large associated backlog vs. a "hardware and consumables" model with a small associated backlog).

The mix of these factors, among others, dictates whether our backlog increases or decreases for any given period.

Over the next few years, we anticipate several states to request bids on their driver license issuance system programs. This period of expected high bid activity could lead to additional backlog if we are successful with our bids. Another factor that could affect backlog in this period is the revenue model utilized for a particular customer. From time to time we have sales to our customers that are not made on a price-per-card basis, but instead include hardware and consumable sales. Although these types of revenue models are positive growth indicators for our business, they can lead to lower reported backlog.

There is no assurance that our backlog will result in actual revenue in any particular period, because the orders, awards and contracts included in our backlog may be subject to modification, cancellation or suspension. We may not realize revenue on certain contracts, orders or awards included in our backlog or the timing of such realization may change.

*Restructuring.* During the last half of 2005 and continuing during 2006, we restructured our operations to improve productivity and reduce fixed costs. During the second quarter of 2006 we accelerated those activities significantly, resulting in a reduction of our workforce by nearly 20%. Overall, our workforce was reduced by over 30% since mid 2005. Our actions included the redeployment and reallocation of resources to better align with our operating strategies.

### **Additional Information**

A more detailed discussion of our business is contained in our Annual Report on Form 10-K for the fiscal year ended December 31, 2007.

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

The preparation of consolidated financial statements in accordance with accounting principles generally accepted in the U.S. ("U.S. GAAP") requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate our estimates, including those related to bad debts, inventories, fixed assets, intangible assets, income taxes, restructuring, long-term service contracts, warranties, investments, and contingencies and litigation. We base our estimates on historical



experience and on various other assumptions we believe to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions.

Certain of our accounting policies require higher degrees of judgment than others in their application. These include revenue recognition on long-term service contracts, impairments and estimation of useful lives of long-lived assets, inventory valuation, reserves for uncollectible accounts receivable, contingencies and litigation and stock-based compensation. We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our consolidated financial statements:

**Revenue recognition on long-term service contracts:** We recognize revenue on long-term identification and driver license production contracts using primarily a price-per-card method. We use actual monthly volume amounts, if available, or we estimate the card production volume on a monthly basis for certain of these contracts in order to recognize revenue earned during the period. In the case of estimates, when the actual production information becomes available, which is typically within four weeks, we bill the customer accordingly and any differences from the estimates are recognized in the month the billing occurs. These amounts represent our best estimates of cards produced and are based on historical trends, known events during the period, and discussions with contract representatives. Prior to publicly reporting results, our practice is to compare the actual production volumes to estimated production volumes and adjust revenue amounts as necessary. Any estimated amounts are included in unbilled receivables on the balance sheet until the actual production information is available and the billing occurs. Any estimation process involves inherent risk. We reduce the inherent risk relating to production estimation through our approval and monitoring processes related to accounting estimates. We also evaluate contracts for multiple elements and account for these items under the appropriate accounting literature.

Revenue from professional service arrangements is generally determined based on time and material or a cost plus a profit margin measure. Revenue for professional services is recognized as the services are performed. Losses on contracts, if any, are provided for in the period in which the loss becomes determinable. Billing for services rendered generally occurs within one month following when the services are provided. Revenue earned which has not been invoiced is classified as unbilled trade receivables, which is included in the balance of trade accounts receivable, net in the consolidated balance sheets.

**Impairments and estimation of useful lives of long-lived assets:** We periodically assess long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable, in accordance with the provisions of Statement of Financial Accounting Standards ("SFAS") No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. 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. Also, we periodically review the useful lives of long-lived assets whenever events or changes in circumstances indicate that the useful life may have changed. If the estimated useful lives of such assets do change, we adjust the depreciation or amortization period to a shorter or longer period, based on the circumstances identified.

**Inventory valuation:** Inventory consists primarily of consumable supplies that are used in the production of driver licenses and products held for resale to customers. We value inventory at the lower of cost or market value (which lower amount is the net realizable value). We reduce the value of

our inventory for estimated obsolescence or unmarketable inventory equal to the difference between the cost of inventory and the estimated market value based upon assumptions about future demand and market conditions. If actual market conditions are less favorable than those projected by management, additional inventory write-downs may be required.

**Reserves for uncollectible accounts receivable:** We maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. We determine the allowance based on historical write-off experience and current information. We review, and adjust when appropriate, our allowance for doubtful accounts on at least a quarterly basis. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required.

**Contingencies and litigation:** We periodically evaluate all pending or threatened contingencies or commitments, if any, that are reasonably likely to have a material adverse effect on our operations or financial position. We assess the probability of an adverse outcome and determine if it is remote, reasonably possible or probable as defined in accordance with the provisions of SFAS No. 5, *Accounting for Contingencies*. If information available prior to the issuance of our financial statements indicates that it is probable that an asset has been impaired or a liability has been incurred at the date of our financial statements, and the amount of the loss, or the range of probable loss can be reasonably estimated, then such loss is accrued and charged to operations. If no accrual is made for a loss contingency because one or both of the conditions pursuant to SFAS No. 5 are not met, but the probability of an adverse outcome is at least reasonably possible, we will disclose the nature of the contingency and provide an estimate of the possible loss or range of loss, or state that such an estimate cannot be made.

**Stock-based compensation:** We account for stock-based compensation in accordance with SFAS No. 123(R), *Share-Based Payment (Revised 2004)*, which requires the measurement and recognition of compensation for all stock-based awards made to employees and directors including stock options and employee stock purchases under a stock purchase plan based on estimated fair values. We use the Black-Scholes option pricing model as our method of valuation for stock-based awards. Our determination of the fair value of stock-based awards on the date of grant using an option pricing model is affected by our 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, our expected stock price, volatility over the term of the award and actual and projected exercise behaviors. Although the fair value of stock-based awards is determined in accordance with SFAS 123(R), the Black-Scholes option pricing model requires the input of highly subjective assumptions, and other reasonable assumptions could provide differing results. The fair value of restricted stock awards granted is based on the fair market value of our common stock on the date of the grant (measurement date), and is being recognized over the vesting period of the related restricted stock using the straight-line method. The fair value of performance vesting share awards granted is based on a Monte Carlo valuation model that resulted in a factor applied to the fair market value of our common stock on the date of the grant (measurement date), and is being recognized over the derived service period using the straight-line method.

## Results of Operations

The following table presents our consolidated statements of operations data for the periods indicated as a percentage of total revenue. Unless otherwise indicated, all references to the three-

Edgar Filing: DIGIMARC CORP - Form 10-Q

month period relate to the three-month period ended March 31, 2008 and all changes discussed with respect to such period reflect changes as compared to the three-month period ended March 31, 2007.

	Three Months Ended March 31,	
	2008	2007
<b>Revenue:</b>		
Service	81%	79%
Product and subscription	19	21
	<u>        </u>	<u>        </u>
Total revenue	100	100
<b>Cost of revenue:</b>		
Service	53	55
Product and subscription	8	8
	<u>        </u>	<u>        </u>
Total cost of revenue	61	63
Gross profit	39	37
<b>Operating expenses:</b>		
Sales and marketing	15	16
Research, development and engineering	7	7
General and administrative	15	15
Amortization of intangibles	1	2
Intellectual property	2	2
Acquisition related costs	4	
	<u>        </u>	<u>        </u>
Total operating expenses	44	42
	<u>        </u>	<u>        </u>
Operating income (loss)	(5)	(5)
	<u>        </u>	<u>        </u>
Other income (expense), net	1	1
	<u>        </u>	<u>        </u>
Income (loss) before provision for income taxes	(4)	(4)
Provision for income taxes	0	0
	<u>        </u>	<u>        </u>
Net income (loss)	(4)%	(4)%
	<u>        </u>	<u>        </u>

Our total revenue for the three months ended March 31, 2008 was \$30.6 million, or 14% higher as compared to \$26.8 million for the prior year period. While reporting a loss of \$1.4 million, or \$0.06 per share, in 2008 compared to a loss of \$1.0 million, or \$0.05 per share, in 2007, our results reflect increases in primarily two areas of cost. We incurred \$1.1 million, or \$0.05 per share, of non-recurring costs in connection with the pending acquisition of our ID Systems business by L-1. We also accrued \$0.8 million, or \$0.04 per share, of costs associated with the corporate incentive bonus program. In 2007, there were no accrued amounts for the corporate incentive bonus program. The results for the quarter also reflect improved gross margins originating from improved operating leverage attributable to the field support and manufacturing operations, originating from an operational restructuring that occurred during 2005 and 2006. We made significant cost reductions and improved operating efficiencies whereby we lowered our fixed costs to more normal levels.

## Revenue

	Three Months Ended March 31,		Dollar Increase (Decrease)	Percent Increase (Decrease)
	2008	2007		
	(in 000'S)			
<b>Revenue:</b>				
Service	\$ 24,674	\$ 21,299	\$ 3,375	16%
Product and subscription	5,896	5,547	349	6%
	<b>_____</b>	<b>_____</b>	<b>_____</b>	
Total	\$ 30,570	\$ 26,846	\$ 3,724	14%
	<b>_____</b>	<b>_____</b>	<b>_____</b>	
<b>Revenue (as % of total revenue):</b>				
Service	81%	79%		
Product and subscription	19%	21%		
	<b>_____</b>	<b>_____</b>		
Total	100%	100%		
	<b>_____</b>	<b>_____</b>		

*Service.* Service revenue consists primarily of:

card production on a price-per-card basis,

software development and consulting services, and

hardware and software maintenance.

The majority of service revenue arrangements are typically structured as price-per-card product agreements, time and materials consulting agreements, or fixed price consulting agreements.

The increase in service revenue for the three-month period was due primarily to:

higher production volumes under our Mexico contract relating to governmental initiatives to increase voter registration,

full quarter of revenues generated from two additional provinces brought on-line under our Atlantic Canada contract,

higher issuance revenues, primarily attributable to return to normal production after changes in renewal cycles, and

consulting revenues, to a lesser extent, generated from our new contract with The Nielsen Company that was signed late last year.

*Product and subscription.* Product revenue consists primarily of the sale of equipment, software licenses and consumables related to identification card production systems that are variable in nature and occur from time to time. Subscription revenue consists primarily of royalty revenue from our intellectual property licenses and the sale of our web-based subscriptions related to various software products, both of which are more recurring in nature. Revenues from our licensing products have minimal associated costs and are nearly all margin.

The increase in product and subscription revenue for the three-month period was due primarily to:



## Edgar Filing: DIGIMARC CORP - Form 10-Q

initial license revenues from the Nielsen contract,

net increase in variable sales, add-ons and upgrades to various domestic and international customers, including a large, low margin file sale to an international customer, offset by

elimination of consumables revenues associated with our United Kingdom contract that ended production in the second quarter of 2007.

## Revenue by Geography

	Three Months Ended March 31,		Dollar Increase (Decrease)	Percent Increase (Decrease)
	2008	2007		
(in 000'S)				
<b>Revenue by geography:</b>				
Domestic	\$ 24,422	\$ 20,520	\$ 3,902	19%
International	6,148	6,326	(178)	(3)%
<b>Total</b>	<b>\$ 30,570</b>	<b>\$ 26,846</b>	<b>\$ 3,724</b>	<b>14%</b>
<b>Revenue (as % of total revenue):</b>				
Domestic	80%	76%		
International	20%	24%		
<b>Total</b>	<b>100%</b>	<b>100%</b>		

Domestic revenue increased for the three-month period due primarily to service and license revenues associated with the Nielsen contract and higher driver license production revenues from various states.

International revenue slightly decreased for the three-month period due primarily to the expiration of the United Kingdom contract, offset by higher production volumes from our Mexico and Atlantic Canada operations.

## Revenue by Source

	Three Months Ended March 31,		Dollar Increase (Decrease)	Percent Increase (Decrease)
	2008	2007		
(in 000'S)				
<b>Revenue by source:</b>				
Media identification and management	\$ 5,088	\$ 3,485	\$ 1,603	46%
Identification	25,482	23,361	2,121	9%
<b>Total</b>	<b>\$ 30,570</b>	<b>\$ 26,846</b>	<b>\$ 3,724</b>	<b>14%</b>
<b>Revenue (as % of total revenue):</b>				
Media identification and management	17%	13%		
Identification	83%	87%		
<b>Total</b>	<b>100%</b>	<b>100%</b>		

The increase in media identification and management revenue was due primarily to higher service and licensing revenue from the Nielsen contract.

The increase in identification revenue was due primarily to higher production volumes from our Mexico and Atlantic Canada operations, and higher revenues from various states primarily from a volume mix, including California and Iowa, offset by the expiration of the United Kingdom contract.



Edgar Filing: DIGIMARC CORP - Form 10-Q

Cost of Revenue

	Three Months Ended March 31,		Dollar Increase (Decrease)	Percent Increase (Decrease)
	2008	2007		
(in 000'S)				
<b>Cost of revenue:</b>				
Service	\$ 16,203	\$ 14,715	\$ 1,488	10%
Product and subscription	2,420	2,100	320	15%
	<u>          </u>	<u>          </u>	<u>          </u>	
Total	\$ 18,623	\$ 16,815	\$ 1,808	11%
	<u>          </u>	<u>          </u>	<u>          </u>	
<b>Cost of revenue (as % of related revenue components):</b>				
Service	66%	69%		
Product and subscription	41%	38%		

*Service.* Cost of service revenue primarily includes:

costs of consumables used in delivering a service,

compensation, benefits and related costs of software developers, quality assurance personnel, product managers and field operations personnel,

payment to outside contractors,

depreciation charges for machinery, equipment, software and capitalized labor,

deployment costs used specifically for service delivery,

provisions for obsolete and excess inventories,

travel costs directly attributable to service and development contracts,

stock-based compensation expense, and

charges for infrastructure and centralized costs.

Cost of service revenue increased for the three-month period primarily due to:

increased depreciation expense of \$0.4 million related to programs completed in the later half of 2007 or implemented during the quarter,

increased accrued benefits of \$0.2 million for corporate incentive bonus program,

increased compensation related costs of \$0.2 million and repair and maintenance of \$0.2 million related to improving the efficiency of certain programs, and

increased costs of approximately \$0.2 million related to lower resource allocations to capital and deferred cost projects.

*Product and subscription.* Cost of product and subscription revenue primarily includes costs of equipment and consumables related to our ID production systems, as well as Internet service provider connectivity charges and image search data fees to support the services offered to our subscription customers.

Cost of product and subscription revenue increased for the three-month period primarily due to corresponding increases in revenues, including issuance production revenues, higher add-ons and upgrade revenues, and a large consumable film sale to an international customer, offset by lower consumables sales related to the expiration of the United Kingdom contract. The increase in the cost of product and subscription revenue percentage for the three-month period reflects the volume and mix

Edgar Filing: DIGIMARC CORP - Form 10-Q

impact on gross margins from increased add-ons, upgrades and film revenues which carried higher direct costs, offset by the expiration of the United Kingdom contract which carried lower direct costs.

The costs included in our cost of revenue fall under three categories as described below:

*Cost of Revenue Components*

	Three Months Ended March 31,		Dollar Increase (Decrease)	Percent Increase (Decrease)
	2008	2007		
	(in 000'S)			
Cost of revenue:				
Variable	\$ 9,040	\$ 7,611	\$ 1,429	19%
Fixed field support and manufacturing	6,377	6,439	(62)	(1)%
Program depreciation	3,206	2,765	441	16%
<b>Total</b>	<b>\$ 18,623</b>	<b>\$ 16,815</b>	<b>\$ 1,808</b>	<b>11%</b>
Cost of revenue (as % of total revenue):				
Variable	30%	29%		
Fixed field support and manufacturing	21%	24%		
Program depreciation	10%	10%		
<b>Total</b>	<b>61%</b>	<b>63%</b>		

*Variable.* Variable costs include:

price of materials to produce an identification card,

direct costs of hardware and software, and related labor, delivered to customers, and

other costs that are variable in nature.

The increase in variable costs for the three-month period was primarily due to increased sales from a combination of issuances and various products to domestic and international customers, offset by lower sales of consumables related to the end of the United Kingdom contract.

*Fixed field support and manufacturing.* Fixed field support and manufacturing costs include:

field operations and support costs,

manufacturing costs,

supply chain costs, and

charges for infrastructure and centralized costs.

Fixed costs remained relatively consistent for the three-month period.

*Program depreciation.* Program depreciation primarily consists of amortization and depreciation of costs incurred during the delivery process, where such costs are capitalized and then amortized or depreciated over the useful lives of the assets to which the costs relate. Costs capitalized during the delivery process typically include equipment, purchased software, capitalized labor for software development and implementation and travel.

The increase in program depreciation was primarily due to delivery of new programs in the later half of 2007 or implemented during the quarter ended March 31, 2008.

*Gross Profit*

	<b>Three Months Ended March 31,</b>		<b>Dollar Increase (Decrease)</b>	<b>Percent Increase (Decrease)</b>
	<b>2008</b>	<b>2007</b>		
(in 000'S)				
<b>Gross profit</b>				
Service	\$ 8,471	\$ 6,584	\$ 1,887	29%
Product and subscription	3,476	3,447	29	1%
<b>Total</b>	<b>\$ 11,947</b>	<b>\$ 10,031</b>	<b>\$ 1,916</b>	<b>19%</b>
<b>Gross profit (as % of related revenue components):</b>				
Service	34%	31%		
Product and subscription	59%	62%		
<b>Total</b>	<b>39%</b>	<b>37%</b>		

The changes in gross profit as a percentage of revenue, for both the revenue components and overall gross profit, for the three-month period ended March 31, 2008 as compared to the three-month period ended March 31, 2007 were primarily due to commensurate changes in revenues and costs of revenues, as described above. In particular, the increase in gross profit reflects significant operating leverage improvement in the field support and manufacturing areas from significant cost reductions and improved operating efficiencies.

*Operating Expenses**Sales and marketing*

	<b>Three Months Ended March 31,</b>		<b>Dollar Increase (Decrease)</b>	<b>Percent Increase (Decrease)</b>
	<b>2008</b>	<b>2007</b>		
(in 000'S)				
Sales and marketing	\$ 4,623	\$ 4,277	\$ 346	8%
Sales and marketing (as % of total revenue)	15%	16%		

Sales and marketing expenses consist primarily of:

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

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

stock-based compensation expense, and

charges for infrastructure and centralized costs.

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

increased accrued benefits of \$0.2 million for corporate incentive bonus program, and



Edgar Filing: DIGIMARC CORP - Form 10-Q

increased professional fees of \$0.1 million related to supporting the sales effort in a number of federal and state lobbying efforts.

We anticipate that we will continue to invest in sales and marketing at current or higher levels.

Edgar Filing: DIGIMARC CORP - Form 10-Q

*Research, development and engineering*

	Three Months Ended March 31,		Dollar Increase (Decrease)	Percent Increase (Decrease)
	2008	2007		
	(in 000'S)			
Research, development and engineering	\$ 2,278	\$ 2,042	\$ 236	12%
Research, development and engineering (as % of total revenue)	7%	7%		

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, primarily in the card systems area,

stock-based compensation expense, and

charges for infrastructure and centralized costs.

The increase in research, development and engineering expense for the three-month period resulted primarily due to increased employee compensation-related expenses of \$0.2 million resulting from additional headcount and corporate incentive bonus program.

We anticipate that we will continue to invest in research, development and engineering expenses at current or above levels in the near term to support certain ongoing product initiatives, and expect to moderate spending in the longer term.

*General and administrative*

	Three Months Ended March 31,		Dollar Increase (Decrease)	Percent Increase (Decrease)
	2008	2007		
	(in 000'S)			
General and administrative	\$ 4,584	\$ 4,098	\$ 486	12%
General and administrative (as % of total revenue)	15%	15%		

General and administrative expenses consist primarily of:

compensation, benefits and related costs of executive, finance and administrative personnel,

legal, human resources and other professional fees,

stock-based compensation expense, and

charges for infrastructure and centralized costs.

## Edgar Filing: DIGIMARC CORP - Form 10-Q

The increase in general and administrative expenses for the three-month period resulted primarily due to increased accrued benefits of \$0.2 million for corporate incentive bonus program and \$0.2 million of other general and administrative expenses.

We anticipate that we will continue to incur general and administrative expenses at or above current levels in the near term, while continuing to examine means to gain efficiencies to reduce general and administrative spending as a percentage of revenue in the longer term.

Edgar Filing: DIGIMARC CORP - Form 10-Q

*Amortization of intangible assets*

	Three Months Ended March 31,		Dollar Increase (Decrease)	Percent Increase (Decrease)
	2008	2007		
	(in 000'S)			
Amortization of intangibles	\$ 420	\$ 500	\$ (80)	(16)%
Amortization of intangibles (as % of total revenue)	1%	2%		

We account for intangible assets resulting from acquisitions in accordance with Financial Accounting Standards Board ("FASB") Statement Nos. 141, *Business Combinations* and 142, *Goodwill and Other Intangible Assets*. These statements require the recording of intangible assets under purchase accounting rules, and require the amortization of such intangible assets over their expected useful life. As a result, in December 2001, we recorded \$29.5 million of intangible assets related to the acquisition of certain assets and certain liabilities from Polaroid and affiliates. These intangible assets were set up to amortize over an average of a 12-year period, representing the expected useful life. Changes in contract status and customer relationships may lengthen or shorten the expected useful life of such intangible assets, or cause an impairment charge related to the intangible asset, so some variability is expected to exist related to intangibles depending on internal and external factors.

The decrease in amortization of intangible assets for the three-month period resulted primarily from extended amortization periods from contract extensions with several domestic customers and the impact of certain international programs being fully amortized.

*Intellectual property*

	Three Months Ended March 31,		Dollar Increase (Decrease)	Percent Increase (Decrease)
	2008	2007		
	(in 000'S)			
Intellectual Property	\$ 545	\$ 499	\$ 46	9%
Intellectual Property (as % of total revenue)	2%	2%		

Intellectual property costs primarily consist of:

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

costs associated with documenting, applying for, and maintaining patents and trademarks,

stock-based compensation expense, and

charges for infrastructure and centralized costs.

Intellectual property expense remained relatively consistent for the three-month period. We anticipate that we will continue to invest in intellectual property expenses at current levels or slightly higher.

*Acquisition related costs.* During the quarter, we entered into the merger agreement to sell our ID Systems business to L-1 in a stock and cash transaction. In connection with the sale we have incurred professional fees for legal, accounting and investment banking costs of \$1.1 million.

We anticipate that we will continue to incur acquisition related costs at or above current levels in the near term until the proposed sale is completed or terminated.

*Stock-based compensation.* Stock-based compensation includes expense charges for all stock-based awards to officers, employees and directors. Such awards include option grants, restricted stock awards, and shares expected to be purchased under an employee stock purchase

plan. We account for stock-

based compensation in accordance with SFAS 123(R), which requires the measurement and recognition of compensation for all stock-based awards made to officers, employees and directors including stock options and employee stock purchases under a stock purchase plan based on estimated fair values. SFAS 123(R) supersedes previous accounting under Accounting Principles Board Opinion ("APB") No. 25, *Accounting for Stock Issued to Employees*, for periods beginning in fiscal 2006. In March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin ("SAB") No. 107 relating to the application of SFAS 123(R). We have applied the provisions of SAB 107 in our adoption of SFAS 123(R).

We adopted SFAS 123(R) using the modified prospective transition method, which requires the application of the accounting standard as of January 1, 2006, the first day of our 2006 fiscal year. In accordance with the modified prospective transition method, our consolidated financial statements for periods prior to fiscal year 2006 have not been restated to reflect this change. Stock-based compensation recognized in the year ended December 31, 2007 and 2006 is based on the value of the portion of the stock-based award that will vest during the period, adjusted for expected forfeitures. Stock-based compensation recognized in our consolidated financial statements in the year ended December 31, 2007 and 2006 includes compensation cost for stock-based awards granted prior to, but not fully vested as of, December 31, 2005 and stock-based awards granted subsequent to December 31, 2005. The compensation cost for awards granted prior to January 1, 2006 is based on the grant date fair value estimated in accordance with the pro forma provisions of SFAS 123 while awards granted on or after January 1, 2006 follow the provisions of SFAS 123(R) to determine the grant date fair value and compensation cost. Compensation cost for all stock-based awards is recognized using the straight-line method.

Upon adoption of SFAS 123(R), we continued to use the Black-Scholes option pricing model as its method of valuation for stock-based awards. Our determination of the fair value of stock-based awards on the date of grant using an option pricing model is affected by our 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, our expected stock price volatility over the term of the award and actual and projected exercise behaviors. Although the fair value of stock-based awards is determined in accordance with SFAS 123(R) and SAB 107, the Black-Scholes option pricing model requires the input of highly subjective assumptions, and other reasonable assumptions could provide differing results. The fair value of restricted stock awards granted is based on the fair market value of our common stock on the date of the grant (measurement date), and is being recognized over the vesting period of the related restricted stock using the straight-line method. The fair value of performance vesting share awards granted is based on a Monte Carlo valuation model that resulted in a factor applied to the fair market value of our common stock on the date of the grant (measurement date), and is being recognized over the Stock-based compensation expense was recorded in the respective statement of operations expense categories for the employees to whom it applies, as set forth in the table below:

	<b>Three Months Ended March 31,</b>		<b>Dollar Increase (Decrease)</b>	<b>Percent Increase (Decrease)</b>
	<b>2008</b>	<b>2007</b>		
	(in 000'S)			
Cost of revenue	\$ 114	\$ 106	\$ 8	8%
Sales and marketing	168	207	(39)	(19)%
Research, development and engineering	113	72	41	57%
General and administrative	702	608	94	15%
Intellectual property	17	12	5	42%
	<b>\$ 1,114</b>	<b>\$ 1,005</b>	<b>\$ 109</b>	<b>11%</b>

## Edgar Filing: DIGIMARC CORP - Form 10-Q

The slight increase in stock-based compensation expense was primarily due to an additional layer of stock-based awards being expensed pursuant to SFAS 123(R). We anticipate incurring an additional \$7.3 million in stock-based compensation expense through fiscal 2012 for awards outstanding as of March 31, 2008. The future effect of the adoption of this statement on our financial position and results of operations will be determined by stock-based awards granted in future periods and the assumptions on which the value of those stock-based awards is based. Our tax accounting may also be affected by actual exercise behavior and the relative market prices at exercise.

### *Other income (expense), net*

	<b>Three Months Ended March 31,</b>	
	<b>2008</b>	<b>2007</b>
	(in 000'S)	
Interest income	\$ 318	\$ 412
Interest expense	(48)	(19)
Foreign currency and other	83	(11)
	\$ 353	\$ 382

The slight decrease in other income (expense) was due primarily to lower interest earned on cash and investment balances, offset by increased interest expense related to additional capitalized leases.

*Provision for Income Taxes.* The provision for income taxes reflects expected tax expense from profitability in certain foreign jurisdictions. We have recorded a full valuation allowance against net deferred tax assets at March 31, 2008 due to the uncertainty of realization of the Company's net operating losses. We will continue to evaluate the realizability of our domestic and foreign net deferred tax assets in future periods and may recognize income tax benefits in future earnings if we determine the realization of these assets is more likely than not.

### **Liquidity and Capital Resources**

As of March 31, 2008, we had cash and cash equivalents, restricted cash, and short-term investments of \$37.4 million, representing an increase of approximately \$4.7 million from \$32.7 million at December 31, 2007. As of March 31, 2008, \$9.4 million of cash and cash equivalents is restricted as a result of the requirements of performance bonds that we are obligated to maintain in connection with some of our long-term contracts in our personal identification systems business. Subsequent to the end of the quarter, \$1.5 million of the restriction was released. Working capital at March 31, 2008 was \$37.1 million, compared to working capital of \$35.6 million at December 31, 2007. The increases in cash and in working capital primarily relates to improved cash flow from operating activities and lower capital expenditures.

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

	<b>Three Months Ended March 31,</b>	
	<b>2008</b>	<b>2007</b>
	(in 000'S)	
Net income (loss)	\$ (1,361)	\$ (1,022)
Non-cash items	5,393	4,898
Changes in operating assets and liabilities	4,523	1,533
	\$ 8,555	\$ 5,409

## Edgar Filing: DIGIMARC CORP - Form 10-Q

The major changes in the non-cash charges related to:

increases in depreciation and amortization from \$3.9 million to \$4.2 million primarily related to delivery of new programs in the later half of 2007 or implemented during the quarter ended March 31, 2008, and

increased stock-based compensation expense from \$1.0 million to \$1.1 million primarily related to the effect of the timing of grants of stock-based awards.

The major changes in the operating assets and liabilities for the three-month period ended March 31, 2008 primarily related to:

a decrease in trade accounts receivable, net of \$3.4 million primarily reflecting payments of deferred revenues in receivables, shorter payment terms realized on an international film sale and recognition of revenue from previously paid amounts recorded in deferred revenues in prior periods,

a decrease in inventory, net of \$1.2 million primarily reflecting the sale of a large consumables order purchased in the fourth quarter of 2007 and recognition of revenues and related costs incurred and deferred in prior quarters, and

an increase in compensation related liabilities of \$0.8 million for the Company's 2008 incentive bonus program compared to none recorded in the prior year, offset by payments of other accrued liabilities in the normal course of business.

The major changes in the operating assets and liabilities for the three-month period ended March 31, 2007 primarily related to:

an increase in deferred revenue of \$2.5 million related to cash collections of future revenues, offset by

a decrease in accrued payroll and related costs of \$2.2 million reflecting payment of accrued benefits related to the company's 2006 incentive bonus program.

The \$3.9 million of cash used in investing activities for the three-month period ended March 31, 2008 primarily related to \$3.6 million for expenditures of property and equipment on contracts signed over the prior two and one-half years, including capitalization of labor costs of \$1.5 million, and \$0.3 million in net purchase of short-term investments.

The \$6.9 million of cash used in investing activities for the three-month period ended March 31, 2007 primarily related to expenditures of property and equipment on new contracts signed over the prior two years, including capitalization of labor costs of \$1.6 million.

Cash used in financing activities for the three-month periods ended March 31, 2008 resulted primarily from the net issuance of stock of \$0.1 million, offset by principal payments on capital leases of \$0.1 million.

The \$0.3 million of cash provided by financing activities for the three-month periods ended March 31, 2007 resulted primarily from the net issuance of stock of \$0.4 million, offset by principal payments on capital leases of \$0.1 million.

Our significant commitments consist of obligations under non-cancelable operating leases, which totaled \$6.7 million as of March 31, 2008, and are payable in monthly installments through August 2011. Our obligations under non-cancelable capital leases, which totaled \$1.5 million as of March 31, 2008, are payable in monthly installments through April 2012.

Many of our secure identity management contracts have significant capital requirements. The general industry model for supplying driver license issuance systems to state driver license issuers is for



the system supplier to develop and install the issuance system using the supplier's capital and to charge the customer on a per-card issued basis. As a result, during times of substantial competitive wins and/or substantial system upgrades, the Company may experience significant working capital needs that may exceed cash flow from operations. To date, the Company has relied upon cash reserves to fund such expenditures.

We have driver license contracts with various states that are not yet fully deployed and we have pending add-on and upgrade orders. In order to complete these contracts and pending orders, we estimate we will incur approximately \$10 million of expenditures. The estimates are derived from information known to us as of quarter end, the time the estimates were prepared. Actual expenditures may vary from our estimates. We anticipate that these expenditures will be recouped through receipts from the related long-term price-per-card agreements and from the value of the add-on and upgrade orders we have received.

Our planned operating expenses and capital expenditures may constitute a material use of our cash resources. In addition, we expect that we will continue to utilize cash in the upcoming few quarters as we complete program implementations. We may utilize cash resources to fund acquisitions or investments in complementary businesses, technologies or product lines.

We believe that our current cash, cash equivalents, and short-term investment 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 short-term investment balances to satisfy our projected working capital and capital expenditure requirements. However, in the event that we were to win contracts requiring significant capital investment, we may need to seek additional financing.

In order to take advantage of opportunities, we may find it necessary to obtain additional equity financing, debt financing, or credit facilities, although at this time we believe that our long-term working capital is sufficient to cover our foreseeable capital expenditures. If it were necessary to obtain additional financings 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.

In April 2007, we filed a shelf registration with the SEC. The shelf registration is intended to provide us flexibility to raise funds from time to time over a period of up to 3 years, subject to market conditions and our capital needs. Should the pending acquisition of our ID Systems business by L-1 become final, we will withdraw the shelf registration.

#### **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.

#### **Recent Accounting Pronouncements**

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value. This statement does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. SFAS No. 157 is effective the first fiscal year beginning after November 15, 2007. The Company has applied the provisions of this standard regarding the framework of measuring fair value and noted no material effect on the current financial statements.

## Edgar Filing: DIGIMARC CORP - Form 10-Q

In February 2007, the FASB issued SFAS No. 159, *The Fair Option for the Financial Assets and Financial Liabilities*, which permits entities to choose to measure certain financial assets and liabilities at fair value. SFAS No. 159 is effective for first fiscal year beginning after November 15, 2007. The Company has elected not to measure certain financial assets and liabilities at fair value as permitted by SFAS No. 159.

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

Because this Report on Form 10-Q contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, any of the risk factors set forth in Part II, Item 1A or elsewhere in this Report on Form 10-Q or incorporated herein by reference could cause our actual results to differ materially from those results projected or suggested in such forward-looking statements. Statements that are not historical facts are hereby identified as "forward-looking statements" for the purposes of the safe harbor provided by Section 21E of the Securities Exchange Act of 1934 and Section 27A of the Securities Act of 1933. Such forward-looking statements include but are not limited to statements relating to:

the timing and consummation of the merger with L-1 and spin-off of our digital watermarking business;

the scale and timing of adoption of digital watermarking in the U.S.;

trends and expectations in revenue growth, including, but not limited to, statements regarding the temporary nature of the decrease in ID systems bid activity and the expected increase of such activity in the future, and statements regarding anticipated growth in U.S. driver license revenues due to broadening use of the driver license as a secure credential;

our future level of investment in our business, including investment in development of products and technology, 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;

the investments required to complete certain driver license programs and our ability to recoup those expenses under the relevant contract;

our profitability in future periods;

business opportunities that could require that we seek additional financing;

opportunities for increased participation in the global market for ID systems;

the size and growth of our markets, including the U.S. driver license market;

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

the source of our future revenue;

Edgar Filing: DIGIMARC CORP - Form 10-Q

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

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

our use of cash in upcoming quarters;

anticipated levels of backlog and bid activity in future periods;

anticipated levels of stock-based compensation expense in future periods and the future effect of our adoption of SFAS 123(R); and

the likelihood or outcome of legal proceedings and claims and their effect on our business.

Such forward-looking statements also include other statements containing words such as "anticipate," "estimate," "expect," "management believes," "we believe," "we intend," "should" and similar words or phrases, which are intended to identify forward-looking statements. Actual results may vary materially due to, among other things, our failure to become profitable, the failure of the potential markets for our digital watermarking technology to develop as anticipated, or the adoption of alternative technologies within these markets, as well as changes in economic, business, competitive, technology and/or regulatory factors and trends, and the other factors described in this Form 10-Q or in our other documents filed with the SEC. All forward-looking statements are necessarily only estimates of future results and there can be no assurance that actual results will not differ materially from expectations and, therefore, investors are cautioned not to place undue reliance on such statements. Investors should understand that it is not possible to predict or identify all risk factors and that the risks discussed below should not be considered a complete statement of all potential risks and uncertainties. We do not intend to update any forward-looking statements as a result of future events or developments.

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

The market risk disclosures as set forth in Item 7A of our Annual Report on Form 10-K for the year ended December 31, 2007 have not changed materially.

### **Item 4. Controls and Procedures.**

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

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, have evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934) as of the end of the period covered by this Form 10-Q. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures, as of the end of the period covered by this Form 10-Q, were effective in ensuring that information required to be disclosed by us in reports that we file or submit under the Securities Exchange Act of 1934 is (i) recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and (ii) accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

#### **Changes in Internal Controls**

There was no change in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) of the Securities Exchange Act of 1934) that occurred during the quarter ended March 31, 2008 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**PART II. OTHER INFORMATION.**

**Item 1. Legal Proceedings.**

In 2004, three purported class action lawsuits were filed in the U.S. District Court for the District of Oregon against us and certain of our current and former directors and officers on behalf of purchasers of our securities during the period April 17, 2002 to July 28, 2004. These lawsuits were later consolidated into one action for all purposes. The amended complaint, which sought unspecified damages, asserted claims under the federal securities laws relating to the restatement of our financial statements for 2003 and the first two quarters of 2004 and alleged that we issued false and misleading financial statements and issued misleading public statements about our operations and prospects. On August 4, 2006, the court granted our motion to dismiss the lawsuit with prejudice and entered judgment in our favor. Plaintiffs appealed to the Ninth Circuit Court of Appeals. The appeal has been fully briefed but not yet scheduled for oral argument. Due to the inherent uncertainties of litigation, we cannot accurately predict the ultimate timing of a decision in or the outcome of this matter.

On or about October 19, 2004, two purported shareholder derivative lawsuits were filed against certain of our officers and directors, naming us as a nominal defendant, in the Superior Court of the State of California for the County of San Luis Obispo. These lawsuits were consolidated into one action for all purposes on March 14, 2005. This suit claims that certain of these officers and directors breached their fiduciary duties to our stockholders and to us. The complaint is derivative in nature and does not seek relief from us. The Board of Directors appointed an independent committee to investigate the claims asserted in this derivative lawsuit. On July 19, 2005, the court granted our motion to dismiss these consolidated actions in favor of a shareholder derivative action to be filed by plaintiffs in the Circuit Court of the State of Oregon for the County of Washington. On August 25, 2005, the California plaintiffs filed two new derivative lawsuits in the United States District Court for the District of Oregon. On October 17, 2005, the defendants filed a motion to dismiss these complaints for lack of subject matter jurisdiction and failure to state a claim. In May of 2006, the Board committee, after completing its investigation, concluded that pursuit of the allegations would not be in the best interests of Digimarc or its stockholders. On August 24, 2006, the court granted the defendants' motion and dismissed the lawsuit with prejudice. Plaintiffs filed a notice of appeal on September 22, 2006. The briefs to the Ninth Circuit were completed in June 2007, and we anticipate oral argument and a decision in 2008. However, due to the inherent uncertainties of litigation, we cannot accurately predict the ultimate timing or outcome of the matter.

On or about April 6, 2005, another purported shareholder derivative lawsuit was filed against certain of our officers and directors, and also naming us as a nominal defendant, in the Circuit Court for the State of Oregon for the County of Washington containing similar allegations to the complaints discussed above. That case was stayed pending the report of the Board committee referenced above, and was ultimately dismissed following the Board committee's investigation.

Beginning in May 2001, a number of substantially identical class action complaints alleging violations of the federal securities laws were filed in the United States District Court for the Southern District of New York naming approximately 300 companies, including Digimarc, and their officers and directors and underwriters as defendants in connection with the initial public offerings of these companies. The plaintiffs allege that the defendants fraudulently inflated the share prices of these companies during and after their initial public offerings through an elaborate scheme characterized by tie-in agreements, undisclosed compensation and analyst conflicts. The plaintiffs also allege that the underwriter defendants required some substantial investors who requested allocations in the initial public offerings to participate in the scheme. Some of our officers and directors are named in the amended complaint pursuant to Section 11 of the Securities Act of 1933 and Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 on the basis of an alleged failure to disclose the underwriters' alleged compensation arrangements and manipulative practices. The complaint seeks

unspecified damages. The individual officer and director defendants entered into tolling agreements and, pursuant to a court order dated October 9, 2002, were dismissed from the litigation without prejudice. The plaintiffs have continued to litigate their claims primarily against the underwriter defendants. The district court directed that the litigation proceed within a number of "focus cases" rather than in all of the 309 cases that have now been consolidated. We are not one of these focus cases. On December 5, 2006, the Court of Appeals for the Second Circuit reversed the district court's class certification decision for the six focus cases. In response to that ruling, the plaintiffs amended their master allegations and the focus case complaints, and the defendants moved to dismiss those amended complaints. The court issued an opinion and order on March 26, 2008, essentially denying the motion to dismiss and allowing the case to continue. New motions for class certification in the six focus cases are in the briefing process which is expected to be completed in May of 2008. Due to the inherent uncertainties of litigation, we cannot accurately predict the ultimate outcome of the matter.

On October 10, 2007, a Digimarc stockholder filed a lawsuit in the United States District Court for the Western District of Washington against several companies that acted as lead underwriters for the Digimarc initial public offering. The complaint names Digimarc as a nominal defendant, and asserts claims against the underwriters under Section 16(b) of the Securities Exchange Act of 1934 for recovery of alleged short-swing profits on trades of Digimarc stock. On February 28, 2008, an amended complaint was filed, with Digimarc still named only as a nominal defendant. Similar complaints have been filed by this same plaintiff against a number of other issuers in connection with their initial public offerings, and the factual allegations are closely related to the allegations in the litigation pending in the United States District Court for the Southern District of New York which is described above in this Form 10-Q.

#### **Item 1A. Risk Factors**

Our business, financial condition, results of operations and cash flows may be affected by a number of factors, including the factors set forth below.

*(1) Failure to complete the merger with L-1 could negatively impact our stock price and our future businesses and financial results.*

Completion of the merger is subject to a number of closing conditions, including obtaining requisite regulatory and stockholder approvals, and Digimarc and L-1 may be unable to satisfy such conditions on a timely basis or at all. If the merger is not completed, the price of our common stock may decline and our ongoing businesses may be adversely affected. If we fail to complete and realize any benefits from the merger, we will be subject to a number of risks, including the following:

we may be required to pay a termination fee of \$7.5 million if the merger is terminated under certain circumstances, plus reimbursement of fees and expenses of up to \$3 million, and if any of these fees and expenses were to be paid we would experience a material negative impact on our financial condition and results of operations;

we will be required to pay our costs relating to the merger, such as legal, accounting, financial advisor and printing fees, whether or not the merger is completed, which could be significant; and

matters relating to the merger (including integration planning) may require substantial commitments of time and resources by our management, which could otherwise have been devoted to other opportunities that may have been beneficial to us.

We could also be subject to litigation related to any failure to complete the merger. If the merger is not completed, these risks may materialize and may adversely affect our financial results, stock price and ongoing businesses.

## Edgar Filing: DIGIMARC CORP - Form 10-Q

*(2) The regulatory approvals required to complete the merger may not be obtained or may contain materially burdensome conditions.*

Completion of the merger is conditioned upon the receipt of certain governmental approvals, including the expiration or termination of the applicable waiting periods under the HSR Act. Although L-1 and Digimarc have agreed in the merger agreement to use their reasonable best efforts to obtain the requisite governmental approvals, we cannot assure you that these approvals will be obtained. In addition, the governmental authorities from which these approvals are required may impose conditions on the completion of the merger or require changes to the terms of the merger. While L-1 and Digimarc do not currently expect that any such conditions or changes would be imposed, we cannot assure you that will be the case, and any such conditions or changes could have the effect of jeopardizing or delaying completion of the merger or reducing the anticipated benefits of the merger.

*(3) Our obligation to pay a termination fee under certain circumstances and the restrictions on our ability to solicit other acquisition proposals may discourage other companies from trying to acquire Digimarc.*

Until the merger is completed or the merger agreement is terminated, with limited exceptions, the merger agreement prohibits us from entering into or soliciting any acquisition proposal or offer for a merger or other business combination with a party other than L-1. In addition, we have agreed to pay L-1 a termination fee of \$7.5 million and/or fees and expenses incurred in connection with the merger agreement and performance under the merger agreement of up to \$3 million under specified circumstances. These provisions could discourage other parties from trying to acquire Digimarc for a higher price.

*(4) We have a history of losses and we may not achieve or sustain profitability, particularly if we were to lose large contracts.*

Except for the year 2003, we have incurred significant net losses from inception. Our accumulated deficit as of March 31, 2008 was \$101.4 million. In the second half of 2005 and continuing through 2006, we restructured our operations to improve productivity and reduce fixed costs. During the second quarter of 2006, we accelerated those activities significantly, resulting in a reduction of our workforce by nearly 20%. Overall, our workforce has been reduced by 30% since mid 2005. These actions resulted in an increase in earnings to a near break even level in the second half of 2006. However, in order to achieve sustained profitability, we will need to generate higher revenue than we have in prior years while controlling expenditures. Achieving sustained profitability will depend upon a variety of factors, including the impact of financial accounting mandates requiring us to expense stock options, as well as the extent to which we may be required to increase the size of our workforce in order to execute our business strategy and capitalize on new opportunities. In addition, we evaluate our strategy and market opportunities on an ongoing basis and will adjust our approach to market conditions that prevail from time to time. Finally, various adverse developments including the loss of large contracts or cost overruns on our existing contracts could have a negative impact on our revenue or our margins. Accordingly, increases in our expenses may not be offset by revenue increases and as a result we may not be able to achieve or sustain profitability.

*(5) The loss of any large contract may result in loss of revenue and potential impairment of capital assets and/or intangible assets, including the acceleration of depreciation and/or amortization expense.*

Contracts between government agencies and Digimarc have varying durations, generally five or more years in length. Some contracts we enter into contain termination for convenience provisions. In addition, as a contract nears expiration, generally the government agency begins a competitive procurement process. We anticipate that several of our significant customers will award new contracts through such a competitive procurement process during the coming quarters. If we were to lose a contract due to termination for convenience or in a competitive procurement situation, then, in

addition to the loss of revenue and margin on a prospective basis, we could also incur impairment of capital and/or intangible assets related to the customer, which could adversely affect our financial results.

*(6) The majority of our revenue is subject to government procurement processes that may involve unpredictable delays and other unexpected changes which might limit our actual revenue in any given quarter or year.*

We derive substantial portions of our revenue from government contracts which are subject to periodic open, competitive procurement. The timing of such procurements is solely within the discretion of the governmental authority. Consequently, large components of new revenue are tied to procurement schedules, which could shift for months, quarters or years as the needs of the related government procurement agencies change. Many of these governmental customers are facing continued budget pressures introducing added uncertainty. In addition, the Department of Homeland Security's initiatives in passports and border crossing cards, as well as delays in disbursement of funding for REAL ID Act projects, could create confusion within the U.S. driver license market that may delay purchase decisions by government customers. Any shift in the government procurement process, which is outside our control and may not be predictable, could result in delays in bookings forecasted for any particular financial period, could affect the predictability of our quarterly and annual results, and might limit our actual revenue in any given quarter or year, resulting in reduced and less predictable revenue and an adverse affect on profitability.

*(7) The market for our products is highly competitive, and as a result, alternative technologies or larger companies may undermine, limit or eliminate the market for our products' technologies, which would decrease our revenue and profits.*

The markets in which we compete for business are intensely competitive and rapidly evolving. We expect competition to continue from both existing competitors and new market entrants. We face competition from other companies and from alternative technologies. The potential for an influx of federal funds into our core U.S. driver license market has drawn new competition and is likely to continue to do so. As we expand the applications for our technologies, we will experience more competition from products and services that are substitutes for our applications. Because our digital watermarking business is still in an early stage of development, we also may face competition from unexpected sources.

Alternative technologies that may directly or indirectly compete with particular applications of our watermarking technologies include:

Encryption securing data during distribution using a secret code so it cannot be accessed except by authorized users;

Containers inserting a media object in an encrypted wrapper, which prevents the media object from being duplicated and is used for content distribution and transaction management;

DataGlyphs® a slightly visible modification of the characteristics of an image or document that is machine-readable;

Scrambled Indicia® an optical refraction-based data-hiding technique that is inserted into an image and can be read with a lens;

Traditional anti-counterfeiting technologies a number of solutions used currently by many governments (and that compete for budgetary outlays) designed to deter counterfeiting, including optically sensitive ink, magnetic threads and other materials used in the printing of currencies;



## Edgar Filing: DIGIMARC CORP - Form 10-Q

Radio frequency tags embedding a chip that emits a signal when in close proximity with a receiver, which is being used in photo identification credentials, labels and tags;

Internet technologies numerous existing and potential Internet access and search methods are competitive with the Digimarc MediaBridge and Digimarc Mobile systems and the searching capabilities of Digimarc ImageBridge;

Digital fingerprints and signatures a metric, or metrics, computed solely from a source image or audio or video track, that can be used to uniquely identify an image or track, or authenticate the image or track;

Smart cards badges and cards including a semiconductor memory and /or processor used for authentication and related purposes; and

Bar codes a data-carrying code, typically visible in nature (but invisible if printed in ultraviolet- or infrared-responsive inks).

In addition, as we more broadly apply our digital watermarking technologies to the Internet through new commercial solutions applications, we may begin to compete with a wide range of other types of companies beyond those companies using digital watermarking technologies and alternative technologies. We do not assure you that digital watermarking technologies, and our products and services using these technologies, will gain widespread market acceptance.

In the competitive environment in which we operate, product generation, development and marketing processes relating to technology are uncertain and complex, requiring accurate prediction of demand as well as successful management of various development risks inherent in technology development. In light of these dependencies, it is possible that failure to successfully manage future changes in technology with respect to our technology could have a long-term impact on our growth and results of operations.

New developments are expected to continue, and we do not assure you that discoveries by others, including current and potential competitors, will not render our services and products noncompetitive. Moreover, because of rapid technological changes, we may be required to expend greater amounts of time and money than currently anticipated to develop new products and services, which in turn may require greater revenue streams from such products and services to cover developmental costs. Many of the companies that currently compete with us for some of our business, as well as other companies with whom we may compete in the future, are larger and national or international in scope and may have greater technical, financial, marketing, and political resources than we do. These resources could enable these companies to initiate severe price cuts or take other measures in an effort to gain market share or otherwise impede our progress. We do not assure you that we will be able to compete successfully against current or future participants in our market or against alternative technologies, or that the competitive pressures we face will not decrease our revenue and profits in the future.

*(8) We depend on our senior management and key employees for our future success. If we are not able to retain, hire or integrate these employees, we may not be able to meet our commitments.*

Our success depends to a significant extent on the performance and continued service of our senior management. Except for our Chief Executive Officer, our senior management does not have employment agreements. The loss of the services of any of our senior management could delay projects or undermine customer relationships.

Due to the high level of technical expertise that our industry requires, our ability to successfully develop, market, sell, license and support our products, services, and intellectual property depends to a significant degree upon the continued contributions of our key personnel in engineering, sales, marketing, operations, legal and licensing, many of whom would be difficult to replace. Similarly,

without the continued contributions of our key finance personnel, we believe that our ability to meet our reporting obligations and operate successfully as a public company may be limited. We believe our future success will depend in large part upon our ability to retain our current key employees and our ability to attract, integrate and retain such personnel in the future. It may not be practical for us to match the compensation certain of our employees could garner at other employment. In addition, we may encounter difficulties in hiring and retaining employees because of concerns related to our financial performance. In addition, these circumstances may have a negative effect on the market price of our common stock, and employees and prospective employees may factor in the uncertainties relating to our stability and the value of any equity-based incentives in their decisions regarding employment opportunities and decide to leave our employ. In addition, our business is based in part on patented technology, which is unique and not generally known. New employees require substantial training, involving significant resources and management attention. Competition for experienced personnel in our business can be intense. If we do not succeed in attracting new, qualified personnel or in integrating, retaining and motivating our current personnel, our growth and ability to deliver products and services that our customers require may be hampered. Although our employees generally have executed agreements containing non-competition clauses, there is no assurance that a court would enforce all of the terms of these clauses or the clauses generally. If these clauses were not fully enforced, our employees could be able to freely join our competitors. Although we generally attempt to control access to and distribution of our proprietary information by our employees, there are no assurances that the confidential nature of our proprietary information will be maintained in the course of such future employment. Any of these events could have a material adverse effect on our financial and business prospects.

*(9) If leading companies in our industry or standard-setting bodies or institutions downplay, minimize, or reject the use of digital watermarking, its deployment may be slowed and we may be unable to achieve revenue growth particularly in the media and entertainment sectors.*

Many of our business endeavors, such as our licensing of intellectual property in support of audio and video copy-control applications, can be impeded or frustrated by larger, more influential companies or by standard-setting bodies or institutions downplaying, minimizing or rejecting the value or use of watermarking technology or any of our other technologies. Such a negative position by these companies, bodies or institutions, if taken, may result in obstacles for us that we would be incapable of overcoming and may block or impede the adoption of digital watermarking particularly in the media and entertainment market. In addition, potential customers in the media and entertainment industry may delay or reject initiatives that relate to deployment of digital watermarking. Such a development would make the achievement of our business objectives in this market difficult or impossible.

*(10) If we are unable to respond to regulatory or industry standards effectively, or if we are unable to develop and integrate new technologies effectively, our growth and the development of our products and services could be delayed or limited.*

Our future success will depend in part on our ability to enhance and improve the responsiveness, functionality and features of our products and services in accordance with regulatory or industry standards. Our ability to remain competitive will depend in part on our ability to influence and respond to emerging industry and governmental standards, such as future regulations under the REAL ID Act, in a timely and cost-effective manner. If we are unable to influence these or other standards or respond to such standards effectively, our growth and the development of certain products and services could be delayed or limited.

Our market is characterized by new and evolving technologies. The success of our business will depend on our ability to develop and integrate new technologies effectively and address the increasingly

sophisticated technological needs of our customers in a timely and cost-effective manner. Our ability to remain competitive will depend in part on our ability to:

enhance and improve the responsiveness, functionality and other features of the products and services we offer or plan to offer;

continue to develop our technical expertise; and

develop and introduce new services, applications and technologies to meet changing customer needs and preferences and to integrate new technologies.

We do not assure you that we will be successful in responding to these technological and industry challenges in a timely and cost-effective manner. If we are unable to develop or integrate new technologies effectively or respond to these changing needs, our margins could decrease, and our release of new products and services and the deployment of our watermarking technology could be adversely affected.

*(11) We may need to retain additional employees or contract labor in the future in order to take advantage of new business opportunities arising from increased demand, which could impede our ability to achieve or sustain profitability.*

In the second half of 2005 and in 2006, we made significant reductions in our workforce as part of our efforts to reach profitability. These reductions did not impede our ability to meet demand because they were accompanied by improvements in our internal business processes and coincided with a period of relatively low bid activity with respect to development and deployment of new systems. We believe that this decrease in bid activity is temporary and that the U.S. driver license market will demonstrate increased demand in future periods. Our current reduced staffing levels could affect our ability to respond to increased demand for our services. In addition, to meet any increased demand and take advantage of new business opportunities in the future, we may need to increase our workforce through additional employees or contract labor, which would increase our costs. If we experience such an increase in costs, we may not succeed in achieving or sustaining profitability.

*(12) We may decline to pursue new, or renew existing, business opportunities in secure ID systems markets due to objectionable terms required by the contracting agencies, or we may agree to objectionable contract terms for competitive reasons.*

Government agencies sometimes insist on unduly onerous terms in their contracts with vendors of secure ID issuance systems. For example, it is customary for state agencies to require that a vendor fund the capital-intensive initial deployment of a driver license issuance system (the costs of which the vendor normally recoups over the life of the contract in per-card fees), while reserving the right to terminate the contract for convenience. Similarly, in connection with intellectual property rights, a contract may require that our pre-existing issuance system software be written in a different language and a state may then argue that it falls within the class of works for which it owns the copyright, enabling the state to turn the Digimarc-authored software over to one of our competitors, dedicate it to the public domain, or otherwise use the software in a manner detrimental to our business. Objectionable contract terms may lead us to decline to bid on identification issuance systems to new customers, or to decline to retain business with customers we have historically served, which could reduce our market share and lower our revenues or profits. In addition, if we decline to retain business with customers we have historically served, it could result in the accelerated depreciation of intangible assets. Alternatively, we may decide to accept at least some level of objectionable terms rather than cede an important contract to a competitor, which could also lower our revenues or profits.

## Edgar Filing: DIGIMARC CORP - Form 10-Q

*(13) We expect our secure ID systems business to experience variability in gross margins.*

We are likely to experience variability in gross margins on our government contracts due to numerous factors, including, among other things, the following:

delays in project implementation;

failure to achieve add-on sales to existing customers;

governmental regulation of credentials and issuance policies;

private sector usage trends for driver licenses and other credentials;

level of commodity vs. proprietary components applicable to customer system specifications;

whether contracts have been extended or renewed, and the amount of capital expenditure associated with such extension or renewal;

price competition in competitive bids, contract renewals and contract extensions;

variations in costs of materials and manufacturing;

varying levels of efficiency of our workforce in delivering, implementing, and servicing contracts;

seasonality of issuance volumes;

sales mix related to card issuance revenues compared to product sales;

sales mix related to domestic sales compared to international sales;

sales mix related to adoption of new products compared to sales of current products;

strategic decisions on new business;

depreciation and amortization of capitalized project costs related to new or upgraded programs; and

variability in the extent to which we are able to allocate personnel expenses to capital projects and thereby amortize such costs over the life of the relevant contract, rather than expensing such costs in the quarter in which they are incurred.

The numerous factors affecting gross margins make such margins complex and difficult to predict. We are continually refining our predictive tools and increasing our understanding of what drives these various factors. For reasons such as those listed above, we expect that there will be fluctuations in our future operating results as a result of the variability in margins from period to period in the secure ID systems business.

## Edgar Filing: DIGIMARC CORP - Form 10-Q

*(14) Our future growth will depend to some extent on our successful implementation of our intellectual property in solutions provided by third parties, including partners and suppliers.*

Our business and strategy rely, in part, on deployment of our digital watermark reader technology by third-party software developers and original equipment manufacturers. For example, one form of our digital watermark reader is commonly deployed in image editing applications to permit users of these products to read watermarks embedded in imagery, and thereby discern the identities of image owners. Another form of our digital watermark reader is used in our anti-counterfeiting product offerings. If third parties who include our technologies in their products cease to do so, or we fail to obtain other partners that will incorporate, embed, integrate or bundle our technologies, or these partners are unsuccessful in their efforts, our efforts to expand deployment of our technologies would be adversely affected and, consequently, our ability to increase revenues would be adversely affected and we may

suffer other adverse effects to our business. In addition, if our technologies do not perform according to market expectations, our future sales would suffer as customers seek other providers.

*(15) The loss of international customers or the failure to find new international customers could adversely affect our profitability and slow our growth.*

We expect revenue from sales of products and services to governments and other customers outside the U.S. to represent a growing percentage of our total revenue in the future. International sales and services are subject to a number of risks that can adversely affect our sales of products and services to customers outside of the U.S., including the following:

changes in foreign government regulations and security requirements;

export license requirements, tariffs and taxes;

trade barriers;

difficulty in protecting intellectual property;

difficulty in collecting accounts receivable;

currency fluctuations;

longer payment cycles than those for customers in the U.S.;

difficulty in managing foreign operations; and

political and economic instability.

In addition, our experience with large international issuance programs is more limited than our experience with domestic programs. We do not have an extensive operational infrastructure for our international business. We generally act as a subcontractor or depend on local or international business partners and subcontractors for performance of substantial portions of these programs. These factors may result in greater risk of performance problems or of reduced profitability with respect to our international programs. In addition, if foreign customers, in particular foreign government authorities, terminate or delay the implementation of our products and services, we may have limited recourse against them to recover any potential losses.

We generally do not invoice our foreign sales in U.S. dollars and, consequently, we are exposed to currency exchange fluctuations. We currently do not engage in foreign currency hedging transactions. We may in the future choose to limit our exposure by the purchase of forward foreign exchange contracts, collared options, currency swap agreements or through similar hedging strategies. However, no currency hedging strategy can fully protect against exchange-related losses.

*(16) A significant portion of our business depends on contracts with fixed price terms. In the event of inflation occurring, or in the event of cost overruns in connection with such contracts, our margins may be adversely affected.*

In addition to our normal price-per-card issuance contracts, we occasionally enter into fixed price contracts. Fixed price contracts typically consist of agreements to sell entire systems or portions of a system for an agreed upon price. These contracts normally do not have clauses that allow for recovery of cost overruns. Under these contracts, we provide specific tasks for a specific price and are typically paid on a milestone basis. We have experienced low margins or losses on some of these contracts in the recent past. These contracts involve greater financial risks because we bear the risk if actual project costs exceed the amounts we are paid under the contracts. A material percentage of our revenues are derived from fixed price contracts and our reliance on fixed price contracts may grow.



*(17) A significant portion of our business depends on contracts that are subject to a variety of terms and conditions, including damage payment obligations, as well as a variety of other provisions that may cause our quarterly results to fluctuate and our anticipated revenue to potentially decrease significantly.*

Our contracts for driver license and other identification issuance systems and related products typically include provisions imposing (i) development, delivery and installation schedules and milestones, (ii) customer acceptance and testing requirements and (iii) other performance requirements. Such provisions are common in large scale government contracts at the state and federal levels. To the extent these provisions involve performance over extended periods of time, there may be increased risk of noncompliance. From time to time we have experienced delays in identification system implementation, timely acceptance for identification systems programs, concerns regarding identification system program performance and other contractual disputes. Customers have asserted from time to time, and may in the future assert, claims for compensatory or liquidated damages, or breach of contract, or other claims alleging that we have failed to meet timing or delivery requirements and milestones pursuant to the terms of such contracts. Consequently, our failure to meet contractual milestones or other performance requirements as promised, or to successfully resolve customer disputes, could result in our having to incur liability for damages, as well as increased costs, lower margins, or compensatory obligations in addition to other losses, such as harm to our reputation. Such unexpected increases in costs to meet our contractual obligations or any other requirements necessary to address claims and damages with regard to our customer contracts could have a material adverse effect on our business and financial results. We anticipate that future contracts will continue to have such provisions unless and until industry practices change.

A significant portion of our business depends on a limited number of large, public-sector contracts, which are generally subject to termination for convenience, as determined by the subject agency, or for lack of budgetary appropriation provided for the subject agency. Some government contracts also may be one-time events, such as in the case of some personal identification systems in non-U.S. markets involving voter registration programs. In such cases, we may generate substantial revenue that may not be subject to future renewal. Moreover, government contracts result from purchasing decisions made by public sector agencies that may be subject to political influence, unusual procurement procedures, strict legal requirements, budget changes and cutbacks during economic downturns, variations in appropriations cycles, and protests of contract awards.

Additionally, some governmental authorities require performance bonds that we are obligated to maintain during the life of the contract. Often, the terms of these bonds require that we obtain letters of credit to secure our obligations under the bonds. The letters of credit may in turn require us to maintain large restricted cash reserves as security, reducing our ability to use these funds for our other business purposes. Even with the availability of such cash reserve guarantees, we may not be able to obtain such performance bond underwriting at a favorable rate or at all. In addition, these performance bonds may provide for security interests covering our receivables or other assets, which could cause additional financing to be more difficult or more expensive to obtain.

Our failure to be able to provide such performance bonds may preclude our ability to bid on new government contracts or maintain our existing contracts for their full terms. The size, nature and purpose of, and the risks and uncertainties associated with, public sector contracts can potentially cause our quarterly results to fluctuate and anticipated revenue to decrease significantly.

*(18) Our products could have unknown defects or errors, which may give rise to claims against us, divert application of our resources from other purposes or increase our project implementation and support costs.*

Products and systems as complex as those we offer or develop may contain undetected defects or errors. Furthermore, we often provide complex implementation, integration, customization, consulting and other technical services in connection with the implementation and ongoing maintenance of our



products. Despite testing, defects or errors in our products and services may occur, which could result in delays in the development and implementation of products and systems, inability to meet customer requirements or expectations in a timely manner, loss of revenue or market share, increased implementation and support costs, failure to achieve market acceptance, diversion of development resources, injury to our reputation, increased insurance costs, increased service and warranty costs and warranty or breach of contract claims. Although we attempt to reduce the risk of losses resulting from warranty or breach of contract claims through warranty disclaimers and liability limitation clauses in our sales agreements, these contractual provisions are sometimes not included and may not be enforceable in every instance. If a court refuses to enforce the liability-limiting provisions of our contracts for any reason, or if liabilities arise that are not contractually limited or adequately covered by insurance, the expense associated with defending such actions or paying the resultant claims could be significant.

*(19) The security systems used in our product and service offerings may be circumvented or sabotaged by third parties, which could result in the disclosure of sensitive government information or private personal information or cause other business interruptions that could damage our reputation and disrupt our business.*

Our business relies on computers and other information technologies, both internal and at customer and vendor locations. In addition, many of the systems we sell manage private personal information and protect information involved in sensitive government functions. The protective measures that we use in these systems may not prevent security breaches, and failure to prevent security breaches may disrupt our business, damage our reputation, and expose us to litigation and liability. A party who is able to circumvent security measures used in these systems could misappropriate sensitive or proprietary information or materials or cause interruptions or otherwise damage our products, services and reputation, and the property of our customers. If unintended parties obtain sensitive data and information, or create bugs or viruses or otherwise sabotage the functionality of our systems, we may receive negative publicity, incur liability to our customers or lose the confidence of our customers, any of which may cause the termination or modification of our contracts. Further, our insurance coverage may be insufficient to cover losses and liabilities that may result from such events.

In addition, we may be required to expend significant capital and other resources to protect ourselves against the threat of security breaches or to alleviate problems caused by these breaches. Such protection or remedial measures may not be available at a reasonable price or at all, or may not be entirely effective if commenced.

*(20) A loss of a material supplier could have a material adverse effect on our ability to perform effectively under some of our contracts.*

We are materially dependent on a limited number of third parties to produce systems or assemblies necessary for us to produce some of our products. The loss of one or more of these suppliers could have a material adverse effect on our ability to perform effectively, if at all, under some of our contracts.

*(21) We are subject to risks encountered by companies developing and relying upon new technologies, products and services for substantial amounts of their growth or revenue.*

Our business and prospects must be considered in light of the risks and uncertainties to which companies with new and rapidly evolving technologies, products and services, such as digital watermarking, are exposed. These risks include the following:

we may be unable to develop sources of new revenue or sustainable growth in revenue because our current and anticipated technologies, products and services may be inadequate or may be unable to attract or retain customers;

the intense competition and rapid technological change in our industry could adversely affect the market's acceptance of our existing and new products and services; and

we may be unable to develop and maintain new technologies upon which our existing and new products and services are dependent in order for our products and services to be sustainable and competitive and in order for us to expand our revenue and business.

Some of our key technologies are in the development stage. Consequently, products incorporating these key technologies are undergoing technological change and are in the early stage of introduction in the marketplace. Delays in the adoption of these products or adverse competitive developments may result in delays in the development of new revenue sources or the growth in our revenue. In addition, we may be required to incur unanticipated capital expenditures in the event product changes or improvements are required. Additionally, new industry standards might redefine the products that we are able to sell, especially if these products are only in the prototype stage of development. If product changes or improvements are required, success in marketing these products and achieving profitability from these products could be delayed or halted. We also may be required to fund such changes or improvements out of operating income, which could adversely affect our profitability.

*(22) We may not be able to protect adequately our intellectual property, and we may be subject to infringement claims and other litigation, which could adversely affect our business.*

Our success depends in part on licensing our proprietary technologies. To protect our growing intellectual property investments, we rely on a combination of patent, copyright, trademark and trade secret rights, confidentiality procedures and licensing arrangements. Unlicensed copying and use of our intellectual property or illegal infringements of our intellectual property rights represent losses of revenue to us.

We face risks associated with our patent position, including the potential and sometimes actual need from time to time to engage in significant legal proceedings to enforce our patents, the possibility that the validity or enforceability of our patents may be denied, and the possibility that third parties will be able to compete against us without infringing our patents. Budgetary concerns may cause us not to file, or continue, litigation against known infringers of our patent rights, or may cause us not to file for, or pursue, patent protection for all of our inventive technologies in jurisdictions where they may have value. Some governmental entities that might infringe our intellectual property rights may enjoy sovereign immunity from such claims. Failure to reliably enforce our patent rights against infringers may make licensing more difficult. If we fail to protect our intellectual property rights and proprietary technologies adequately, if there are changes in applicable laws that are adverse to our interests, or if we become involved in litigation relating to our intellectual property rights and proprietary technologies or relating to the intellectual property rights of others, our business could be seriously harmed because the value ascribed to our intellectual property could diminish and result in a lower stock price or we may incur significant costs in bringing legal proceedings against third parties who are infringing our patents.

Effective protection of intellectual property rights may be unavailable or limited, both in the U.S. and in other countries. Patent protection throughout the world is generally established on a country-by-country basis. We have applied for patent protection both in the U.S. and in various other countries. However, we do not assure you that pending patents will be issued or that issued patents will be valid or enforceable. Failure to obtain such patents or failure to enforce those patents that are obtained may result in a loss of revenue to us. We do not assure you that the protection of our proprietary rights will be adequate or that our competitors will not independently develop similar technologies, duplicate our services or design around any of our patents or other intellectual property rights.

We are the exclusive licensee under some third-party patents, and may need the assistance of these parties if we choose to enforce any of these patent rights. The cooperation of these third parties cannot be assured even though we rely on some of these technologies for our products.

As more companies engage in business activities relating to personal identification technologies and digital watermarking, and develop corresponding intellectual property rights, it is increasingly likely that claims may arise which assert that some of our products or services infringe upon other parties' intellectual property rights. These claims could subject us to costly litigation, divert management resources and result in the invalidation of our intellectual property rights. These claims may require us to pay significant damages, cease production of infringing products, terminate our use of infringing technologies or develop non-infringing technologies. In these circumstances, continued use of our technologies may require that we acquire licenses to the intellectual property that is the subject of the alleged infringement, and we might not be able to obtain these licenses on commercially reasonable terms or at all. Our use of protected technologies may result in liability that threatens our continuing operation.

Some of our contracts include provisions by which we assure non-infringement of third-party intellectual property rights. As deployment of our technology increases, and more companies enter our markets, the likelihood of a third party lawsuit resulting from such indemnification increases. If an infringement arises in a context governed by such a contract, we may have to refund to our customer amounts already paid to us or pay significant damages, or we may be sued by the party allegedly infringed upon. Similarly, as we seek to broaden the number of companies licensed under our patent portfolio, some may seek contractual assurances that we will pursue by litigation if necessary their competitors who use our patented technology but are not licensed to do so. Compliance with any such contract provisions may require that we pursue litigation where our costs exceed our likely recovery.

As part of our confidentiality procedures, we generally enter into non-disclosure agreements with our employees, directors, consultants and corporate partners, and attempt to control access to and distribution of our technologies, solutions, documentation and other proprietary information. Despite these procedures, third parties could copy or otherwise obtain and make unauthorized use of our technologies, solutions or other proprietary information or independently develop similar technologies, solutions or information. The steps that we have taken to prevent misappropriation of our solutions, technologies or other proprietary information may not prevent their misappropriation, particularly outside the U.S. where laws or law enforcement practices may not protect our proprietary rights as fully as in the U.S.

*(23) Products that we are developing for new secure identification markets and components and subsystems markets may not be accepted as quickly as we have projected or at all, which may negatively impact our revenues, margins and earnings.*

We have invested significant time and resources in product development activities for new secure identification markets, including designing and developing numerous enhancements to our driver license systems and improving our cards' ability to withstand intrusions or alterations without detection.

If we do not experience a timely, positive reaction from issuing authorities to our new offerings, our projected revenues, margins and earnings may be negatively impacted.

*(24) We are engaged in several lawsuits alleging violations of securities law and cannot predict the outcome or ultimate cost of these actions with certainty.*

We currently are engaged in litigation relating to the initial public offering of our securities, in addition to the actions filed against us in connection with our previously announced accounting errors. These matters are discussed in greater detail in Part II, Item 1 (Legal Proceedings) of this Quarterly Report on Form 10-Q and in Note 11 (Commitments and Contingencies) of the Notes to Consolidated Financial Statements included in this Quarterly Report on Form 10-Q. We have incurred significant costs relating to these matters. Due to the inherent uncertainties of such litigation, the ultimate cost and outcome cannot be predicted.

*(25) There is no assurance that our internal controls and procedures will succeed in achieving their stated goals under all potential future conditions, regardless of how remote.*

We have deployed significant resources to design, implement, and maintain effective internal controls and procedures, including disclosure controls and procedures. While our internal controls and procedures are designed to provide reasonable assurance of achieving their objectives, the design of any system of controls is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions, regardless of how remote. Any failure to maintain adequate controls or to adequately implement required new or improved controls could harm our operating results or cause us to fail to meet our reporting obligations in a timely and accurate manner.

*(26) Some of our revenue models relating to anticipated products and services are under development. If these revenue models and pricing structures do not gain market acceptance, the corresponding anticipated products and services may fail to attract or retain customers and we may not be able to generate new or sustain existing revenue.*

Some of our business involves embedding digital watermarks in traditional and digital media, including identification documents, secure documents, audio, video and imagery, and licensing our intellectual property. Through 2001, our revenue stream was based primarily on a combination of development, consulting, subscription and license fees from copyright protection and counterfeit deterrence applications. Beginning in 2002 and for the foreseeable future, we have seen, and we anticipate, that the majority of our revenue will be from government and private-sector customers for providing security-related applications relating to secure personal identification, copyright protection, and counterfeit deterrence. We have not fully developed revenue models for certain of our future digital watermarking applications and licensing endeavors. Because some of our products and services are not yet well-established in the marketplace, and because some of such products and services will not directly displace existing solutions, we cannot be certain that the pricing structure for these products and services will gain market acceptance or be sustainable over time or that the marketing for such products and services will be effective.

*(27) If a judgment were to be entered against us and certain of our officers and directors and our director and officer liability insurance is inadequate or unavailable, the obligation to pay the judgment may materially harm our business and financial condition.*

Our director and officer liability insurance policies provide protection against certain liabilities relating to the securities class action and derivative lawsuits against us and certain of our officers and directors up to prescribed policy limits. If these policies do not adequately cover expenses and certain liabilities relating to these lawsuits, our financial condition could be materially harmed. In addition, if

this insurance coverage becomes unavailable to us or premiums increase significantly in the future, it could make it more difficult for us to retain and attract officers and directors and could expose us to potentially self-funding certain future liabilities ordinarily mitigated by director and officer liability insurance.

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

The following table sets forth information regarding purchases of our equity securities during the quarter ended March 31, 2008, all of which were shares subject to restricted stock awards that we purchased to cover applicable tax withholding obligations when these awards vested.

Period	(a) Total number of shares (or units) purchased	(b) Average price paid per share (or unit)	(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 or programs
<b>Month 1</b>				
January 1, 2008 to January 31, 2008	21,688	\$ 8.21		
<b>Month 2</b>				
February 1, 2008 to February 29, 2008	12,581	\$ 8.99		
<b>Month 3</b>				
March 1, 2008 to March 31, 2008				
<b>Total.</b>	34,269	\$ 8.49		

**Item 6. Exhibits.**

See attached exhibit index.



**EXHIBIT INDEX**

<b>Exhibit Number</b>	<b>Document</b>
2.1	Agreement and Plan of Merger, dated March 23, 2008, by and among Digimarc Corporation, L-1 Identity Solutions, Inc. and Dolomite Acquisition Co. (incorporated by reference to Exhibit 2.1 to Registrant's Report on Form 8-K, as filed with the Securities and Exchange Commission on March 24, 2008)
3.1	Second Amended and Restated Certificate of Incorporation of the Registrant, as amended (incorporated by reference to Exhibit 3.1 of Exhibits to the Registrant's Annual Report on Form 10-K, as filed with the Securities and Exchange Commission on March 13, 2006)
3.2	Amended and Restated Bylaws of the Registrant (incorporated by reference to Exhibit 3.3 of Exhibits to Registrant's Quarterly Report on Form 10-Q, as filed with the Securities and Exchange Commission on August 9, 2005)
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

QuickLinks

Table of Contents

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements.

DIGIMARC CORPORATION CONSOLIDATED BALANCE SHEETS (In thousands, except share data) (UNAUDITED)

DIGIMARC CORPORATION CONSOLIDATED STATEMENTS OF OPERATIONS (In thousands, except per share data) (UNAUDITED)

DIGIMARC CORPORATION CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY (In thousands, except share data)

DIGIMARC CORPORATION CONSOLIDATED STATEMENTS OF CASH FLOWS (In thousands) (UNAUDITED)

DIGIMARC CORPORATION NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (In thousands, except share and per share data) (UNAUDITED)

PART II. OTHER INFORMATION.

SIGNATURES

EXHIBIT INDEX