

Digimarc CORP  
Form 10-Q  
July 31, 2012

**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 June 30, 2012

OR

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

For the transition period from            to

Commission File Number: 001-34108

**DIGIMARC CORPORATION**

(Exact name of registrant as specified in its charter)

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ☒ No ☐

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

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

As of July 20, 2012, there were 7,125,065 shares of the registrant's common stock, par value \$0.001 per share, outstanding.

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**Table of Contents**

**PART I FINANCIAL INFORMATION**

Item 1.	<u>Financial Statements (Unaudited):</u>	3
	<u>Balance Sheets as of June 30, 2012 and December 31, 2011</u>	3
	<u>Statements of Operations for the three- and six-months ended June 30, 2012 and 2011</u>	4
	<u>Statements of Shareholders' Equity for the six-months ended June 30, 2012 and 2011</u>	5
	<u>Statements of Cash Flows for the six-months ended June 30, 2012 and 2011</u>	6
	<u>Notes to Financial Statements</u>	7
Item 2.	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	20
Item 3.	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	31
Item 4.	<u>Controls and Procedures</u>	32

**PART II OTHER INFORMATION**

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

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

	<b>June 30, 2012</b>	<b>December 31, 2011</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 7,473	\$ 3,419
Marketable securities	26,525	22,244
Trade accounts receivable, net	2,543	3,502
Other current assets	1,162	1,306
Total current assets	37,703	30,471
Marketable securities	9,522	7,715
Property and equipment, net	1,357	1,395
Intangible assets, net	3,361	2,808
Investments in joint ventures		415
Deferred tax assets	2,229	2,634
Other assets, net	214	355
Total assets	\$ 54,386	\$ 45,793
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable and other accrued liabilities	\$ 651	\$ 952
Income taxes payable	1,014	
Deferred revenue	2,338	2,660
Total current liabilities	4,003	3,612
Deferred rent and other long-term liabilities	419	464
Total liabilities	4,422	4,076
Commitments and contingencies (Note 12)		
Shareholders' equity:		
Preferred stock (par value \$0.001 per share, 2,500,000 authorized, 10,000 shares issued and outstanding at June 30, 2012 and December 31, 2011)	50	50
Common stock (par value \$0.001 per share, 50,000,000 authorized, 7,108,372 and 7,008,031 shares issued and outstanding at June 30, 2012 and December 31, 2011, respectively)	7	7
Additional paid-in capital	37,322	34,511
Retained earnings	12,585	7,149
Total shareholders' equity	49,964	41,717
Total liabilities and shareholders' equity	\$ 54,386	\$ 45,793

The accompanying notes are an integral part of these unaudited financial statements.



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

	<b>Three Months Ended June 30, 2012</b>	<b>Three Months Ended June 30, 2011</b>	<b>Six Months Ended June 30, 2012</b>	<b>Six Months Ended June 30, 2011</b>
Revenue:				
Service	\$ 2,609	\$ 3,165	\$ 5,657	\$ 6,234
License and subscription	6,503	6,308	20,501	12,330
Total revenue	9,112	9,473	26,158	18,564
Cost of revenue:				
Service	1,485	1,614	3,182	3,198
License and subscription	98	76	211	141
Total cost of revenue	1,583	1,690	3,393	3,339
Gross profit	7,529	7,783	22,765	15,225
Operating expenses:				
Sales and marketing	970	1,017	1,977	2,119
Research, development and engineering	2,146	1,884	4,144	3,659
General and administrative	2,191	2,270	4,949	5,117
Intellectual property	291	266	610	567
Total operating expenses	5,598	5,437	11,680	11,462
Operating income	1,931	2,346	11,085	3,763
Net loss from joint ventures		(698)	(1,107)	(1,235)
Interest income, net	33	48	91	106
Income before provision for income taxes	1,964	1,696	10,069	2,634
(Provision) benefit for income taxes	(748)	1,930	(3,854)	1,930
Net income	\$ 1,216	\$ 3,626	\$ 6,215	\$ 4,564
Earnings per common share:				
Net income per common share basic	\$ 0.17	\$ 0.54	\$ 0.88	\$ 0.67
Net income per common share diluted	\$ 0.17	\$ 0.50	\$ 0.84	\$ 0.62
Weighted average common shares outstanding basic	6,737	6,696	6,738	6,780
Weighted average common shares outstanding diluted	6,993	7,245	6,999	7,381

The accompanying notes are an integral part of these unaudited financial statements.

**DIGIMARC CORPORATION****STATEMENTS OF SHAREHOLDERS' EQUITY**

(In thousands, except share data)

(UNAUDITED)

	Preferred stock		Common stock		Additional	Retained	Total
	Shares	Amount	Shares	Amount	paid-in capital	earnings	shareholders equity
<b>BALANCE AT DECEMBER 31, 2010</b>	10,000	\$ 50	7,443,450	\$ 7	\$ 49,609	\$ 1,493	\$ 51,159
Exercise of stock options			74,168		733		733
Issuance of restricted common stock			114,180				
Forfeiture of restricted common stock			(395)				
Purchase and retirement of common stock			(646,480)		(17,647)		(17,647)
Stock-based compensation					2,007		2,007
Tax benefit from stock-based awards					501		501
Net income						4,564	4,564
<b>BALANCE AT JUNE 30, 2011</b>	10,000	\$ 50	6,984,923	\$ 7	\$ 35,203	\$ 6,057	\$ 41,317
<b>BALANCE AT DECEMBER 31, 2011</b>	10,000	\$ 50	7,008,031	\$ 7	\$ 34,511	\$ 7,149	\$ 41,717
Exercise of stock options			62,500		603		603
Issuance of restricted common stock			129,220				
Forfeiture of restricted common stock			(6,360)				
Purchase and retirement of common stock			(85,019)		(2,187)		(2,187)
Stock-based compensation					2,857		2,857
Tax benefit from stock-based awards					1,538		1,538
Net income						6,215	6,215
Cash dividends declared						(779)	(779)
<b>BALANCE AT JUNE 30, 2012</b>	10,000	\$ 50	7,108,372	\$ 7	\$ 37,322	\$ 12,585	\$ 49,964

The accompanying notes are an integral part of these unaudited financial statements.

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

(In thousands)

(UNAUDITED)

	Six Months Ended June 30, 2012	Six Months Ended June 30, 2011
Cash flows from operating activities:		
Net income	\$ 6,215	\$ 4,564
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization of property and equipment	292	309
Amortization of intangibles	119	54
Stock-based compensation	2,807	1,981
Net loss from joint ventures	1,107	1,235
Deferred income tax expense (benefit)	62	(2,433)
Tax benefit from stock-based awards	1,893	501
Excess tax benefit from stock-based awards	(1,538)	(501)
Changes in operating assets and liabilities:		
Trade accounts receivable, net	959	635
Other current assets	132	296
Other assets, net	141	4
Accounts payable and other accrued liabilities	(341)	(45)
Income taxes payable	1,014	
Deferred revenue	(327)	(412)
Net cash provided by operating activities	12,535	6,188
Cash flows from investing activities:		
Purchase of property and equipment	(254)	(357)
Capitalized patent costs	(622)	(293)
Investments in joint ventures, net	(692)	(1,400)
Sale or maturity of marketable securities	69,136	53,768
Purchase of marketable securities	(75,224)	(43,123)
Net cash (used in) provided by investing activities	(7,656)	8,595
Cash flows from financing activities:		
Issuance of common stock	603	733
Purchase of common stock	(2,187)	(17,647)
Cash dividends paid	(779)	
Excess tax benefit from stock-based awards	1,538	501
Net cash used in financing activities	(825)	(16,413)
Net increase (decrease) in cash and cash equivalents	4,054	(1,630)
Cash and cash equivalents at beginning of period	3,419	6,340
Cash and cash equivalents at end of period	\$ 7,473	\$ 4,710
Supplemental disclosure of cash flow information:		
Cash paid for income taxes	\$ 842	\$



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

Stock-based compensation capitalized to patent costs	\$	50	\$	26
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The accompanying notes are an integral part of these unaudited financial statements.

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**DIGIMARC CORPORATION**

**NOTES TO FINANCIAL STATEMENTS**

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

**(UNAUDITED)**

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

*Description of Business*

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

*Interim Financial Statements*

The accompanying unaudited financial statements have been prepared from the Company's records and, in management's opinion, include all adjustments (consisting of only normal recurring adjustments) necessary to fairly reflect the financial condition and the results of operations for the periods presented. Certain information and note disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States (the U.S. ) have been condensed or omitted in accordance with the rules and regulations of the Securities and Exchange Commission ( SEC ).

These financial statements should be read in conjunction with the audited financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2011, which was filed with the SEC on February 24, 2012. The results of operations for the interim periods presented in these financial statements are not necessarily indicative of the results for the full year.

*Use of Estimates*

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

*Cash Equivalents*

The Company considers all highly liquid marketable securities with original maturities of 90 days or less at the date of acquisition to be cash equivalents. Cash equivalents include money market funds, certificates of deposit, commercial paper, and investments in government bonds totaling \$6,868 and \$2,992 at June 30, 2012 and December 31, 2011, respectively. Cash equivalents are carried at cost or amortized cost, which approximates market.

*Marketable Securities*

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

A decline in the market value of any security below amortized cost that is deemed to be other-than-temporary results in a reduction in the carrying amount. The impairment is charged to earnings and a new cost basis for the security is established. To determine whether an

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impairment is other-than-temporary, the Company considers whether it has the ability and intent to hold the investment until a market price recovery and considers whether evidence indicating that the cost of the investment is recoverable outweighs evidence to the contrary. There have been no other-than-temporary impairments identified or recorded by the Company.

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

#### *Fair Value of Financial Instruments*

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

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

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

Level 3 Pricing inputs are unobservable for the investment; that is, inputs that reflect the reporting entity's own assumptions about the assumptions market participants would use in pricing the asset or liability.

The estimated fair values of the Company's financial instruments, which include cash and cash equivalents, short-term marketable securities, accounts receivable, accounts payable and other accrued liabilities approximate their carrying values due to the short-term nature of these instruments. The Company records marketable securities at amortized cost, which approximates fair value.

The Company's fair value hierarchy for its financial assets as of June 30, 2012 and December 31, 2011 was as follows:

<b>June 30, 2012</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Total</b>
Money market securities	\$ 551	\$	\$	\$ 551
Certificates of deposits		736		736
US Treasuries		518		518
Federal agency notes		9,241		9,241
Pre-refunded and other municipals		3,279		3,279
Corporate notes		16,742		16,742
Commercial paper		11,848		11,848
Total	\$ 551	\$ 42,364	\$	\$ 42,915

<b>December 31, 2011</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Total</b>
Money market securities	\$ 896	\$	\$	\$ 896
Certificates of deposits		736		736
US Treasuries		718		718
Federal agency notes		7,942		7,942
Pre-refunded and other municipals		2,800		2,800
Corporate notes		16,459		16,459
Commercial paper		3,400		3,400
Total	\$ 896	\$ 32,055	\$	\$ 32,951

#### *Concentrations of Business and Credit Risk*

A significant portion of the Company's business depends on a limited number of large contracts. The loss of any large contract may result in loss of revenue and margin on a prospective basis. Financial instruments that potentially subject Digimarc to concentrations of credit risk consist primarily of cash and cash equivalents, marketable securities, and trade accounts receivable. Digimarc places its cash and cash equivalents with major banks and financial institutions and at times deposits may exceed insured limits. Other than cash used for operating needs, which may include short-term marketable securities with the Company's principal banks, Digimarc's investment policy limits its credit exposure to any one

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financial institution or type of financial instrument by limiting the maximum of 5% or \$1,000, whichever is greater, to be invested in any one issuer except for the U.S. Government and U.S. federal agencies, which have no limits, at the time of purchase. The Company's investment policy also limits its credit exposure by limiting the maximum of 40% of its cash and cash equivalents and marketable securities, or \$15,000, whichever is greater, to be invested in any one industry category, e.g., financial or energy industries, at the time of purchase. As a result, Digimarc's credit risk associated with cash and cash equivalents and marketable securities is believed to be minimal.

#### *Equity Method Investments*

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

#### *Impairment of Long-Lived Assets*

The Company accounts for long-lived assets in accordance with the provisions of ASC 360 *Property, Plant and Equipment*. This statement requires that long-lived assets, including definite-lived intangible assets, 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 over its remaining useful life. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Fair value is determined based on discounted cash flows or appraised values, depending on the nature of the asset. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell. Through June 30, 2012, there have been no significant impairment losses.

#### *Research and Development*

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

#### *Software Development Costs*

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

#### *Patent Costs*

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

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

#### *Revenue Recognition*

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

#### *Stock-Based Compensation*

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

For stock option awards the Company uses the Black-Scholes option pricing model as its method of valuation. The Company's determination of the fair value on the date of grant is affected by its stock price as well as assumptions regarding a number of highly subjective variables. These variables include, but are not limited to, the expected life of the award, the Company's expected stock price volatility over the term of the award and the expected dividend yield. Although the fair value of stock-based awards is determined in accordance with ASC 718 and SAB No. 107

*Shared-Based Payment*, the Black-Scholes option pricing model requires the input of highly subjective assumptions, and other reasonable assumptions could provide differing results.

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### *Income Taxes*

The Company accounts for income taxes under the asset and liability method. Under the asset and liability method, deferred income taxes reflect the future tax consequences of differences between the tax basis of assets and liabilities and their financial

reporting amounts at each year-end. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. Valuation allowances are established when necessary to reduce deferred tax assets to the amount that is more likely than not expected to be realized.

The Company is subject to federal and state income taxes within the United States and in the ordinary course of business, there are transactions and calculations where the ultimate tax determination is uncertain. We report a liability (or contra asset) for unrecognized tax benefits resulting from uncertain tax positions taken or expected to be taken in a tax return. We recognize interest and penalties, if any, related to the unrecognized tax benefits in income tax expense.

## 2. Recent Accounting Pronouncements

In May 2011, the Financial Accounting Standards Board ( FASB ) issued Accounting Standards Update ( ASU ) No. 2011-04, *Fair Value Measurement: Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS*, which provides common requirements for measuring fair value and for disclosing information about fair value measurements in accordance with U.S. generally accepted accounting principles (GAAP) and International Financial Reporting Standards (IFRS). The amendments of ASU No. 2011-04 are effective during interim and annual periods beginning after December 15, 2011. Early application is prohibited. The Company has adopted the provisions of this standard and noted no material impact on the financial condition or results of operations of the Company.

## 3. Revenue Recognition

We derive our revenue primarily from development services and licensing of our patent portfolio:

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

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

Revenue is recognized in accordance with ASC 605 *Revenue Recognition* and ASC 985 *Software* 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.

Some customer arrangements encompass multiple deliverables, such as patent license, professional services, software subscriptions, and maintenance fees. For arrangements that include multiple deliverables, the Company identifies separate units of accounting at inception based on the consensus reached under ASC 605-25 *Multiple-Element Arrangements*, which provides that revenue arrangements with multiple deliverables should be divided into separate units of accounting if certain criteria are met. The consideration for the arrangement is allocated to the separate units of accounting using the relative selling price method.

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

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



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

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

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

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

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

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

#### 4. Segment Information

##### *Geographic Information*

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

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

	Three Months Ended June 30, 2012	Three Months Ended June 30, 2011	Six Months Ended June 30, 2012	Six Months Ended June 30, 2011
Domestic	\$ 5,522	\$ 6,030	\$ 19,093	\$ 12,100
International	3,590	3,443	7,065	6,464
<b>Total</b>	<b>\$ 9,112</b>	<b>\$ 9,473</b>	<b>\$ 26,158</b>	<b>\$ 18,564</b>

##### *Major Customers*

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

	Three Months Ended June 30, 2012	Three Months Ended June 30, 2011	Six Months Ended June 30, 2012	Six Months Ended June 30, 2011
Intellectual Ventures	35%	32%	25%	32%
Central Banks	30%	25%	21%	26%
Verance Corporation ( Verance )	12%	11%	38%	12%
The Nielsen Company ( Nielsen )	11%	11%	*	11%

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\* Less than 10%

On January 30, 2012, the Company and Verance, a longtime cash-basis customer, settled all disputes regarding breach of contract and patent infringement claims. In connection with the resolution of these matters, Verance paid the Company \$8,852 for amounts due to Digimarc through December 31, 2011 and all claims between the parties were dismissed. Revenue from this payment was recorded in the quarter ended March 31, 2012.

### **5. Stock-Based Compensation**

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

Stock-based compensation expense related to internal legal labor is allocated to patent costs based on direct labor hours charged to capitalized patent costs.

## Determining Fair Value

### Preferred Stock

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

The Series A Preferred is redeemable based on the stated fair value of \$5.00 per share. The Series A Preferred has no dividend rights and no rights to the undistributed earnings of the Company.

### Stock Options

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

**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 generally vest over three to four years for employee grants and one to two years for director grants, and have contractual terms of ten years.

**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 based on historical prices over the most recent period commensurate with the estimated expected life of the award.

**Risk-Free Interest Rate.** The Company determines the risk-free interest rate using current US Treasury yields for bonds with a maturity commensurate with the estimated expected life of the award.

**Expected Dividend Yield.** The expected dividend yield used is derived using a formula which uses the expected Company annual dividend rate over the expected term divided by the fair value of the Company's common stock at the grant date.

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

	2011	
Expected life (in years)	5.28	5.75
Expected volatility	42%	44%
Risk-free interest rate	1.0%	2.0%
Expected dividend yield		0%

	Three Months Ended June 30, 2012	Three Months Ended June 30, 2011	Six Months Ended June 30, 2012	Six Months Ended June 30, 2011
Fair value of stock options granted	\$	\$	\$	\$ 954

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

### Restricted Stock

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

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

### Stock-based Compensation

	Three Months Ended June 30, 2012	Three Months Ended June 30, 2011	Six Months Ended June 30, 2012	Six Months Ended June 30, 2011
Stock-based compensation:				
Cost of revenue	\$ 154	\$ 178	\$ 338	\$ 288
Sales and marketing	137	76	233	161
Research, development and engineering	212	108	397	266
General and administrative	830	586	1,664	1,171
Intellectual property	68	47	125	95
Stock-based compensation expense	1,401	995	2,757	1,981
Capitalized to patent costs	23	15	50	26
Total stock-based compensation	\$ 1,424	\$ 1,010	\$ 2,807	\$ 2,007

The following table sets forth total unrecognized compensation cost related to non-vested stock-based awards granted under all equity compensation plans, including preferred stock, stock options and restricted stock:

	As of June 30, 2012	As of December 31, 2011
Unrecognized compensation costs	\$ 9,613	\$ 9,463

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

The Company expects to recognize this compensation cost for stock options and restricted stock over a weighted average period through June 2016:

	Stock Options	Restricted Stock
Weighted average period	1.05 years	1.68 years

### Stock Option Activity

As of June 30, 2012, under all of the Company's stock-based compensation plans, options to purchase 773,005 shares were available for future grants under the plans. The Company issues new shares upon option exercises.

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

Three-months ended June 30, 2012:	Options	Weighted Average Exercise	Weighted Average Grant Date	Aggregate Intrinsic Value
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		Price	Fair Value	
Outstanding at March 31, 2012	1,020,738	\$ 14.27	\$ 7.62	
Options granted				
Options exercised	(55,000)	\$ 9.64	\$ 6.30	
Options canceled or expired				
Outstanding at June 30, 2012	965,738	\$ 14.53	\$ 7.70	\$ 11,269

		Weighted Average Exercise Price	Weighted Average Grant Date Fair Value	Aggregate Intrinsic Value
<b>Six-months ended June 30, 2012:</b>	<b>Options</b>			
Outstanding at December 31, 2011	1,028,238	\$ 14.23	\$ 7.61	
Options granted				
Options exercised	(62,500)	\$ 9.64	\$ 6.30	

		Weighted Average Exercise Price	Weighted Average Grant Date Fair Value	Aggregate Intrinsic Value
<b>Six-months ended June 30, 2012:</b>				
Options canceled or expired	Options			
Outstanding at June 30, 2012	965,738	\$ 14.53	\$ 7.70	\$ 11,269
Exercisable at June 30, 2012	672,043	\$ 11.93		\$ 9,379
Unvested at June 30, 2012	293,695	\$ 20.47		\$ 1,890

The aggregate intrinsic value is based on the closing price of \$25.66 per share of Digimarc common stock on June 30, 2012, which would have been received by the optionees had all of the options with exercise prices less than \$25.66 per share been exercised on that date. The following table summarizes information about stock options outstanding at June 30, 2012:

Range of Exercise Prices	Options Outstanding			Options Exercisable		
	Number Outstanding	Remaining Contractual Life (Years)	Weighted Average Exercise Price	Number Exercisable	Remaining Contractual Life (Years)	Weighted Average Exercise Price
\$9.64 - \$9.91	617,822	6.36	\$ 9.65	531,659	6.37	\$ 9.65
\$14.99 - \$18.01	132,916	7.58	\$ 15.67	89,376	7.62	\$ 16.00
\$24.35 - 30.01	215,000	9.08	\$ 27.84	51,008	8.93	\$ 28.54
\$9.64 - \$30.01	965,738	7.14	\$ 14.53	672,043	6.73	\$ 11.93

#### Restricted Stock Activity

The following table reconciles the unvested balance of restricted stock:

	Number of Shares	Weighted Average Grant Date Fair Value
<b>Three-months ended June 30, 2012:</b>		
Unvested balance, March 31, 2012	356,150	\$ 21.96
Granted	16,700	\$ 25.19
Vested	(12,600)	\$ 25.70
Canceled	(2,385)	\$ 18.21
Unvested balance, June 30, 2012	357,865	\$ 22.01

	Number of Shares	Weighted Average Grant Date Fair Value
<b>Six-months ended June 30, 2012:</b>		
Unvested balance, December 31, 2011	296,710	\$ 21.51
Granted	129,220	\$ 24.18
Vested	(61,705)	\$ 24.53
Canceled	(6,360)	\$ 18.28



Unvested balance, June 30, 2012	357,865	\$ 22.01
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## 6. Earnings Per Common Share

The Company calculates basic and diluted earnings per common share in accordance with ASC 260 *Earnings Per Share*, using the two-class method as the Company's unvested restricted stock is a participating security given these awards contain non-forfeitable rights to receive dividends. Under the two-class method, net earnings are allocated to each class of common stock and participating security as if all of the net earnings for the period had been distributed.

Basic earnings per common share excludes dilution and is calculated by dividing net earnings allocable to common shares by the weighted-average number of common shares outstanding for the period. Diluted earnings per common share is calculated by dividing net earnings allocable to common shares by the weighted-average number of common shares as of the balance sheet date, as adjusted for the potential dilutive effect of non-participating securities. The following table reconciles earnings per common share for the three- and six-month periods ended June 30, 2012:

	Three Months Ended June 30, 2012	Six Months Ended June 30, 2012
<b>Basic EPS:</b>		
Net income	\$ 1,216	\$ 6,215
Less: Net income allocable to participating securities	(61)	(313)
Net income allocable to common shares	\$ 1,155	\$ 5,902
Weighted average common shares outstanding basic (in thousands)	6,737	6,738
Basic earnings per common share	\$ 0.17	\$ 0.88

	Three Months Ended June 30, 2012	Six Months Ended June 30, 2012
<b>Diluted EPS:</b>		
Net income	\$ 1,216	\$ 6,215
Less: Net income allocable to participating securities	(61)	(313)
Net income allocable to common shares	\$ 1,155	\$ 5,902
Weighted average common shares outstanding basic (in thousands)	6,737	6,738
Dilutive effect of non-participating securities (in thousands)	256	261
Weighted average common shares outstanding dilutive (in thousands)	6,993	6,999
Diluted earnings per common share	\$ 0.17	\$ 0.84

There were 175,000 common stock equivalents related to stock options that were anti-dilutive and excluded from diluted net income per share calculations for the three-months and six-months ended June, 30, 2012 as their exercise prices were higher than the average market price of the underlying common stock for the period.

Net income per common share was calculated under the treasury stock method in prior periods because the impact of applying the two-class method for computing basic and diluted earnings per common share was not material. Basic and diluted net income per share were computed using the weighted average number of common shares outstanding during each period, with diluted net income per share including the effect of potentially dilutive common shares.

	Three Months Ended June 30, 2011			Six Months Ended June 30, 2011		
	Income (Numerator)	Shares (in thousands) (Denominator)	Per Share Amount	Income (Numerator)	Shares (in thousands) (Denominator)	Per Share Amount
<b>Basic EPS</b>						
Income available to common shareholders	\$ 3,626	6,696	\$ 0.54	\$ 4,564	6,780	\$ 0.67
<b>Effect of Dilutive Securities</b>						
Options		265			317	
Restricted stock		284			284	
<b>Diluted EPS</b>						
Income available to common shareholders	\$ 3,626	7,245	\$ 0.50	\$ 4,564	7,381	\$ 0.62

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There were 75,000 common stock equivalents related to stock options that were anti-dilutive and excluded from diluted net income per common share calculations for the three- and six-months ended June 30, 2011 as their exercise prices were higher than the average market price of the underlying common stock for the period.

### 7. Trade Accounts Receivable

#### *Trade Accounts Receivable*

Trade accounts receivable are recorded at the invoiced amount.

	June 30, 2012	December 31, 2011
Trade accounts receivable	\$ 2,543	\$ 3,502
Allowance for doubtful accounts		
Trade accounts receivable, net	\$ 2,543	\$ 3,502
Unpaid deferred revenues included in accounts receivable	\$ 1,137	\$ 2,084

*Allowance for Doubtful Accounts*

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

*Unpaid Deferred Revenues*

The unpaid deferred revenues that are included in trade accounts receivable are billed in accordance with the provisions of the contracts with the Company's customers. Unpaid deferred revenues from the Company's cash-basis customers are not included in trade accounts receivable nor deferred revenue accounts.

*Major Customers*

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

	June 30, 2012	December 31, 2011
Nielsen	39%	29%
Central Banks	31%	45%
Civolution	21%	14%

**8. Property and Equipment**

Property and equipment are stated at cost. Repairs and maintenance are charged to expense when incurred.

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

	June 30, 2012	December 31, 2011
Office furniture fixtures	\$ 414	\$ 410
Equipment	2,089	1,872
Leasehold improvements	1,074	1,041
	3,577	3,323
Less accumulated depreciation and amortization	(2,220)	(1,928)
	\$ 1,357	\$ 1,395

**9. Intangible Assets Purchased and Capitalized Patent Costs**

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

	June 30, 2012	December 31, 2011
Gross intangible assets	\$ 3,720	\$ 3,048
Accumulated amortization	(359)	(240)

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Intangible assets, net	\$ 3,361	\$ 2,808
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## **10. Joint Ventures and Related Party Transactions**

In March 2012, Digimarc and Nielsen decided to reduce the investments in their two joint ventures to minimal levels while assessing alternative approaches to achieving each of their goals in the emerging market opportunity of synchronized second screen television. In connection with this plan for the suspension of operations, the joint ventures accrued estimated expenses for the quarter's operations and severance costs for joint venture employees. Digimarc's share of the one-time severance and suspension costs was approximately \$500. Pursuant to the plan of suspending operations of the joint ventures with Nielsen, in April 2012 the Company received \$104 of remaining cash from TVaura LLC and contributed \$796 to TVaura Mobile LLC to fund both the first quarter's operating expenses as well as the suspension related costs. Payment of all expenses incurred after the suspension of operations of each joint venture is the responsibility of the majority member.

The investment in joint ventures account balances have been reduced to zero.

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

#### Related Party Transactions

	Three Months Ended June 30, 2012	Three Months Ended June 30, 2011	Six Months Ended June 30, 2012	Six Months Ended June 30, 2011
TVaura LLC:				
Capital contributions (return of capital)	\$ (104 )	\$ 400	\$ (104)	\$ 800
Revenue(1)	\$	\$ 720	\$	\$ 1,411
TVaura Mobile LLC:				
Capital contributions	\$ 796	\$ 300	\$ 796	\$ 600
Revenue(1)	\$	\$	\$ 272	\$
Total:				
Capital contributions, net	\$ 692	\$ 700	\$ 692	\$ 1,400
Revenue(1)	\$	\$ 720	\$ 272	\$ 1,411

(1) Technical and development services

	June 30, 2012	December 31, 2011
TVaura LLC:		
Accounts receivable	\$	\$ 164

Summarized financial data for TVaura LLC:

	June 30, 2012	December 31, 2011
Current assets	\$ 3	\$ 402
Noncurrent assets	\$	\$ 22
Current liabilities	\$ 3	\$ 169

	Three Months Ended June 30, 2012	Three Months Ended June 30, 2011	Six Months Ended June 30, 2012	Six Months Ended June 30, 2011
Revenue	\$	\$	\$	\$
Gross profit	\$	\$	\$	\$
Operating expenses	\$	\$ 733	\$ 52	\$ 1,450
Net loss from continuing operations	\$	\$ (733)	\$ (52)	\$ (1,449)
The Company's pro-rata share net loss	\$	\$ (374)	\$ (27)	\$ (739)
The Company's gain on investment	\$	\$	\$ 70	\$

Summarized financial data for TVaura Mobile LLC:

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	June 30, 2012	December 31, 2011
Current assets	\$ 1,494	\$ 1,308
Current liabilities	\$ 1,571	\$ 720

	Three Months Ended June 30, 2012	Three Months Ended June 30, 2011	Six Months Ended June 30, 2012	Six Months Ended June 30, 2011
Revenue	\$	\$ 50	\$	\$ 50
Gross loss	\$	\$ (27)	\$	\$ (27)
Operating expenses	\$ 77	\$ 635	\$ 2,322	\$ 985
Net loss from continuing operations	\$ (77)	\$ (662)	\$ (2,322)	\$ (1,012)
The Company's pro-rata share net loss	\$	\$ (324)	\$ (1,100)	\$ (496)
The Company's loss on investment	\$	\$	\$ (50)	\$

### 11. Income Taxes

The provision for income taxes for the three- and six-month periods ended June 30, 2012, reflects income taxes for federal and state jurisdictions reduced by available tax credit carry-forwards and tax credits claimed during the period. The effective tax rate for the period ended June 30, 2012 was 38%. The valuation allowance against net deferred tax assets as of June 30, 2012 is \$0.

The effective tax rate for the period ended June 30, 2012 differs from the effective rate for the period ended June 30, 2011, primarily due to the release of the valuation allowance on net deferred tax assets during the quarter ended June 30, 2011. During the quarter ended June 30, 2011, the Company concluded, based on projections of future income, that it was more likely than not that the Company's deferred tax assets would be realized.

The Company's income tax provision for the three- and six-month periods ended June 30, 2011 was a tax benefit of \$1.9 million. The tax benefit includes a \$2.6 million deferred tax benefit from the valuation allowance release as well as benefits from federal and state research credits, offset in part by a recognized windfall to additional paid-in capital of \$0.5 million on stock option exercises.

### 12. Commitments and Contingencies

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

The Company is subject from time to time to other legal proceedings and claims arising in the ordinary course of business. No such proceedings are currently pending.

### 13. Stock Repurchases

Summary of common stock shares repurchased:

	Three Months Ended June 30, 2012	Three Months Ended June 30, 2011	Six Months Ended June 30, 2012	Six Months Ended June 30, 2011
Private transaction				552,536
Repurchase program	19,940	24,204	27,547	41,077
Exercise of stock options	20,391	24,099	22,780	24,099
Tax withholding obligations on stock options	12,270	17,753	14,121	17,753
Tax withholding obligations on restricted shares	1,032	139	20,571	11,015
Total	53,633	66,195	85,019	646,480

Value of common stock shares repurchased:





	<b>Three Months Ended June 30, 2012</b>	<b>Three Months Ended June 30, 2011</b>	<b>Six Months Ended June 30, 2012</b>	<b>Six Months Ended June 30, 2011</b>
Private transaction	\$	\$	\$	\$ 14,927
Repurchase program	\$ 512	\$ 665	\$ 711	\$ 1,120
Exercise of stock options	\$ 530	\$ 733	\$ 602	\$ 733
Tax withholding obligations on stock options	\$ 319	\$ 541	\$ 375	\$ 541
Tax withholding obligations on restricted shares	\$ 26	\$ 4	\$ 499	\$ 326