Digimarc CORP
Form 10-Q
July 28, 2011
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2011

OR

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

For the transition period from to

Commission File Number: 001-34108

DIGIMARC CORPORATION

(Exact name of registrant as specified in its charter)

Oregon	**26-2828185**
(State or other jurisdiction of incorporation or organization)	**(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 x 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 x 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	x
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 x

As of July 22, 2011, there were 6,984,923 shares of the registrant s common stock, par value $0.001 per share, outstanding.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements.

DIGIMARC CORPORATION

BALANCE SHEETS

(In thousands, except share data)

(UNAUDITED)

	June 30, 2011	December 31, 2010
ASSETS		
Current assets:		
Cash and cash equivalents	$ 4,710	$ 6,340
Marketable securities	23,003	28,441
Trade accounts receivable, net	2,846	3,481
Other current assets	1,252	1,345
Total current assets	31,811	39,607
Marketable securities	5,956	11,163
Property and equipment, net	1,378	1,330
Intangibles, net	2,439	2,174
Investments in joint ventures	1,194	1,029
Deferred tax assets	2,275	
Other assets	458	462
Total assets	$ 45,511	$ 55,765
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable and other accrued liabilities	$ 1,532	$ 1,519
Deferred revenue	2,154	2,562
Total current liabilities	3,686	4,081
Long-term liabilities	508	525
Total liabilities	4,194	4,606
Commitments and contingencies (Note 11)		
Shareholders equity:		
Preferred stock (10,000 shares issued and outstanding at June 30, 2011 and December 31, 2010)	50	50
Common stock (6,984,923 and 7,443,450 shares issued and outstanding at June 30, 2011 and December 31, 2010, respectively)	7	7
Additional paid-in capital	35,203	49,609
Retained earnings	6,057	1,493
Total shareholders equity	41,317	51,159
Total liabilities and shareholders equity	$ 45,511	$ 55,765

See Notes to Unaudited Financial Statements.

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DIGIMARC CORPORATION

STATEMENTS OF OPERATIONS

(In thousands, except per share data)

(UNAUDITED)

	Three Months Ended June 30, 2011	Three Months Ended June 30, 2010	Six Months Ended June 30, 2011	Six Months Ended June 30, 2010
Revenue:				
Service	$ 3,165	$ 2,918	$ 6,234	$ 6,432
License and subscription	6,308	2,330	12,330	9,008
Total revenue	9,473	5,248	18,564	15,440
Cost of revenue:				
Service	1,614	1,483	3,198	3,283
License and subscription	76	57	141	114
Total cost of revenue	1,690	1,540	3,339	3,397
Gross profit	7,783	3,708	15,225	12,043
Operating expenses:				
Sales and marketing	1,017	759	2,119	1,500
Research, development and engineering	1,884	1,321	3,659	2,580
General and administrative	2,270	1,687	5,117	3,572
Intellectual property	266	319	567	576
Total operating expenses	5,437	4,086	11,462	8,228
Operating income (loss)	2,346	(378)	3,763	3,815
Net loss from joint ventures	(698)	(561)	(1,235)	(1,018)
Interest income, net	48	61	106	122
Income (loss) before provision for income taxes	1,696	(878)	2,634	2,919
(Provision) benefit for income taxes	1,930	(18)	1,930	(39)
Net income (loss)	$ 3,626	$ (896)	$ 4,564	$ 2,880
Earnings (loss) per share:				
Net income (loss) per share basic	$ 0.54	$ (0.13)	$ 0.67	$ 0.41
Net income (loss) per share diluted	$ 0.50	$ (0.13)	$ 0.62	$ 0.39
Weighted average shares outstanding basic	6,696	7,097	6,780	7,097
Weighted average shares outstanding diluted	7,245	7,097	7,381	7,403

See Notes to Unaudited Financial Statements.

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DIGIMARC CORPORATION

STATEMENTS OF SHAREHOLDERS EQUITY

(In thousands, except share data)

(UNAUDITED)

	Preferred stock		Common stock			Retained	
	Shares	Amount	Shares	Amount	Additional paid-in capital	Earnings (Accumulated Deficit)	Total shareholders equity
BALANCE AT DECEMBER 31, 2009	10,000	$ 50	7,205,701	$ 7	$ 49,283	$ (2,681)	$ 46,659
Exercise of stock options			313,832		3,045		3,045
Issuance of restricted common stock			124,560				
Purchase and retirement of common stock			(200,643)		(5,824)		(5,824)
Stock-based compensation					3,105		3,105
Net income						4,174	4,174
BALANCE AT DECEMBER 31, 2010	10,000	$ 50	7,443,450	$ 7	$ 49,609	$ 1,493	$ 51,159
Exercise of stock options			74,168		733		733
Issuance of restricted common stock			114,180				
Purchase and retirement of common stock			(646,875)		(17,647)		(17,647)
Stock-based compensation					2,007		2,007
Excess tax benefit from stock-based awards					501		501
Net income						4,564	4,564
BALANCE AT JUNE 30, 2011	10,000	$ 50	6,984,923	$ 7	$ 35,203	$ 6,057	$ 41,317

See Notes to Unaudited Financial Statements.

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DIGIMARC CORPORATION

STATEMENTS OF CASH FLOWS

(In thousands)

(UNAUDITED)

	Six Months Ended June 30, 2011	Six Months Ended June 30, 2010
Cash flows from operating activities:		
Net income	$ 4,564	$ 2,880
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization, property and equipment	309	295
Amortization, intangibles	54	32
Stock-based compensation	1,981	1,505
Net loss from joint ventures	1,235	1,018
Deferred income tax benefit	(2,433)	
Tax benefit from stock-based awards	501	
Excess tax benefit from stock-based compensation	(501)	
Changes in operating assets and liabilities:		
Trade accounts receivable, net	635	1,177
Other current assets	296	(146)
Other assets, net	4	(20)
Accounts payable and other accrued liabilities	(45)	(519)
Deferred revenue	(412)	(346)
Net cash provided by operating activities	6,188	5,876
Cash flows from investing activities:		
Purchase of property and equipment	(357)	(129)
Capitalized patent costs	(293)	(534)
Investments in joint ventures	(1,400)	(1,400)
Sale or maturity of marketable securities	53,768	44,714
Purchase of marketable securities	(43,123)	(49,569)
Net cash provided by (used in) investing activities	8,595	(6,918)
Cash flows from financing activities:		
Issuance of common stock	733	8
Purchase of common stock	(17,647)	(25)
Excess tax benefit from stock-based awards	501	
Net cash used in financing activities	(16,413)	(17)
Net decrease in cash and cash equivalents	(1,630)	(1,059)
Cash and cash equivalents at beginning of period	6,340	8,884
Cash and cash equivalents at end of period	$ 4,710	$ 7,825
Supplemental disclosure of cash flow information:		
Cash paid for income taxes	$	$ 39
Supplemental schedule of non-cash investing activities:		

Stock-based compensation capitalized to patent costs	$	26	$	22

See Notes to Unaudited Financial Statements.

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DIGIMARC CORPORATION

NOTES TO FINANCIAL STATEMENTS

(Dollar amounts in thousands, except per share data)

(UNAUDITED)

1. Description of Business and Summary of Significant Accounting Policies

Description of Business

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

The Company

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

Interim Financial Statements

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

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

Use of Estimates

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

Cash Equivalents

The Company considers all highly liquid marketable securities with original maturities of 90 days or less at the date of acquisition to be cash equivalents. Cash equivalents include money market funds, certificates of deposit, commercial paper, and investments in government bonds totaling $4,074 and $6,036 at June 30, 2011 and December 31, 2010, respectively. Cash equivalents are carried at cost or amortized cost, which approximates market.

Marketable Securities

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

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

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

Fair Value of Financial Instruments

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

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

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

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

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

	June 30, 2011	December 31, 2010
Marketable securities, at amortized cost	$ 32,079	$ 43,898
Cash equivalents, included above	$ 3,120	$ 4,294
Money market funds	$ 953	$ 1,742

Concentrations of Business and Credit Risk

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

Equity Method Investments

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

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

Impairment of Long-Lived Assets

The Company accounts for long-lived assets in accordance with the provisions of ASC 360 *Property, Plant and Equipment.* This statement requires that long-lived assets and certain identifiable intangibles be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future net undiscounted cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Fair value is determined based on discounted cash flows or appraised values, depending on the nature of the asset. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell. Through June 30, 2011, there have been no material impairment losses.

Research and Development

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

Software Development Costs

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

Patent Costs

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

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

Revenue Recognition

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

Stock-Based Compensation

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

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

Income Taxes

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

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2. Recent Accounting Standards Update

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

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

In October 2009, the FASB issued ASU No. 2009-13, *Revenue Recognition: Multiple-Deliverable Revenue Arrangements a consensus of the FASB Emerging Issues Task Force*, which eliminates the use of the residual method for allocating consideration, as well as the criteria that requires objective and reliable evidence of fair value of undelivered elements in order to separate the elements in a multiple-element arrangement. By removing the criterion requiring the use of objective and reliable evidence of fair value in separately accounting for deliverables, the recognition of revenue will more closely align with the economics of the revenue arrangements. The standard also replaces the term fair value in the revenue allocation guidance with selling price to clarify that the allocation of revenue is based on entity-specific assumptions rather than assumptions of a marketplace participant. ASU No. 2009-13 is effective for revenue arrangements entered or materially modified in fiscal years beginning on or after June 15, 2010. The Company has adopted the provisions of this standard and noted no material impact on the financial condition or results of operations of the Company. The Company does not expect this standard to have a material effect on the financial condition or results of operations in periods after the initial adoption.

3. Revenue Recognition

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

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

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

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

(i) persuasive evidence of an arrangement exists,

(ii) delivery has occurred,

(iii) the fee is fixed or determinable, and

(iv) collection is probable.

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

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

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

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

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

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

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

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

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

4. Segment Information

Geographic Information

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

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

	Three Months Ended June 30, 2011	Three Months Ended June 30, 2010	Six Months Ended June 30, 2011	Six Months Ended June 30, 2010
Domestic	$ 6,030	$ 2,103	$ 12,100	$ 9,343
International	3,443	3,145	6,464	6,097
Total	$ 9,473	$ 5,248	$ 18,564	$ 15,440

Major Customers

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

	Three Months Ended June 30, 2011	Three Months Ended June 30, 2010	Six Months Ended June 30, 2011	Six Months Ended June 30, 2010
Intellectual Ventures	32%		32%	
Central Banks	25%	47%	26%	32%
Verance	11%	*	12%	*
The Nielsen Company	11%	17%	11%	12%
Arbitron				29%

* Less than 10%

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5. Stock-Based Compensation

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

Determining Fair Value

Preferred Stock

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

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

Stock Options

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

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

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

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

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

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

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

	Three Months Ended June 30, 2011	Three Months Ended June 30, 2010	Six Months Ended June 30, 2011	Six Months Ended June 30, 2010
Fair value of stock options granted	$	$ 266	$ 954	$ 1,159

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

Restricted Stock

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

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

Stock-based Compensation

	Three Months Ended June 30, 2011	Three Months Ended June 30, 2010	Six Months Ended June 30, 2011	Six Months Ended June 30, 2010
Stock-based compensation:				
Cost of revenue	$ 178	$ 91	$ 288	$ 188
Sales and marketing	76	49	161	91
Research, development and engineering	108	76	266	146
General and administrative	586	527	1,171	1,034
Intellectual property	47	22	95	46
Stock-based compensation expense	995	765	1,981	1,505
Capitalized to patent costs	15	11	26	22
Total stock-based compensation	$ 1,010	$ 776	$ 2,007	$ 1,527

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

	As of June 30, 2011	As of December 31, 2010
Unrecognized compensation costs	$ 8,556	$ 6,212

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 weighted average periods through June 2015 as follows:

	Stock Options	Restricted Stock
Weighted average period		

	1.04 years	1.79 years

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Stock Option Activity

As of June 30, 2011, under all of the Company s stock-based compensation plans, options to purchase an additional 958,916 shares were authorized for future grants under the plans. The Company issues new shares upon option exercises.

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

Three-months ended June 30, 2011:	Options	Weighted Average Exercise Price	Weighted Average Grant Date Fair Value	Aggregate Intrinsic Value
Outstanding at March 31, 2011	1,068,491	$ 11.84	$ 6.98	
Options granted				
Options exercised	(74,168)	$ 9.88	$ 6.38	
Options canceled or expired				
Outstanding at June 30, 2011	994,323	$ 11.99	$ 7.03	$ 22,532
Exercisable at June 30, 2011	498,100	$ 10.82		$ 12,019
Unvested at June 30, 2011	496,223	$ 13.16		$ 10,513

Six-months ended June 30, 2011:	Options	Weighted Average Exercise Price	Weighted Average Grant Date Fair Value	Aggregate Intrinsic Value
Outstanding at December 31, 2010	993,491	$ 10.47	$ 6.55	
Options granted	75,000	$ 30.01	$ 12.72	
Options exercised	(74,168)	$ 9.88	$ 6.38	
Options canceled or expired				
Outstanding at June 30, 2011	994,323	$ 11.99	$ 7.03	$ 22,532
Exercisable at June 30, 2011	498,100	$ 10.82		$ 12,019
Unvested at June 30, 2011	496,223	$ 13.16		$ 10,513

The aggregate intrinsic value is based on the closing price of $35.03 per share of Digimarc common stock on June 30, 2011, which would have been received by the optionees had all of the options with exercise prices less than $35.03 per share been exercised on that date.

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

	Options Outstanding			Options Exercisable		
Range of Exercise Prices	Number Outstanding	Remaining Contractual Life (Years)	Weighted Average Price	Number Exercisable	Remaining Contractual Life (Years)	Weighted Average Price
$9.64	756,407	7.33	$ 9.64	398,411	7.33	$ 9.64

$9.91	30,000	7.84	$ 9.91	30,000	7.84	$ 9.91
$14.99	102,916	8.51	$ 14.99	31,876	8.51	$ 14.99
$18.01	30,000	8.83	$ 18.01	30,000	8.83	$ 18.01
$30.01	75,000	9.51	$ 30.01	75,000	9.51	$ 30.01
$9.64 - $30.01	994,323	7.68	$ 11.99	498,100	7.56	$ 10.82

Restricted Stock Activity

The following table reconciles the unvested balance of restricted stock:

Three-months ended June 30, 2011:	**Number of Shares**	**Weighted Average Grant Date Fair Value**
Unvested balance, March 31, 2011	271,605	$ 20.09
Granted	13,000	$ 27.71
Vested	(350)	$ 9.80
Canceled	(395)	$ 23.57
Unvested balance, June 30, 2011	283,860	$ 20.42

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Six-months ended June 30, 2011:	Number of Shares	Weighted Average Grant Date Fair Value
Unvested balance, December 31, 2010	197,760	$ 14.25
Granted	114,180	$ 29.75
Vested	(27,685)	$ 14.73
Canceled	(395)	$ 23.57
Unvested balance, June 30, 2011	283,860	$ 20.42

6. Trade Accounts Receivable

Trade Accounts Receivable

Trade accounts receivable are recorded at the invoiced amount.

	June 30, 2011	December 31, 2010
Trade accounts receivable	$ 2,846	$ 3,481
Allowance for doubtful accounts		
Trade accounts receivable, net	$ 2,846	$ 3,481
Unpaid deferred revenues included in accounts receivable	$ 1,111	$ 2,045

Allowance for doubtful accounts

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

Unpaid deferred revenues

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

Major customers

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

	June 30, 2011	December 31, 2010
The Nielsen Company	35%	29%
Central Banks	24%	43%
Civolution	23%	11%

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7. Property and Equipment

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

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

	June 30, 2011	December 31, 2010
Office furniture fixtures	$ 359	$ 294
Equipment	1,623	1,365
Leasehold improvements	1,020	986
	3,002	2,645
Less accumulated depreciation and amortization	(1,624)	(1,315)
	$ 1,378	$ 1,330

8. Intangible Assets Purchased and Capitalized Patent Costs

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

	June 30, 2011	December 31, 2010
Gross intangible assets	$ 2,609	$ 2,290
Accumulated amortization	(170)	(116)
Intangible assets, net	$ 2,439	$ 2,174

9. Joint Venture and Related Party Transactions

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

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

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

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

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

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

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Related Party Transactions

	Three Months Ended June 30, 2011	Three Months Ended June 30, 2010	Six Months Ended June 30, 2011	Six Months Ended June 30, 2010
TVaura LLC:				
Capital contributions	$ 400	$ 400	$ 800	$ 800
Revenue(1)	$ 720	$ 682	$ 1,411	$ 1,374
TVaura Mobile LLC:				
Capital contributions	$ 300	$ 300	$ 600	$ 600
Total:				
Capital contributions	$ 700	$ 700	$ 1,400	$ 1,400
Revenue(1)	$ 720	$ 682	$ 1,411	$ 1,374

(1) Technical and development services

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	June 30, 2011	December 31, 2010
TVaura LLC:		
Accounts receivable	$ 240	$ 255

Summarized financial data for TVaura LLC are as follows:

	June 30, 2011	December 31, 2010
Current assets	$ 918	$ 777
Noncurrent assets	$ 26	$ 31
Current liabilities	$ 241	$ 255
Noncurrent liabilities	$	$

	Three Months Ended June 30, 2011	Three Months Ended June 30, 2010	Six Months Ended June 30, 2011	Six Months Ended June 30, 2010
Revenue	$	$	$	$
Gross profit	$	$	$	$
Operating expenses	$ 733	$ 730	$ 1,450	$ 1,470
Net loss from continuing operations	$ (733)	$ (730)	$ (1,449)	$ (1,469)
The Company s pro-rata share net loss	$ (374)	$ (372)	$ (739)	$ (749)

Summarized financial data for TVaura Mobile LLC are as follows:

	June 30, 2011	December 31, 2010
Current assets	$ 2,049	$ 1,831
Noncurrent assets	$	$
Current liabilities	$ 309	$ 279
Noncurrent liabilities	$	$

	Three Months Ended June 30, 2011	Three Months Ended June 30, 2010	Six Months Ended June 30, 2011	Six Months Ended June 30, 2010
Revenue	$ 50	$	$ 50	$
Gross loss	$ (27)	$	$ (27)	$
Operating expenses	$ 635	$ 385	$ 985	$ 549
Net loss from continuing operations	$ (662)	$ (385)	$ (1,012)	$ (549)
The Company s pro-rata share net loss	$ (324)	$ (189)	$ (496)	$ (269)

10. Income Taxes

The Company s income tax provision for the three- and six-months 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. During the three-months ended June 30, 2011, the Company concluded, based on projections of future income, that it is more likely than not that the Company s deferred tax assets will be realized.

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

		Six-Months Ended June 30, 2011	%
Income taxes computed at statutory rates	$	893	34%
Increases (decreases) resulting from:			
State income taxes, net of federal tax benefit		134	5%
Change in valuation allowance		(2,581)	(98)%
Federal and state research and experimentation credits		(484)	(18)%
Other, net		108	4%
Total	$	(1,930)	(73)%

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The provision for income taxes for the three- and six-month periods ended June 30, 2010 reflects withholding tax expense in various foreign jurisdictions. Withholding taxes are computed by the Company s customers and paid to foreign jurisdictions on its behalf.

11. Commitments and Contingencies

Certain of the Company s product license and services agreements include an indemnification provision for claims from third parties relating to the Company s intellectual property. Such indemnification provisions are accounted for in accordance with ASC 450 *Contingencies.* To date, there have been no claims made under such indemnification provisions. Verance Corporation, a Digimarc licensee, filed a declaratory judgment action against Digimarc in the United States District Court in Delaware on September 30, 2010, alleging the invalidity and non-infringement of 22 patents held by Digimarc. Verance Corp. v. Digimarc Corp., 1:10-cv-00831-UNA. The Court dismissed Verance s action on June 2, 2011. Verance filed a motion asking the Court to alter or amend its dismissal order on June 23, 2011. Digimarc filed a reply to Verance s motion on July 11, 2011.

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

Digimarc has been named as one of several defendants in a complaint filed by Walker Digital, LLC, in the U.S. District Court for the District of Delaware on April 22, 2011, case number 11-cv-00363-UNA, alleging patent infringement. The plaintiff is seeking a declaratory judgment, injunctive relief and damages. All defendants, including Digimarc, separately filed an answer to Walker Digital s complaint on July 11, 2011.

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 June 30, 2011, the final disposition of these proceedings will not have a material adverse effect on the financial position, results of operations, or liquidity of the Company. In accordance with ASC 450, no accrual has been recorded because the amounts are not probable or reasonably estimatable, and a range of possible outcomes is not determinable.

12. Stock Repurchases

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

In April 2009, the Board of Directors approved a stock repurchase program authorizing the purchase, at the discretion of management, of up to $5,000 of our common stock through either periodic open-market or private transactions at then prevailing market prices through April 30, 2010. In both April 2010 and April 2011, the Board of Directors approved an extension of the stock repurchase program for one year periods.

	Three Months Ended June 30, 2011	Three Months Ended June 30, 2010	Six Months Ended June 30, 2011	Six Months Ended June 30, 2010	Since Inception (April 2009)
Shares purchased	24,204		41,077		152,744
Purchases	$ 665	$	$ 1,120	$	$ 2,681

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

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

	Three Months Ended June 31, 2011	Three Months Ended March 31, 2010	Six Months Ended June 30, 2011	Six Months Ended June 30, 2010
Stock option purchased for exercise	24,099		24,099	
Purchases	$ 733	$	$ 733	$
Stock option shares withheld (purchased) for taxes	17,753		17,753	
Tax withholding obligations	$ 541	$	$ 541	$

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

	Three Months Ended June 30, 2011	Three Months Ended June 30, 2010	Six Months Ended June 30, 2011	Six Months Ended June 30, 2010
Restricted shares withheld (purchased) for tax	139	146	11,015	1,295
Tax withholding obligations	$ 4	$ 3	$ 326	$ 25

13. Subsequent Events

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

14. Quarterly Financial Information

Quarter ended:	**March 31**	**June 30**
2011		
Service revenue	$ 3,069	$ 3,165
License and subscription revenue	6,022	6,308
Total revenue	9,091	9,473
Total cost of revenue	1,649	1,690
Gross profit	7,442	7,783
Gross profit percent, service revenue	48%	49%
Gross profit percent, license and subscription revenue	99%	99%
Gross profit percent, total	82%	82%
Sales and marketing	1,102	1,017
Research, development and engineering	1,775	1,884
General and administrative	2,847	2,270
Intellectual property	301	266
Operating income	1,417	2,346
Net income	938	3,626
Earnings per share:		

Net income per share basic	$ 0.14	$ 0.54
Net income per share diluted	$ 0.12	$ 0.50
Weighted average shares outstanding basic	6,864	6,696
Weighted average shares outstanding diluted	7,505	7,245

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

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Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations.

The following Management s Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements relating to future events or the future financial performance of Digimarc, which involve risks and uncertainties. Our actual results could differ materially from those anticipated in these forward-looking statements. Please see the discussion regarding forward-looking statements included in this Quarterly Report on Form 10-Q under the caption Safe Harbor Statement under the Private Securities Litigation Reform Act of 1995.

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

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

All dollar amounts are in thousands, unless otherwise noted.

Overview

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

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

- Quickly identify and effectively manage music, movies, television programming, digital images, documents and other printed materials, especially in light of new non-linear distribution over the internet;
- Deter counterfeiting of money, media and goods, and piracy of movies and music;
- Support new digital media distribution models and methods to monetize media content;
- Leverage the power of ubiquitous computing to instantly link consumers to a wealth of information and/or interactive experiences related to the media and objects they encounter each day;
- Provide consumers with more choice and access to media content when, where and how they want it;
- Enhance imagery and video by associating metadata or authenticating media content for government and commercial uses; and
- Better secure identity documents to enhance national security and combat identity theft and fraud.

At the core of our intellectual property is a signal processing technology innovation known as digital watermarking which allows imperceptible digital information to be embedded in all forms of digitally designed, produced or distributed media content and some physical objects, including photographs, movies, music, television, personal identification documents, financial instruments, industrial parts and product packages. The digital information can be detected and read by a wide range of computers, mobile phones, and other digital devices.

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

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

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

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

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

Critical Accounting Policies and Estimates

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

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Results of Operations

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

	Three Months Ended June 30, 2011	Three Months Ended June 30, 2010	Six Months Ended June 30, 2011	Six Months Ended June 30, 2010
Revenue:				
Service	33%	56%	34%	42%
License and subscription	67	44	66	58
Total revenue	100	100	100	100
Cost of revenue:				
Service	17	28	17	21
License and subscription	1	1	1	1
Total cost of revenue	18	29	18	22
Gross profit	82	71	82	78
Operating expenses:				
Sales and marketing	11	15	11	10
Research, development and engineering	20	25	20	16
General and administrative	23	32	28	23
Intellectual property	3	6	3	4
Total operating expenses	57	78	62	53
Operating income (loss)	25	(7)	20	25
Net loss from joint ventures	(7)	(11)	(7)	(7)
Interest income, net		1	1	1
Income (loss) before provision for income taxes	18	(17)	14	19
(Provision) benefit for income taxes	20		10	
Net income (loss)	38%	(17)%	24%	19%

Our revenue for the three- and six-month periods ended June 30, 2011 increased 81% to $9.5 million from $5.2 million and 20% to $18.6 million from $15.4 million, respectively, from the prior periods primarily as a result of revenue derived from our relationship with IV and some of our long-term licensees, including Verance and Civolution. The lower percent of revenue increase for the six-month period resulted from a one-time payment of license fees of $4.5 million from Arbitron in the first quarter of the prior period. Throughout the three- and six-month periods ended June 30, 2011, we continued to invest in the development and marketing of Digimarc Discover, as well as developing additional intellectual property and investing in our strategic initiatives. We also continued to incur legal expenses in the three- and six-month periods ended June 30, 2011 in connection with our litigation matter with Verance.

As a result of our continued success and positive operating results, in the second quarter we reversed our valuation allowance on our deferred tax assets and recorded the tax assets in our financial statements. Notwithstanding the reversal of our valuation allowance, we achieved pre-tax income from continuing operations for the three- and six-month periods ended June 30, 2011, while improving operational leverage arising from controlling operating costs with increased revenues.

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Revenue

	Three Months Ended June 30, 2011	Three Months Ended June 30, 2010	Dollar Increase	Percent Increase	Six Months Ended June 30, 2011	Six Months Ended June 30, 2010	Dollar Increase (Decrease)	Percent Increase (Decrease)
Revenue:								
Service	$ 3,165	$ 2,918	$ 247	8%	$ 6,234	$ 6,432	$ (198)	(3)%
License and subscription	6,308	2,330	3,978	171%	12,330	9,008	3,322	37%
Total	$ 9,473	$ 5,248	$ 4,225	81%	$ 18,564	$ 15,440	$ 3,124	20%
Revenue (as % of total revenue):								
Service	33%	56%			34%	42%		
License and subscription	67%	44%			66%	58%		
Total	100%	100%			100%	100%		

We derive our revenue primarily from:

1) development services provided to government and commercial customers and

2) licensing our patents.

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

Service revenue for the three- and six-month periods ended June 30, 2011, compared to the corresponding three- and six-month periods ended June 30, 2010, remained relatively constant.

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

The increase in license and subscription revenue for the three- and six-month periods ended June 30, 2011, compared to the corresponding three- and six-month periods ended June 30, 2010, was primarily attributed to revenue derived from the IV relationship and increased royalty revenue from Verance and Civolution.

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Revenue by Geography

	Three Months Ended June 30, 2011	Three Months Ended June 30, 2010	Dollar Increase	Percent Increase	Six Months Ended June 30, 2011	Six Months Ended June 30, 2010	Dollar Increase	Percent Increase
Revenue by geography:								
Domestic	$ 6,030	$ 2,103	$ 3,927	187%	$ 12,100	$ 9,343	$ 2,757	30%
International	3,443	3,145	298	9%	6,464	6,097	367	6%
Total	$ 9,473	$ 5,248	$ 4,225	81%	$ 18,564	$ 15,440	$ 3,124	20%
Revenue (as % of total revenue):								
Domestic	64%	40%			65%	61%		
International	36%	60%			35%	39%		
Total	100%	100%			100%	100%		

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

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

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

Cost of Revenue

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

- salaries, a payroll tax and benefit factor, incentive compensation and related costs of our software developers, quality assurance personnel, product managers, business development managers and other personnel where we bill our customers for time and materials costs;
- payments to outside contractors that are billed to customers;
- charges for equipment directly used by the customer;
- depreciation charges for machinery, equipment and software;
- travel costs directly attributable to service and development contracts; and

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

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

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

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

amortization of capitalized patent costs.

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Gross Profit

	Three Months Ended June 30, 2011	Three Months Ended June 30, 2010	Dollar Increase	Percent Increase	Six Months Ended June 30, 2011	Six Months Ended June 30, 2010	Dollar Increase (Decrease)	Percent Increase (Decrease)
Gross Profit:								
Service	$ 1,551	$ 1,435	$ 116	8%	$ 3,036	$ 3,149	$ (113)	(4)%
License and subscription	6,232	2,273	3,959	174%	12,189	8,894	3,295	37%
Total	$ 7,783	$ 3,708	$ 4,075	110%	$ 15,225	$ 12,043	$ 3,182	26%
Gross Profit (as % of related revenue components):								
Service	49%	49%			49%	49%		
License and subscription	99%	98%			99%	99%		
Total	82%	71%			82%	78%		

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

The increase in gross profit as a percentage of revenue for the three- and six-month periods ended June 30, 2011, compared to the corresponding three- and six-month periods ended June 30, 2010, was due primarily to changes in revenue mix resulting in higher license revenue, as a percent of total revenue, which carries a higher margin than service revenue.

Operating Expenses

Sales and marketing