Digimarc CORP
Form 10-Q
October 30, 2009

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2009

OR

o **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)

Delaware	**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 ý No o

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 o No o

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

Indicate by check mark whether the registrant is a shell company (as defined in rule 12b-2 of the Exchange Act). Yes o No ý

As of October 26, 2009, there were 7,256,200 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)

	Successor September 30, 2009	Successor December 31, 2008(1)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 10,685	$ 18,928
Marketable securities	30,760	21,240
Trade accounts receivable, net	3,027	3,839
Other current assets	1,001	875
Total current assets	45,473	44,882
Marketable securities	2,087	5,744
Property and equipment, net	1,180	1,212
Intangibles, net	1,088	456
Other assets, net	544	147
Total assets	$ 50,372	$ 52,441
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable and other accrued liabilities	$ 767	$ 937
Accrued payroll and related costs	246	42
Accrued merger related liabilities	144	386
Deferred revenue	1,716	2,418
Total current liabilities	2,873	3,783
Long-term liabilities	134	257
Total liabilities	3,007	4,040
Commitments and contingencies (Note 11)		
Stockholders' equity:		
Preferred stock (10,000 shares issued and outstanding at September 30, 2009 and December 31, 2008)	50	50
Common stock (7,256,200 and 7,279,442 shares issued and outstanding at September 30, 2009 and December 31, 2008, respectively)	7	7
Additional paid-in capital	49,406	48,268
Retained earnings (accumulated deficit)	(2,098)	76
Total stockholders' equity	47,365	48,401

Total liabilities and stockholders' equity	$	50,372	$	52,441

(1) Derived from the Company's December 31, 2008 audited financial statements

See Notes to Unaudited Financial Statements.

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DIGIMARC CORPORATION

STATEMENTS OF OPERATIONS

(In thousands, except per share data)

(UNAUDITED)

	Successor Three Months Ended September 30, 2009	Successor Period August 2, 2008 through September 30, 2008	Predecessor Period July 1, 2008 through August 1, 2008
Revenue:			
Service	$ 2,827	$ 1,645	$ 921
License and subscription	1,942	1,536	829
Total revenue	4,769	3,181	1,750
Cost of revenue:			
Service	1,499	890	527
License and subscription	42	44	25
Total cost of revenue	1,541	934	552
Gross profit	3,228	2,247	1,198
Operating expenses:			
Sales and marketing	753	390	589
Research, development and engineering	1,191	780	239
General and administrative	1,566	932	442
Intellectual property	262	120	176
Transitional services	(45)	(196)	
Total operating expenses	3,727	2,026	1,446
Operating income (loss)	(499)	221	(248)
Other income (expense), net	(185)	179	75
Income (loss) before provision for income taxes	(684)	400	(173)
Provision for income taxes	(3)		
Net income (loss)	$ (687)	$ 400	$ (173)
Earnings (loss) per share:			
Net income (loss) per share basic	$ (0.10)	$ 0.06	
Net income (loss) per share diluted	$ (0.10)	$ 0.06	
Weighted average shares outstanding basic	7,134	7,143	
Weighted average shares outstanding diluted	7,134	7,143	
Pro-forma loss per share:			
Net loss per share basic			$ (0.02)
Net loss per share diluted			$ (0.02)

Weighted average shares outstanding basic	7,143
Weighted average shares outstanding diluted	7,143

See Notes to Unaudited Financial Statements.

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DIGIMARC CORPORATION

STATEMENTS OF OPERATIONS

(In thousands, except per share data)

(UNAUDITED)

	Successor Nine Months Ended September 30, 2009	Successor Period August 2, 2008 through September 30, 2008	Predecessor Period January 1, 2008 through August 1, 2008
Revenue:			
Service	$ 7,882	$ 1,645	$ 6,456
License and subscription	5,640	1,536	5,494
Total revenue	13,522	3,181	11,950
Cost of revenue:			
Service	4,396	890	3,519
License and subscription	158	44	145
Total cost of revenue	4,554	934	3,664
Gross profit	8,968	2,247	8,286
Operating expenses:			
Sales and marketing	2,226	390	1,928
Research, development and engineering	3,679	780	2,071
General and administrative	4,750	932	2,349
Intellectual property	756	120	1,102
Transitional services	(153)	(196)	
Total operating expenses	11,258	2,026	7,450
Operating income (loss)	(2,290)	221	836
Other income, net	128	179	590
Income (loss) before provision for income taxes	(2,162)	400	1,426
Provision for income taxes	(12)		(11)
Net income (loss)	$ (2,174)	$ 400	$ 1,415
Earnings (loss) per share:			
Net income (loss) per share basic	$ (0.30)	$ 0.06	
Net income (loss) per share diluted	$ (0.30)	$ 0.06	
Weighted average shares outstanding basic	7,150	7,143	
Weighted average shares outstanding diluted	7,150	7,143	
Pro-forma earnings per share:			
Net income per share basic			$ 0.20
Net income per share diluted			$ 0.20

Weighted average shares outstanding basic	7,143
Weighted average shares outstanding diluted	7,143

See Notes to Unaudited Financial Statements.

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DIGIMARC CORPORATION

STATEMENTS OF STOCKHOLDERS' EQUITY

(In thousands, except share data)

(UNAUDITED)

	Preferred stock Shares	Preferred stock Amount	Common stock Shares	Common stock Amount	Additional paid-in capital	Retained Earnings (Accumulated Deficit)	Net Parent Investment	Total stockholders' equity
PREDECESSOR								
BALANCE AT AUGUST 1, 2008		$		$	$	$	$ 47,793	$ 47,793
SUCCESSOR								
August 2, 2008: Stock issued through spin-off of Digimarc	10,000	$ 50	7,143,442	$ 7	$ 47,736	$	$ (47,793)	$
Issuance of restricted common stock			136,000					
Stock-based compensation expense					532			532
Net income						76		76
BALANCE AT DECEMBER 31, 2008	10,000	$ 50	7,279,442	$ 7	$ 48,268	$ 76	$	$ 48,401
Exercise of stock options			15,713		152			152
Issuance of restricted common stock			20,400					
Purchase and retirement of common stock			(59,355)		(822)			(822)
Stock-based compensation expense					1,808			1,808
Net loss						(2,174)		(2,174)
BALANCE AT SEPTEMBER 30, 2009	10,000	$ 50	7,256,200	$ 7	$ 49,406	$ (2,098)	$	$ 47,365

See Notes to Unaudited Financial Statements.

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DIGIMARC CORPORATION

STATEMENTS OF CASH FLOWS

(In thousands)

(UNAUDITED)

	Successor Nine Months Ended September 30, 2009	Successor Period August 2, 2008 through September 30, 2008	Predecessor Period January 1, 2008 through August 1, 2008
Cash flows from operating activities:			
Net income (loss)	$ (2,174)	$ 400	$ 1,415
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Depreciation and amortization	425	69	568
Stock-based compensation expense	1,808		914
Net loss from joint ventures	311		
Decrease in allowance for doubtful accounts			(43)
Other non-cash charges			405
Changes in operating assets and liabilities:			
Trade accounts receivable, net	812	(502)	718
Other current assets	(126)	4,182	(4,370)
Other assets, net	(158)	20	(103)
Accounts payable and other accrued liabilities	(155)	(383)	744
Accrued payroll and related costs	204	(399)	1,854
Accrued merger related liabilities	(242)	(8,860)	10,766
Deferred revenue	(714)	343	(677)
Other liabilities	(87)	50	19
Net cash provided by (used in) operating activities	(96)	(5,080)	12,210
Cash flows from investing activities:			
Purchase of property and equipment	(374)	(24)	(799)
Capitalized patent costs	(651)	(187)	
Investment in joint ventures	(550)		
Sale or maturity of marketable securities	20,738	69,674	136,767
Purchase of marketable securities	(26,601)	(70,745)	(137,048)
Net cash used in investing activities	(7,438)	(1,282)	(1,080)
Cash flows from financing activities:			
Cash from Parent stock activity			23,862
Net activity with Parent			(13,237)
Issuance of common stock	152		
Purchase of common stock	(822)		
Principal payments under capital lease obligations	(39)		
Net cash provided by (used in) financing activities	(709)		10,625
Net increase (decrease) in cash and cash equivalents	(8,243)	(6,362)	21,755
Cash and cash equivalents at beginning of period	18,928	50,900	29,145
Cash and cash equivalents at end of period	$ 10,685	$ 44,538	$ 50,900

Supplemental disclosure of cash flow information:						
Cash paid for interest	$	4	$	1	$	7
Cash paid for income taxes	$	12	$		$	11

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.

Acquisition of Old Digimarc and Separation of DMRC Corporation

On June 29, 2008, the former Digimarc Corporation ("Old Digimarc") entered into an amended and restated merger agreement, as amended by Amendment No. 1 dated as of July 17, 2008, which we refer to as the Old Digimarc/L-1 merger agreement, with L-1 Identity Solutions, Inc. ("L-1") and Dolomite Acquisition Co. ("Dolomite"), a wholly owned subsidiary of L-1, pursuant to which Dolomite, in a transaction which we refer to as the offer, purchased more than 90% of the outstanding shares of Old Digimarc common stock, together with the associated preferred stock purchase rights, for $12.25 per share. On August 13, 2008, following the completion of the offer, Dolomite merged with and into Old Digimarc with Old Digimarc continuing as the surviving company and a wholly owned subsidiary of L-1.

On August 1, 2008, prior to the initial expiration of the offer, Old Digimarc contributed all of the assets and liabilities related to its digital watermarking business, which we refer to as the Digital Watermarking Business, together with all of Old Digimarc's cash, to DMRC LLC. Following the restructuring, all of the limited liability company interests of DMRC LLC were transferred to a newly created trust for the benefit of Old Digimarc record holders. DMRC LLC then merged with and into DMRC Corporation, and each limited liability company interest of DMRC LLC was converted into one share of common stock of DMRC Corporation. After completion of the Old Digimarc/L-1 merger, DMRC Corporation changed its name to Digimarc Corporation. The shares of Digimarc common stock were held by the trust until the Form 10, *General Form for Registration of Securities*, was declared effective by the Securities and Exchange Commission ("SEC") on October 16, 2008, at which time the shares were distributed to Old Digimarc record holders, as beneficiaries of the trust, pro rata in accordance with their ownership of shares of Old Digimarc common stock on August 1, 2008 at 5:30 pm Eastern time, the spin-off record date and time. Each Old Digimarc record holder was entitled to receive one share of Digimarc common stock for every three and one half shares of Old Digimarc common stock held by the stockholder as of the spin-off record date and time.

Joint Venture and Patent License Agreements with The Nielsen Company

On June 11, 2009 the Company entered into two joint venture agreements with The Nielsen Company ("Nielsen") to launch two new companies. The two joint venture agreements and a revised patent license agreement expand and replace the previous license and services agreement between the

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DIGIMARC CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(Dollar amounts in thousands, except per share data)

(UNAUDITED)

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

Company and Nielsen that has been in operation since late 2007. Under the new agreements, the Company and Nielsen plan to work 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.

Joint venture I, TVaura LLC, will engage 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 will make initial cash contributions aggregating $3,900 payable quarterly from July 2009 through October 2011. The Company will provide technical and development services to TVaura LLC's business for the following periods for the following minimum service fees, subject to adjustment for any development service fees paid to the Company by TVaura Mobile LLC: $1,130 for the remainder of 2009; $2,800 in 2010; and $2,740 in 2011.

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

Pursuant to the terms of the agreements and Accounting Standards Codification ("ASC") 810 "*Consolidation*" (formerly Emerging Issues Task Force ("EITF") Issue No. 96-16, "*Investor's Accounting for an Investee When the Investor Has a Majority of the Voting Interest but the Minority Shareholders Have Certain Approval or Veto Rights*"), the joint ventures will not be consolidated with the Company and will be separately disclosed in the financial statements and notes to financial statements.

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 footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States (the "U.S.") have been condensed or omitted in accordance with the rules and regulations of the 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, 2008, which was filed with the SEC on February 27, 2009. The results of operations for the interim periods presented in these financial statements are not necessarily indicative of the results for the full year.

DIGIMARC CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(Dollar amounts in thousands, except per share data)

(UNAUDITED)

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

Basis of Accounting: Predecessor Financial Statements

The predecessor financial statements include certain accounts of Old Digimarc and the assets, liabilities and results of operations of Old Digimarc's Digital Watermarking Business that were separated, or "carved-out" from Old Digimarc. The operating expenses included in the predecessor financial statements include proportional allocations of various shared services common costs of Old Digimarc because specific identification of the expenses was not practicable. The common costs include expenses from Old Digimarc related to various operating shared services cost centers, including executive, finance and accounting, human resources, legal, marketing, intellectual property, facilities and information technology.

Management believes that the assumptions underlying the predecessor financial statements are reasonable. The cost allocation methods applied to certain shared services common cost centers include the following:

Specific identification. Where the amounts were specifically identified to the predecessor or Old Digimarc's Secure ID Business, they were classified accordingly.

Reasonable allocation. Where the amounts were not clearly or specifically identified, management determined if a reasonable allocation method could be applied. For example, in the shared services human resources ("HR") cost center, management allocated the costs based on the relative headcount of the predecessor and Old Digimarc's Secure ID Business. This allocation was based on the assumption that HR support costs should be relatively equal per employee. In the intellectual property cost center, management allocated the costs based on the relative number of patents that were used by each business.

General allocation approach. For consistency, when specific identification or the reasonable allocation method did not seem to fit the situation, management used a general allocation approach. This approach consisted of a blended rate based on what management determined to be the primary drivers for shared services:

Revenue ratio between the businesses.

Property and equipment balances, which served as a proxy for capital expenditures. The effort expended on capital projects is a factor in the expense and effort of shared services. To avoid fluctuations that occur in capital spending, management believes that these allocated balances represent a relative trend of capital spending between the businesses. In determining the relative balances of property, management excluded the central information technology assets because they supported the entire organization.

Headcount between the businesses.

Other key assumptions differing from the historical accounting of Old Digimarc:

Cash: All cash balances of Old Digimarc are treated as retained by Digimarc, consistent with the Old Digimarc/L-1 merger agreement. Accordingly, restricted cash on the books of Old Digimarc that related directly to its operations flowed through to Digimarc in these financial

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DIGIMARC CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(Dollar amounts in thousands, except per share data)

(UNAUDITED)

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

statements as non-restricted cash included in cash and cash equivalents in the predecessor financial statements. The letters of credit that required the restricted cash remained with Old Digimarc following its acquisition by L-1.

Incentive compensation allocations to cost of services: Cost of incentive compensation related to bonus and stock compensation charges for employees in the research, development and engineering cost centers was not considered significant to Old Digimarc's consolidated operations during the periods reported and were treated as research, development and engineering costs in Old Digimarc's financial statements. For Digimarc's reporting purposes, these incentive compensation costs have been allocated to cost of services to the extent that their pro rata salary allocations were made to the cost of services expense category. The impact for the reported periods ranged from a 1% to 3% reduction in margins compared to the results had the allocations not been made.

Pro-forma earnings (loss) per share (unaudited): The weighted average shares outstanding basic and diluted of 7,143,442 was calculated based on a distribution ratio of one share of Digimarc common stock for every three and one-half shares of Old Digimarc common stock, excluding shares held in treasury, outstanding at August 1, 2008, the date of the spin-off of Digimarc from Old Digimarc.

Stock activity: All stock activity (transactions from stock options, restricted stock, employee stock purchase plan and stock compensation) was carried on the books of Old Digimarc. All net cash from these activities was retained by Digimarc and stock-based compensation expense associated with stock activity was allocated to the predecessor in accordance with the basis of accounting methodology outlined above.

Capital leases: Digimarc shares various infrastructure activities with Old Digimarc and was charged for its allocated share of capital lease costs in the form of allocated depreciation and interest expense. The assets and liabilities associated with the capital leases were carried on the books of Old Digimarc.

Leasehold improvements: Digimarc occupies the majority of Old Digimarc's Beaverton facility and assumed the lease and most all related furniture, fixtures and leasehold improvements when Old Digimarc completed the spin-off of Digimarc. The leasehold was recorded as part of property and equipment on the balance sheet of Digimarc, and as a result, pro rata depreciation and rent expenses were allocated to Old Digimarc.

Intercompany transactions: With the retention by Digimarc of all of Old Digimarc's cash, Digimarc's cash balances effectively funded the operations, if needed, of Old Digimarc. The net difference of cash needs for operating and capital expenditures to and from Old Digimarc is shown as "net activity with Parent" in the Statement of Stockholders' Equity. All intercompany transactions were eliminated.

Merger related costs: All Old Digimarc costs related to the Old Digimarc/L-1 merger were allocated to Old Digimarc's Secure ID Business. Digimarc was responsible for the payment of the majority of these costs.

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DIGIMARC CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(Dollar amounts in thousands, except per share data)

(UNAUDITED)

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

Commitments and contingencies: Commitments and contingencies related to the predecessor operations are included in these financial statements, and those relating to Old Digimarc were excluded.

Stock compensation expense: Stock-based compensation is accounted for by Old Digimarc in accordance with ASC 718 "*Compensation Stock Compensation*" (formerly Statement of Financial Accounting Standards ("SFAS") No. 123(R), *Share-Based Payment (Revised 2004))*, which requires the measurement and recognition of compensation for all stock-based awards made to employees and directors, including stock options, employee stock purchases under a stock purchase plan and restricted stock awards based on estimated fair values. Stock compensation expense was allocated to Digimarc based on a combination of specific and shared services resource allocations from Old Digimarc.

The financial information in the predecessor financial statements does not include all of the expenses that would have been incurred had the predecessor been a separate, stand-alone public entity. As such, the predecessor financial information does not reflect the financial position, results of operations and cash flows of Digimarc's current business, had the predecessor operated as a separate, stand-alone public entity during the periods presented in the predecessor financial statements. Additionally, the predecessor financial statements include proportional allocations of various shared services common costs of Old Digimarc because specific identification of these expenses was not practicable. It is expected that the initial operating costs of Digimarc on a stand-alone basis will be higher than those allocated to the predecessor operations under the shared services methodology applied in the predecessor financial statements. Consequently, the financial position, results of operations and cash flows reflected in the predecessor financial statements may not be indicative of those that would have been achieved had the predecessor operated as a separate, stand-alone entity for the periods reflected in the predecessor financial statements.

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

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DIGIMARC CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(Dollar amounts in thousands, except per share data)

(UNAUDITED)

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

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 include federal agency notes, company notes, and commercial paper. The Company's marketable securities are generally classified as held-to-maturity as of the balance sheet date and are reported at amortized cost, which approximates market. The book value of these investments approximates fair market value and, accordingly, no amounts have been recorded to other comprehensive income.

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

ASC 820 "*Fair Value Measurements and Disclosures*" (formerly SFAS 157, "*Fair Value Measurements*") 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.

ASC 825 "*Financial Instruments*" (formerly SFAS No. 159, "*The Fair Value Option for Financial Assets and Financial Liabilities*") allows an entity the irrevocable option to elect fair value for the initial and subsequent measurement for specified financial assets and liabilities on a contract-by-contract basis. The Company did not elect the fair value option under this statement as to specific assets or liabilities.

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DIGIMARC CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(Dollar amounts in thousands, except per share data)

(UNAUDITED)

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

Therefore, through September 30, 2009, the Company has not recognized the net change in fair value of its financial assets and liabilities.

The estimated fair values of the Company's financial instruments, which include cash and cash equivalents, short- and long-term marketable securities, accounts receivable, accounts payable and accrued payroll approximate their carrying values due to the short-term nature of these instruments. The carrying amounts of capital leases approximate fair value because the stated interest rates approximate current market rates. These items are valued using either Level 1 or Level 2 inputs.

The Company records marketable securities at amortized cost of $32,847, which approximates fair value. The fair value of the marketable securities at September 30, 2009, excluding accrued interest, was $32,782. The fair value is based on quoted market prices in active markets for identical assets, a Level 1 input.

The Company records money market funds at cost and continues to carry those amounts at cost which equals fair value. The fair value is based on quoted market prices in active markets for identical assets, a Level 1 input. As of September 30, 2009, the cost and fair value of the Company's money market funds were each equal to $10,685.

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, investments, and trade and unbilled 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 investments with its principal banks, its 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. As a result, the credit risk associated with cash and investments is believed to be minimal.

Impairment of Long-Lived Assets

The Company accounts for long-lived assets in accordance with the provisions of ASC 360 "*Property, Plant and Equipment*" (formerly SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets)*. This statement requires that long-lived assets and certain identifiable intangibles be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future net undiscounted cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Fair value is determined based on discounted cash flows or appraised values, depending on the nature of the asset. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell.

DIGIMARC CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(Dollar amounts in thousands, except per share data)

(UNAUDITED)

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

Software Development Costs

Under ASC 985 "*Software*" (formerly SFAS No. 86, *Accounting for the Cost of Computer Software to Be Sold, Leased, or Otherwise Marketed*), software development costs are to be capitalized beginning when a product's technological feasibility has been established and ending when a product is made available for general release to customers. To date, the establishment of technological feasibility of the Company's products has occurred shortly before general release and, therefore, software development costs qualifying for 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.

Research and Development

Research and development costs are expensed as incurred as defined in 730 "*Research and Development*" (formerly SFAS No. 2, *Accounting for Research and Development Costs)*. Digimarc accounts for amounts received under its funded research and development arrangements in accordance with the provisions of ASC 730 (also formerly SFAS No. 68, *Research and Development Arrangements)*. Under the terms of the arrangements, Digimarc is not obligated to repay any of the amounts provided by the funding parties. As a result, Digimarc recognizes revenue as the services are performed.

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. Such costs were expensed in the predecessor financial statements.

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. These costs were expensed in the predecessor financial statements.

Revenue Recognition

The Company's revenue consists of subscription revenue, which includes hardware and software sales, royalties and revenues from the licensing of digital watermarking products and related authentication services. The Company's revenue recognition policy follows ASC 605 "*Revenue Recognition,*" ASC 985 (formerly Statement of Position ("SOP") No. 97-2, *Software Revenue Recognition*, as amended by SOP No. 98-9, *Modification of SOP No. 97-2, Software Recognition, With Respect to Certain Transactions*, and SOP 81-1 *Accounting for the Performance of Construction Type and Certain Production-Type Contracts*, and EITF Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables)*, and SEC Staff Accounting Bulletin ("SAB") No. 104 *Revenue Recognition*.

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DIGIMARC CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(Dollar amounts in thousands, except per share data)

(UNAUDITED)

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

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 our stock price as well as assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to, the expected life of the award, our expected stock price volatility over the term of the award and actual and projected exercise behaviors. Although the fair value of stock-based awards is determined in accordance with 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 tax assets to the amount expected to be realized.

2. Recent Accounting Standards Update

In October 2009, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2009-14, *Software: Certain Revenue Arrangements That Include Software Elements a consensus of the FASB Emerging Issues Task Force*, which will significantly improve the reporting of certain transactions to more closely reflect the underlying economics of the transactions. By excluding from its scope certain software-enabled devices, multiple-element arrangements that include such software-enabled devices will now be evaluated for separation and allocation using the guidance in ASU No. 2009-13 (described below). ASU No. 2009-14 is effective for revenue arrangements entered or materially modified in fiscal years beginning on or after June 15, 2010. 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 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

DIGIMARC CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(Dollar amounts in thousands, except per share data)

(UNAUDITED)

2. Recent Accounting Standards Update (Continued)

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 certain revenue arrangements. The standard also will replace 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 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 June 2009, the FASB issued ASU 2009-01, *Amendments based on Statement of Financial Accounting Standards No. 168 The* FASB Accounting Standards Codification *and the Hierarchy of Generally Accepted Accounting Principles*, to codify in ASC 105, *Generally Accepted Accounting Principles*, FASB Statement 168, *The* FASB Accounting Standards Codification *and the Hierarchy of Generally Accepted Accounting Principles*, which was issued to establish the Codification as the sole source of authoritative U.S. GAAP recognized by the FASB, excluding SEC guidance, to be applied by nongovernmental entities. The guidance in ASC 105 is effective for financial statements issued for interim and annual periods ending after September 15, 2009. The Company has revised its references to pre-Codification GAAP and noted no impact on the financial condition or results of operations of the Company.

3. Revenue Recognition

Revenue is recognized in accordance with ASC 985 and SAB 104 when the following four criteria are met:

(i) persuasive evidence of an arrangement exists;

(ii) delivery has occurred;

(iii) the fee is fixed or determinable; and

(iv) collection is probable.

Some customer arrangements encompass multiple deliverables, such as software, maintenance fees, and software development fees. If the deliverables meet the criteria in ASC 605 (formerly EITF Issue No. 00-21), the deliverables are divided into separate units of accounting and revenue is allocated to the deliverables based on their relative fair values. The criteria specified in ASC 605 are as follows:

(i) the delivered item has value to the customer on a stand-alone basis;

(ii) there is objective and reliable evidence of the fair value of the undelivered item; and

(iii) if the arrangement includes a general right of return relative to the delivered item, delivery or performance of the undelivered item is considered probable and substantially in the control of the vendor.

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DIGIMARC CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(Dollar amounts in thousands, except per share data)

(UNAUDITED)

3. Revenue Recognition (Continued)

For the Company's purposes, fair value is generally defined as the price at which a customer could purchase each of the elements independently from other vendors or as the price that the Company has sold the element separately to another customer. Management applies judgment to ensure appropriate application of ASC 605, including value allocation among multiple deliverables, determination of whether undelivered elements are essential to the functionality of delivered elements and timing of revenue recognition, among others.

ASC 985 (formerly AICPA SOP No. 98-9) requires that revenue be recognized using the "residual method" in circumstances when vendor specific objective evidence ("VSOE") exists only for undelivered elements. Under the residual method, revenue is recognized as follows: (1) the total fair value of undelivered elements, as indicated by VSOE, is deferred and subsequently recognized in accordance with the relevant sections of ASC 985, and (2) the difference between the total arrangement fee and the amount deferred for the undelivered elements is recognized as revenue related to the delivered elements.

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

Revenue from 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.

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

Software revenue is recognized in accordance with ASC 985 (formerly AICPA SOP No. 97-2, as amended by AICPA SOP No. 98-9). Revenue for licenses of the Company's software products is recognized upon the Company meeting the following criteria: persuasive evidence of an arrangement exists; delivery has occurred; the vendor's fee is fixed or determinable; and collectibility is probable. Software revenue is recognized over the term of the license or upon delivery and acceptance if the Company grants a perpetual license with no further obligations.

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

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

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DIGIMARC CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(Dollar amounts in thousands, except per share data)

(UNAUDITED)

3. Revenue Recognition (Continued)

Revenue earned which has not been invoiced at the last day of the period, but which is generally billed within one to two weeks of the last day of the period, is included in trade accounts receivables, net in the balance sheets.

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

4. Segment Information

Geographic Information

The Company derives its revenue from a single reporting segment: 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:

	Successor Three Months Ended September 30, 2009	Successor Period August 2, 2008 through September 30, 2008	Predecessor Period July 1, 2008 through August 1, 2008	Successor Nine Months Ended September 30, 2009	Predecessor Period January 1, 2008 through August 1, 2008
Domestic	$ 2,165	$ 1,541	$ 960	$ 5,718	$ 6,274
International	2,604	1,640	790	7,804	5,676
Total	$ 4,769	$ 3,181	$ 1,750	$ 13,522	$ 11,950

Major Customers

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

	Successor Three Months Ended September 30, 2009	Successor Period August 2, 2008 through September 30, 2008	Predecessor Period July 1, 2008 through August 1, 2008	Successor Nine Months Ended September 30, 2009	Predecessor Period January 1, 2008 through August 1, 2008
Consortium of Central Banks	49%	44%	40%	51%	39%
The Nielsen Company	21%	35%	38%	27%	38%
TVaura LLC	12%			*	

* Less than 10%

DIGIMARC CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(Dollar amounts in thousands, except per share data)

(UNAUDITED)

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 was allocated to the predecessor based on a combination of specific and shared services resource allocations from Old Digimarc. All cash flow related to stock compensation generated by Old Digimarc was retained by Digimarc. Stock-based compensation recognized in the three- and nine-month periods ended September 30, 2009 was based on the value of the portion of the stock-based award that vested during the period. Compensation cost for all stock-based awards is recognized using the straight-line method.

Determining Fair Value

Preferred Stock

The Board of Directors authorized 10,000 shares of Series A Redeemable Nonvoting Preferred stock 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 by the Board of Directors at any time on or after June 18, 2013.

The fair value of Series A Redeemable Nonvoting Preferred stock is 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.

Stock Options

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

Expected Term (Life). The expected life of awards granted represents the period of time that they are expected to be outstanding. The Company determined the initial expected life based on a simplified method in accordance with ASC 718 (also formerly SAB No. 110 "*Shared-Based Payment*"), giving consideration to the contractual terms, vesting schedules and pre-vesting and post-vesting forfeitures. Stock options granted generally vest over four years for employee grants and two years for director grants, and have contractual terms of ten years.

Expected Volatility. The Company estimated the initial volatility of its common stock at the date of grant based on an independent analysis of a peer group's historical volatility of their common stock using the Black-Scholes option valuation model 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 term estimate.

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DIGIMARC CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(Dollar amounts in thousands, except per share data)

(UNAUDITED)

5. Stock-Based Compensation (Continued)

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.

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, which vest 50% on the first anniversary of the date of grant and then monthly thereafter. 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. Forfeitures that occur during the month are not expensed.

A summary of the weighted average assumptions and results for options granted during the period August 2, 2008 through September 30, 2009 is as follows:

	Range
Period August 2, 2008 through September 30, 2009:	
Expected life (in years)	5.6 - 6.0
Expected volatility	70% - 72%
Risk-free interest rate	2.8% - 2.9%
Expected dividend yield	0%
Expected forfeiture rate	0%

The estimated average fair value of outstanding stock options was $6.28 per share at September 30, 2009.

Restricted Stock

The Compensation Committee of the Board of Directors awarded restricted stock shares under the Company's 2008 Stock Incentive Plan to certain employees. The shares subject to the restricted stock awards vest over a certain period, usually four years, following the date of the grant. Specific terms of the restricted stock awards is 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.

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DIGIMARC CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(Dollar amounts in thousands, except per share data)

(UNAUDITED)

5. Stock-Based Compensation (Continued)

Stock-based Compensation

	Successor Three Months Ended September 30, 2009	Successor Period August 2, 2008 through September 30, 2008	Predecessor Period July 1, 2008 through August 1, 2008	Successor Nine Months Ended September 30, 2009	Predecessor Period January 1, 2008 through August 1, 2008
Stock-based compensation:					
Cost of revenue	$ 57	$	$ 14	$ 156	$ 99
Sales and marketing	50		32	152	208
Research, development and engineering	47		4	140	34
General and administrative	451		81	1,290	537
Intellectual property	24		5	70	35
Total stock-based compensation	$ 629	$	$ 136	$ 1,808	$ 913

At September 30, 2009, the Company had 10,000 shares of Series A redeemable nonvoting preferred stock, 1.0 million non-vested options to purchase common stock and 141,400 shares of restricted common stock outstanding. As of September 30, 2009, the Company had $6,906 of 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. 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 of 1.54 years and 1.82 years, respectively, through June 2013.

Stock Option Activity

As of September 30, 2009, under all of the Company's stock-based compensation plans, options to purchase an aggregate of 1.2 million shares were outstanding, and options to purchase an additional 1.1 million shares were authorized for future grants under the plans. The Company issues new shares upon option exercises.

DIGIMARC CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(Dollar amounts in thousands, except per share data)

(UNAUDITED)

5. Stock-Based Compensation (Continued)

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

Three-months ended September 30, 2009:	Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life
Outstanding at June 30, 2009	1,224,000	$ 9.65	
Options granted			
Options exercised	(15,713)	$ 9.64	
Options canceled or expired			
Outstanding at September 30, 2009	1,208,287	$ 9.65	9.09 years
Exercisable at September 30, 2009	249,573	$ 9.65	9.10 years

Nine-months ended September 30, 2009:	Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life
Outstanding at December 31, 2008	1,194,000	$ 9.64	
Options granted	30,000	$ 9.91	
Options exercised	(15,713)	$ 9.64	
Options canceled or expired			
Outstanding at September 30, 2009	1,208,287	$ 9.65	9.09 years
Exercisable at September 30, 2009	249,573	$ 9.65	9.10 years

The following table summarizes information about stock options outstanding at September 30, 2009:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number Outstanding	Remaining Contractual Life (Years)	Weighted Average Price	Number Exercisable	Weighted Average Price
$9.64	1,178,287	9.08	$ 9.64	239,573	$ 9.64
$9.91	30,000	9.58	$ 9.91	10,000	$ 9.91
$9.64 - $9.91	1,208,287	9,09	$ 9.65	249,573	$ 9.65

At September 30, 2009, the aggregate intrinsic value of outstanding and exercisable stock options was $6,698 and $1,382, respectively. The aggregate intrinsic value is based on our closing price of $15.19 per share on September 30, 2009, which would have been received by the optionees had all of the options with exercise prices less than $15.19 per share been exercised on that date.

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DIGIMARC CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(Dollar amounts in thousands, except per share data)

(UNAUDITED)

5. Stock-Based Compensation (Continued)

Restricted Stock Activity

The following table reconciles the unvested balance of restricted stock:

Three-months ended September 30, 2009:	**Number of Shares**
Unvested balance, June 30, 2009	133,400
Granted	8,000
Vested	
Canceled	
Unvested balance, September 30, 2009	141,400

Nine-months ended September 30, 2009:	**Number of Shares**
Unvested balance, December 31, 2008	121,000
Granted	20,400
Vested	
Canceled	
Unvested balance, September 30, 2009	141,400

6. Trade Accounts Receivable

Trade Accounts Receivable

Trade accounts receivable are recorded at the invoiced amount and do not bear interest.

	Successor September 30, 2009	**Successor December 31, 2008**
Trade accounts receivable	$ 3,027	$ 3,839
Allowance for doubtful accounts		
Trade accounts receivable, net	$ 3,027	$ 3,839
Unpaid deferred revenues included in accounts receivable	$ 1,179	$ 2,155

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.

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DIGIMARC CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(Dollar amounts in thousands, except per share data)

(UNAUDITED)

6. Trade Accounts Receivable (Continued)

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 cash-basis revenue recognition customers are not included in accounts receivable nor deferred revenue accounts.

Major customers

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

	Successor September 30, 2009	Successor December 31, 2008
Central Banks	45%	58%
The Nielsen Company	33%	27%

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.

The property and equipment related to the Company were separated from Old Digimarc and recorded at net book value (cost less accumulated depreciation) and classified as used property and equipment.

Depreciation on property and equipment is calculated by the straight-line method over the estimated useful lives of the assets, generally two to seven years. Property and equipment held under capital leases are amortized by the straight-line method over the shorter of the lease term or the estimated useful life. Amortization of property and equipment under capital lease is included in depreciation expense.

	Successor September 30, 2009	Successor December 31, 2008
Office furniture fixture	$ 291	$ 291
Equipment	1,073	793
Leasehold improvements	413	320
	1,777	1,404
Less accumulated depreciation and amortization	(597)	(192)
	$ 1,180	$ 1,212

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DIGIMARC CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(Dollar amounts in thousands, except per share data)

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8. Intangible Assets Purchase and Capitalized 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.

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

	Successor September 30, 2009	Successor December 31, 2008
Gross intangible assets	$ 1,113	$ 462
Accumulated amortization	(25)	(6)
Intangible assets, net	$ 1,088	$ 456

9. Other Income (Expense), Net

	Successor Three Months Ended September 30, 2009	Successor Period August 2, 2008 through September 30, 2008	Predecessor Period July 1, 2008 through August 1, 2008	Successor Nine Months Ended September 30, 2009	Predecessor Period January 1, 2008 through August 1, 2008
Interest income, net	$ 124	$ 196	$ 75	$ 436	$ 590
Net loss from joint ventures	(311)			(311)	
Other	2	(17)		3	
Total	$ (185)	$ 179	$ 75	$ 128	$ 590

Other income (expense), net consists primarily of interest income from the Company's cash and short-and long-term marketable securities and the net losses from the Company's joint ventureswith The Nielsen Company, TVaura LLC and TVaura Mobile LLC.

10. Income Taxes

Old Digimarc. The provision for income taxes reflects withholding tax expense in various foreign jurisdictions. For all historic periods reported in the financial statements, Old Digimarc maintained valuation allowances against its net deferred tax assets, including net operating loss carry-forwards, because it was not more likely than not that such deferred taxes would be realized. The provision for income taxes included foreign taxes withheld by Old Digimarc's customers and paid to foreign

DIGIMARC CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(Dollar amounts in thousands, except per share data)

(UNAUDITED)

10. Income Taxes (Continued)

jurisdictions on its behalf. The predecessor financial statements indicate cumulative losses through August 1, 2008.

Furthermore, the amounts of cumulative expenses in the financial statements that were not allowed for federal and state income tax purposes were not sufficient to result in positive taxable income which would have required the Company to record income tax expense. As a result, no Federal or state income tax benefit was recognized for the book losses that were incurred in those periods prior to 2007 and no income tax expense was recognized during the 2007 and 2008 periods because any expense was offset by the benefit of net operating loss carry-forwards. Digimarc as a separate legal entity will not benefit from any of the carry-forward tax attributes of Old Digimarc, including net operating loss carry-forwards.

Digimarc. The provision for income taxes reflects withholding tax expense in various foreign jurisdictions. These withholding taxes are computed by the Company's customers and paid to foreign jurisdictions on its behalf. There was no provision for current income taxes related to net income because the computation of taxable income resulted in a net operating loss for the period.

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

The Company is subject from time to time to other legal proceedings and claims arising in the ordinary course of business. Although the ultimate outcome of these matters cannot be determined, management believes that, as of September 30, 2009, 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. No accrual has been recorded because the amounts are not probable or reasonably estimatable in accordance with ASC 450.

12. Stock Repurchases

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 over a period of up to two years through April 30, 2010. For the three- and nine-month period ended September 30, 2009, the Company had paid $822 to repurchase 59,355 shares of outstanding common stock under this program since the program's inception.

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(Dollar amounts in thousands, except per share data)

(UNAUDITED)

13. Related Party Transactions

In connection with the two joint ventures entered into with Nielsen in July 2009, the Company recognized $575 in revenues for the three- and nine-month periods ended September 30, 2009 in connection with technical and development services provided to TVaura LLC.

The net loss from the joint ventures included in other income (expense), net for both the three- and nine-month periods ended September 30, 2009 were $(292) for TVaura LLC and $(19) for TVaura Mobile LLC.

There were net accounts receivable of $214 and $6 from TVaura, LLC and TVaura Mobile, LLC at September 30, 2009, respectively. There were no net accounts payable to either joint venture at September 30, 2009.

14. Subsequent Events

In accordance with ASC 855 "*Subsequent Events*" (formerly SFAS 165, *Subsequent Events*), the Company is required to disclose the date through which subsequent events have been evaluated for disclosure. Subsequent events were evaluated through October 29, 2009, which is the date the Company's quarterly report on Form 10-Q for the quarter ended September 30, 2009 was filed with the Securities and Exchange Commission.

15. Quarterly Financial Information Unaudited

Quarter ended:	**Successor March 31**	**Successor June 30**	**Successor September 30**
2009			
Service revenue	$ 2,470	$ 2,585	$ 2,827
License and subscription revenue	1,959	1,739	1,942
Total revenue	4,429	4,324	4,769
Total cost of revenue	1,485	1,528	1,541
Gross profit	2,944	2,796	3,228
Gross profit percent, service revenue	43%	43%	47%
Gross profit percent, license and subscription revenue	97%	97%	98%
Gross profit percent, total	66%	65%	68%
Sales and marketing	745	728	753
Research, development and engineering	1,271	1,217	1,191
General and administrative	1,688	1,496	1,566
Intellectual property	277	217	262
Transitional services	(60)	(48)	(45)
Operating loss	(977)	(814)	(499)
Net loss	(809)	(678)	(687)
Loss per share:			
Net loss per share basic & diluted	$ (0.11)	$ (0.09)	$ (0.10)
Weighted average shares outstanding basic and diluted	7,158	7,158	7,134

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DIGIMARC CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(Dollar amounts in thousands, except per share data)

(UNAUDITED)

15. Quarterly Financial Information Unaudited (Continued)

	Predecessor	Predecessor	Predecessor	Successor	Successor
Quarter ended:	**March 31**	**June 30**	**Period July 1 through August 1**	**Period August 2 through September 30**	**December 31**
2008					
Service revenue	$ 2,548	$ 2,987	$ 921	$ 1,645	$ 2,419
License and subscription revenue	2,537	2,128	829	1,536	2,232
Total revenue	5,085	5,115	1,750	3,181	4,651
Total cost of revenue	1,408	1,704	552	934	1,428
Gross profit	3,677	3,411	1,198	2,247	3,223
Gross profit percent, service revenue	47%	45%	43%	46%	44%
Gross profit percent, license and subscription revenue	98%	97%	97%	97%	97%
Gross profit percent, total	72%	67%	69%	71%	69%
Sales and marketing	656	683	589	390	764
Research, development and engineering	922	910	239	780	992
General and administrative	980	927	442	932	1,945
Intellectual property	478	448	176	120	184
Transitional services				(196)	(84)
Operating income (loss)	641	443	(248)	221	(578)
Net income (loss)	924	664	(173)	400	(324)
Earnings (loss) per share:					
Net income (loss) per share basic & diluted				$ 0.06	$ (0.05)
Weighted average shares outstanding basic and diluted				7,143	7,156
Pro-forma earnings (loss) per share:					
Net income (loss) per share basic & diluted	$ 0.13	$ 0.09	$ (0.02)		
Weighted average shares outstanding basic and diluted	7,143	7,143	7,143		

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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, 2008 filed on February 27, 2009 (the "2008 Annual Report") and in the audited financial statements and related notes included in our 2008 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 (i) "Digimarc," "we," "our" and "us" refer to Digimarc Corporation and (ii) "Old Digimarc" refers to the former Digimarc Corporation, which merged with and into a wholly owned subsidiary of L-1 Identity Solutions, Inc. ("L-1") on August 13, 2008, and its consolidated subsidiaries (other than us).

The Separation of the Digital Watermarking Business from Old Digimarc

On August 1, 2008, Old Digimarc spun off the common stock of Digimarc, which held all of the assets and liabilities of Old Digimarc's Digital Watermarking Business.

Until August 1, 2008, we were a wholly owned subsidiary of DMRC LLC, which immediately prior to the spin-off was a wholly owned subsidiary of Old Digimarc. DMRC LLC was formed in Delaware on June 18, 2008, in anticipation of the spin-off of the Digital Watermarking Business. Prior to the spin-off, in a transaction which we refer to as the restructuring, Old Digimarc contributed all of the assets and liabilities related to its Digital Watermarking Business, together with all of Old Digimarc's cash, including cash received upon the exercise of stock options, to DMRC LLC. The restructuring did not result in the loss of any significant Digital Watermarking Business customers or contracts.

Following the restructuring, all of the limited liability company interests of DMRC LLC were transferred to a newly created trust for the benefit of Old Digimarc record holders on the basis of one limited liability company interest of DMRC LLC for every three and one-half shares of Old Digimarc common stock held by the stockholder as of the spin-off record date and time. DMRC LLC then merged with and into DMRC Corporation, and each limited liability company interest of DMRC LLC was converted into one share of common stock of DMRC Corporation. After completion of the acquisition of Old Digimarc by L-1, DMRC Corporation changed its name to Digimarc Corporation. As a result, upon effectiveness of the Form 10 on October 16, 2008, each Old Digimarc record holder received one share of Digimarc common stock for every three and one-half shares of Old Digimarc common stock held by the stockholder as of the spin-off record date and time, and we became an independent, publicly-traded company owning and operating the Digital Watermarking Business.

Recent Developments Nielsen Joint Venture

On July 1, 2009, we commenced operation of two joint ventures with The Nielsen Company (US) LLC, or Nielsen. In connection with these joint ventures, we terminated our agreement with Nielsen, dated as of October 1, 2007, to enter into the joint venture agreements, and entered into a new patent license agreement. Under the terms of the new patent license agreement, we granted Nielsen a non-exclusive license to Digimarc patents for use within Nielsen's business and Nielsen

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agreed to pay us $18.75 million as follows: $2.0 million for the remainder of 2009; $3.6 million in 2010; $4.0 million in each of 2011, 2012 and 2103; and $1.15 million in 2014.

Under the first joint venture, TVaura LLC, Digimarc and Nielsen will engage 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. Under the second joint venture, TVaura Mobile LLC, Digimarc and Nielsen will engage in the development of certain enhanced television offerings, and other related products. We will provide technical and development services to TVaura LLC's business for the following periods for the following minimum service fees, subject to adjustment for any development service fees paid to Digimarc by TVaura Mobile LLC: $1.13 million for the remainder of 2009; $2.80 million in 2010; and $2.74 million in 2011.

The initial cash contribution of each of Digimarc and Nielsen to TVaura LLC will be an aggregate of $3.9 million payable in quarterly installments from July 2009 through October 2011. The initial cash contribution of each of Digimarc and Nielsen to TVaura Mobile LLC will be an aggregate of $2.8 million payable in quarterly installments from July 2009 through October 2011. Each of Digimarc and Nielsen own approximately half of each joint venture.

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 technology, and those of our licensees, span the complete 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 authenticate 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

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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.

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. We believe we have one of the world's most extensive patent portfolios in the field of digital watermarking and related media enhancement innovations, with over 545 U.S. and foreign patents and more than 410 U.S. and foreign patent applications on file as of September 30, 2009.

Backlog. Based on projected commitments we have for the periods under contract with our respective customers, we anticipate our current contracts as of September 30, 2009 will generate approximately $46 million in revenue during the contractual terms of such contracts, currently up to five years. We expect more than $5 million of this amount to be recognized as revenue during the remainder of 2009.

Some factors that lead to increased backlog include:

- contracts with new customers;
- renewals with current customers;
- add-on orders to current customers; and
- contracts with longer contractual periods replacing contracts with shorter contractual periods.

Some factors that lead to decreased backlog are:

- recognition of revenue associated with backlog currently in place;
- contracts with shorter contractual periods replacing contracts with longer contractual periods; and
- contracts ending with existing customers.

The mix of these factors, among others, dictates whether our backlog increases or decreases for any given period. There is no assurance that our backlog will result in actual revenue in any particular period, because the orders, awards and contracts included in our backlog may be subject to modification, cancellation or suspension. We may not realize revenue on certain contracts, orders or awards included in our backlog or the timing of such realization may change.

Critical Accounting Policies and Estimates

Detailed information on our critical accounting policies and estimates are set forth in our 2008 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, and have not changed.

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Results of Operations the Three Months Ended September 30, 2009 compared to the Periods July 1, 2008 through August 1, 2008 (predecessor) and August 2, 2008 through September 30, 2008 (successor)

The following table presents our statements of operations data for the periods indicated as a percentage of total revenue.

	Successor Three Months Ended September 30, 2009	Successor Period August 2, 2008 through September 30, 2008	Predecessor Period July 1, 2008 through August 1, 2008	Total* Three Months Ended September 30, 2008
Revenue:				
Service	59%	52%	53%	52%
License and subscription	41	48	47	48
Total revenue	100	100	100	100
Cost of revenue:				
Service	31	28	30	29
License and subscription	1	1	1	1
Total cost of revenue	32	29	31	30
Gross profit	68	71	69	70
Operating expenses:				
Sales and marketing	16	12	34	20
Research, development and engineering	25	25	14	20
General and administrative	33	29	25	28
Intellectual property	5	4	10	6
Transitional services	(1)	(6)		(4)
Total operating expenses	78	64	83	70
Operating income (loss)	(10)	7	(14)	
Other income (expense), net	(4)	6	4	5
Income (loss) before provision for income taxes	(14)	7	(10)	5
Provision for income taxes				
Net income (loss)	(14)%	13%	(10)%	5%

* Used for comparative purposes

Our revenue for the three-month period ended September 30, 2009 decreased 3% to $4.8 million from $4.9 million compared to the combined periods July 1, 2008 through August 1, 2008 and August 2, 2008 through September 30, 2008. The decrease was primarily the result of lower license and royalty revenues from a few of our customers based on a combination of contractual revenue provisions, lower royalty reporting from our licensees whose revenues were lower and receipt of cash from our cash basis customers whose revenues are non-linear in nature, offset in part by increased project work from the consortium of Central Banks. In addition, as further discussed below, we incurred higher operating expenses for the period during which we operated as a stand-alone company.

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Revenue

	Successor Three Months Ended September 30, 2009	Successor Period August 2, 2008 through September 30, 2008	Predecessor Period July 1, 2008 through August 1, 2008	Total* Three Months Ended September 30, 2008	Dollar Increase (Decrease)	Percent Increase (Decrease)
Revenue:						
Service	$ 2,827	$ 1,645	$ 921	$ 2,566	$ 261	10%
License and subscription	1,942	1,536	829	2,365	(423)	(18)%
Total	$ 4,769	$ 3,181	$ 1,750	$ 4,931	$ (162)	(3)%
Revenue (as % of total revenue):						
Service	59%	52%	53%	52%		
License and subscription	41%	48%	47%	48%		
Total	100%	100%	100%	100%		

* Used for comparative purposes

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 an international consortium of Central Banks, Nielsen, and the joint ventures between Nielsen and Digimarc, and other government agencies. The agreements can 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. The increases or decreases in the services 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 needs of the customers arise. 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 since they are subject to government budgets and funding.

The increase in service revenue for the three-month period ended September 30, 2009, compared to the combined periods July 1, 2008 through August 1, 2008 and August 2, 2008 through September 30, 2008, was due primarily to increased revenue from additional program work from the Central Banks and government contract revenues that are non-linear in nature, offset in part by lower consulting revenues from Nielsen, including the revenues from the joint venture TVaura LLC, where we were engaged at an accelerated level of services in the initial year of the contract with Nielsen.

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

The decrease in license and subscription revenue for the three-month period ended September 30, 2009, compared to the combined periods July 1, 2008 through August 1, 2008 and August 2, 2008 through September 30, 2008, were due primarily to lower royalty reporting and lower receipts of cash from our cash basis customers.

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Revenue by Geography

	Successor Three Months Ended September 30, 2009	Successor Period August 2, 2008 through September 30, 2008	Predecessor Period July 1, 2008 through August 1, 2008	Total* Three Months Ended September 30, 2008	Dollar Increase (Decrease)	Percent Increase (Decrease)
Revenue by geography:						
Domestic	$ 2,165	$ 1,541	$ 960	$ 2,501	$ (336)	(13)%
International	2,604	1,640	790	2,430	174	7%
Total	$ 4,769	$ 3,181	$ 1,750	$ 4,931	$ (162)	(3)%
Revenue (as % of total revenue):						
Domestic	45%	48%	55%	51%		
International	55%	52%	45%	49%		
Total	100%	100%	100%	100%		

* Used for comparative purposes

Domestic revenue decreased for the three-month period ended September 30, 2009, compared to the combined periods July 1, 2008 through August 1, 2008 and August 2, 2008 through September 30, 2008, due primarily to lower revenues from Nielsen, including the revenues from the joint venture TVaura LLC, and to a lesser extent lower revenues from our royalty reporting licensees.

International revenue slightly increased for the three-month period ended September 30, 2009, compared to the combined periods July 1, 2008 through August 1, 2008 and August 2, 2008 through September 30, 2008, due primarily to increased revenue from the Central Banks, offset by lower revenues from our royalty reporting licensees.

Cost of Revenue and Gross Profit

Service. Cost of service revenue primarily includes costs that are allocated from research, development, engineering and sales and marketing that relate directly to producing revenue 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; and

- travel costs directly attributable to service and development contracts.

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; and

- internet service provider connectivity charges and image search data fees to support the services offered to our subscription customers.

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Gross Profit

	Successor Three Months Ended September 30, 2009	Successor Period August 2, 2008 through September 30, 2008	Predecessor Period July 1, 2008 through August 1, 2008	Total* Three Months Ended September 30, 2008	Dollar Increase (Decrease)	Percent Increase (Decrease)
Gross Profit:						
Service	$ 1,328	$ 755	$ 394	$ 1,149	$ 179	16%
License and subscription	1,900	1,492	804	2,296	(396)	(17)%
Total	$ 3,228	$ 2,247	$ 1,198	$ 3,445	$ (217)	(6)%
Gross Profit (as % of related revenue components):						
Service	47%	46%	43%	45%		
License and subscription	98%	97%	97%	97%		
Total	68%	71%	69%	70%		

* Used for comparative purposes

The decrease in gross profit dollars for the three-month period ended September 30, 2009, compared to the combined periods July 1, 2008 through August 1, 2008 and August 2, 2008 through September 30, 2008 primarily reflect the impact of variations in scheduled payments in certain of our long-term contracts; lower consulting revenues from Nielsen, including the revenues from the joint venture TVaura LLC; and to a lesser extent, lower royalties from some patent and technology licensees.

The decrease in gross profit as a percentage of revenue for the three-month period ended September 30, 2009, compared to the combined periods July 1, 2008 through August 1, 2008 and August 2, 2008 through September 30, 2008, was due primarily to:

- revenue mix resulting in lower license revenue, as a percent of total revenue, which carries a higher margin than service revenue; and

- higher expenses for the period during which we operated as a stand-alone company compared to the shared services allocation methodology applied in the predecessor financial statements.

Operating Expenses

The financial information in the predecessor financial statements does not include all of the expenses that would have been incurred had the predecessor operated as a separate, stand-alone public entity. As such, the predecessor financial information does not reflect the operating expenses of Digimarc's current business had the predecessor been a separate, stand-alone public entity during the periods presented in the predecessor's financial statements. Additionally, the predecessor financial statements include proportional allocations of various shared services common costs of Old Digimarc because specific identification of these expenses was not practicable. It is expected that the initial operating costs of Digimarc on a stand-alone basis will be higher than those allocated to the predecessor operations under the shared services methodology applied in the predecessor financial statements. Consequently, the operating expenses reflected in the predecessor financial statements may not be indicative of those that would have been achieved had the predecessor operated as a separate, stand-alone entity for the periods reflected in the predecessor financial statements. The operating

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expenses for the three-month period ended September 30, 2009 are consistent with our expectations as a stand-alone entity.

Sales and marketing

	Successor Three Months Ended September 30, 2009	Successor Period August 2, 2008 through September 30, 2008	Predecessor Period July 1, 2008 through August 1, 2008	Total* Three Months Ended September 30, 2008	Dollar Decrease	Percent Decrease
Sales and marketing	$ 753	$ 390	$ 589	$ 979	$ (226)	(23)%
Sales and marketing (as % of total revenue)	16%	12%	34%	20%		

* Used for comparative purposes

Sales and marketing expenses consist primarily of:

- compensation, benefits and related costs of sales and marketing employees and product managers;
- travel and market research costs, and costs associated with marketing programs, such as trade shows, public relations and new product launches;
- incentive compensation in the form of bonuses and stock-based compensation expense; and
- charges for infrastructure and centralized costs of facilities and information technology.

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

- salaries;
- a payroll tax and benefits factor; and
- incentive compensation related to our bonus and stock compensation plans.

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

The decrease in sales and marketing expense for the three-month period ended September 30, 2009, compared to the combined periods July 1, 2008 through August 1, 2008 and August 2, 2008 through September 30, 2008, resulted primarily from delayed spending on various projects due to the effects of the slowdown in the economic environment, offset in part by higher expenses for the period during which we operated as a stand-alone company compared to the shared services allocation methodology applied in the predecessor financial statements.

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

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Research, development and engineering

	Successor Three Months Ended September 30, 2009	Successor Period August 2, 2008 through September 30, 2008	Predecessor Period July 1, 2008 through August 1, 2008	Total* Three Months Ended September 30, 2008	Dollar Increase	Percent Increase
Research, development and engineering	$ 1,191	$ 780	$ 239	$ 1,019	$ 172	17%
Research, development and engineering (as % of total revenue)	25%	25%	14%	20%		

* Used for comparative purposes

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

Fundamental Research:

- Investigation of new watermarking algorithms to increase robustness and/or computational efficiency;
- Mobile device usage models and imaging sub-systems in camera-phones;
- Industry conference participation and authorship of papers for industry journals;
- Development of new intellectual property, including documentation of claims and production of supporting diagrams and materials;
- Video watermarking research focused on low-bit rate video applications; and
- Research in fingerprinting and other content identification technologies.

Platform Development:

- Continued development and porting to different operating systems of the Digimarc Global Software Development Kit, or SDK (DGSDK), which packages the core image watermarking algorithms for Print & Imaging applications;
- Development and support of the Geo-Spatial SDK (GEOSDK) for geospatial imaging applications;
- Tuning and optimization of implementation models to improve resistance to non-malicious attacks and routine transformations, such as JPEG, cropping and printing; and

Creation of a platform to encapsulate fixed point watermarking algorithms, optimized for mobile devices.

Product Development:

Migration of applications to new platforms, specifically linking Digimarc for Images (formerly known as ImageBridge) to DGSDK and Digimarc Mobile;

Updating Digimarc for Images Plug-Ins for Photoshop CS4, including new interfaces and translation into 27 languages;

Porting of Digimarc for Images SDK and related applications such as the Digimarc for Images Reader to various operating systems, including Vista, Linux & OS X;

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- Development of Digimarc Mobile reader prototype for new mobile devices; and
- Prototype UGC site ingest, queue, and content management system to demonstrate potential applications of digital watermarking.

Research, development and engineering expenses consist primarily of:

- compensation, benefits and related costs of software developers and quality assurance personnel;
- payments to outside contractors;
- the purchase of materials and services for product development;
- incentive compensation in the form of bonuses and stock-based compensation expense; and
- charges for infrastructure and centralized costs of facilities and information technology.

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

- salaries;
- a payroll tax and benefits factor; and
- incentive compensation related to our bonus and stock compensation plans.

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

The increase in research, development and engineering expense for the three-month period ended September 30, 2009, compared to the combined periods July 1, 2008 through August 1, 2008 and August 2, 2008 through September 30, 2008, resulted primarily from:

- increased headcount and employee compensation related expenses from hiring additional engineers and scientists to facilitate expected growth in service revenue and to increase our investment in research and development; and
- higher expenses for the period during which we operated as a stand-alone company compared to the shared services allocation methodology applied in the predecessor financial statements.

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

General and administrative

	Successor	Successor	Predecessor	Total*

	Three Months Ended September 30, 2009	Period August 2, 2008 through September 30, 2008	Period July 1, 2008 through August 1, 2008	Three Months Ended September 30, 2008	Dollar Increase	Percent Increase
General and administrative	$ 1,566	$ 932	$ 442	$ 1,374	$ 192	14%
General and administrative (as % of total revenue)	33%	29%	25%	28%		

* Used for comparative purposes

We incur general and administrative costs in the functional areas of finance, legal, human resources, executive and board of directors. Costs for facilities and information technology are also

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managed as part of the general and administrative processes and are allocated to this line item as well as each of the line items in costs of services, sales and marketing, and research development and engineering. General and administrative expenses consist primarily of:

- compensation, benefits and related costs;
- third party and professional fees associated with legal, accounting, human resources and costs associated with being a public company;
- incentive compensation in the form of bonuses and stock-based compensation expense; and
- charges for infrastructure and centralized costs of facilities and information technology.

The increases in general and administrative expenses for the three-month period ended September 30, 2009, compared to the combined periods July 1, 2008 through August 1, 2008 and August 2, 2008 through September 30, 2008, resulted primarily from higher expenses for the period during which we operated as a stand-alone company compared to the shared services allocation methodology applied in the predecessor financial statements.

We anticipate that we will continue to incur general and administrative expenses at least at existing levels, while continuing to examine means to reduce general and administrative expenses as a percentage of revenue in the longer term.

Intellectual property

	Successor Three Months Ended September 30, 2009	Successor Period August 2, 2008 through September 30, 2008	Predecessor Period July 1, 2008 through August 1, 2008	Total* Three Months Ended September 30, 2008	Dollar Decrease	Percent Decrease
Intellectual property	$ 262	$ 120	$ 176	$ 296	$ (34)	(11)%
Intellectual property (as % of total revenue)	5%	4%	10%	6%		

* Used for comparative purposes

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

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

- compensation, benefits and related costs of attorneys and legal assistants;
- third party costs including filing and governmental regulatory fees and fees for outside legal counsel and translation costs, each incurred in the patent process;

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

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

Prior to August 2, 2008, the predecessor accounted for gross expenditures for intellectual property costs as expenses. On August 2, 2008 we began capitalizing patent application and award costs.

The decrease in intellectual property expenses for the three-month period ended September 30, 2009, compared to the combined periods July 1, 2008 through August 1, 2008 and August 2, 2008 through September 30, 2008, resulted primarily from capitalized patent application and award costs

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aggregating $0.2 million, offset by expenses related to legal services in support of intellectual property licensing activities.

We anticipate that we will continue to invest in intellectual property expenses at current levels or higher.

Transitional services

In connection with the sale of Old Digimarc's Secure ID Business and the spin-off of the Digital Watermarking Business, Old Digimarc and Digimarc entered into a transition services agreement to provide one another with transition services and other assistance substantially consistent with the services provided before the spin-off.

To enable Old Digimarc to continue its operation of the Secure ID Business and facilitate the effective transition of the Digital Watermarking Business to Digimarc, under the transition services agreement Old Digimarc provides the following services or support to Digimarc: information technology services and legal services. Similarly, Digimarc provides the following services or support to Old Digimarc: accounting and tax services, information technology services, legal services, human resource services and facilities.

The fees for the transition services generally are intended to cover each party's reasonable costs incurred in connection with providing the transition services. Hourly rates for personnel performing transition services were determined based on fully loaded costs, taking into account base pay, a bonus based on obtaining target earnings, payroll taxes, benefit costs, a pro rata portion of overhead charges paid by Old Digimarc or Digimarc, as applicable, and the current year stock compensation charge for the individual, divided by the total hours available for the employee for the year, taking into account the need for administrative time.

The net transitional services expenses reimbursed to Digimarc aggregated less than $0.1 million for the three-month period ended September 30, 2009 and $0.2 million for the period August 2, 2008 through September 30, 2008, and are expected to decline through the end of the year 2009 as the amount of transition services decline.

Stock-based compensation.

	Successor Three Months Ended September 30, 2009	Successor Period August 2, 2008 through September 30, 2008	Predecessor Period July 1, 2008 through August 1, 2008	Total* Three Months Ended September 30, 2008	Dollar Increase	Percent Increase
Cost of revenue	$ 57	$	$ 14	$ 14	$ 43	307%
Sales and marketing	50		32	32	18	56%
Research, development and engineering	47		4	4	43	1,075%
General and administrative	451		81	81	370	457%
Intellectual property	24		5	5	19	380%
Total	$ 629	$	$ 136	$ 136	$ 493	362%

* Used for comparative purposes

Old Digimarc accounted for stock-based compensation in accordance with Accounting Standards Codification ("ASC") 718 "*Compensation Stock Compensation*" (formerly Statement of Financial Accounting Standards ("SFAS") No. 123(R), *Share-Based Payment (Revised 2004))*, which requires the

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measurement and recognition of compensation for all stock-based awards made to employees and directors, including stock options, employee stock purchases under a stock purchase plan and restricted stock awards based on estimated fair values. Stock compensation expense was allocated to the predecessor based on a combination of specific and shared services resource allocations from Old Digimarc.

The increase in stock-based compensation expense for the three-month period ended September 30, 2009, compared to the combined periods July 1, 2008 through August 1, 2008 and August 2, 2008 through September 30, 2008, resulted primarily from Digimarc applying ASC 718 with respect to our initial stock-based awards compared to the shared services allocation methodology applied in the predecessor financial statements.

Other income (expense), net

	Successor Three Months Ended September 30, 2009	**Successor** Period August 2, 2008 through September 30, 2008	**Predecessor** Period July 1, 2008 through August 1, 2008	**Total*** Three Months Ended September 30, 2008	**Dollar Increase (Decrease)**	**Percent Increase (Decrease)**
Interest income, net	$ 124	$ 196	$ 75	$ 271	(147)	(54)%
Net loss from joint ventures	(311)				(311)	(100)%
Other	2	(17)		(17)	19	112%