Digimarc CORP
Form 10-Q
October 26, 2011
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

September 30, 2011 For the quarterly period ended September 30, 2011

OR

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

For the transition period from to

Commission File Number: 001-34108

DIGIMARC CORPORATION

(Exact name of registrant as specified in its charter)

Oregon	**26-2828185**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

9405 SW Gemini Drive, Beaverton, Oregon 97008

(Address of principal executive offices) (Zip Code)

(503) 469-4800

(Registrant s telephone number, including area code)

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

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

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

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

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

As of October 19, 2011, there were 6,966,590 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)

	September 30, 2011	December 31, 2010
ASSETS		
Current assets:		
Cash and cash equivalents	$ 2,119	$ 6,340
Marketable securities	24,414	28,441
Trade accounts receivable, net	3,420	3,481
Other current assets	1,486	1,345
Total current assets	31,439	39,607
Marketable securities	4,683	11,163
Property and equipment, net	1,468	1,330
Intangibles, net	2,661	2,174
Investments in joint ventures	1,199	1,029
Deferred tax assets	2,361	
Other assets	428	462
Total assets	$ 44,239	$ 55,765
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable and other accrued liabilities	$ 1,631	$ 1,519
Deferred revenue	1,928	2,562
Total current liabilities	3,559	4,081
Long-term liabilities	479	525
Total liabilities	4,038	4,606
Commitments and contingencies (Note 11)		
Shareholders equity:		
Preferred stock (10,000 shares issued and outstanding at September 30, 2011 and December 31, 2010)	50	50
Common stock (6,965,577 and 7,443,450 shares issued and outstanding at September 30, 2011 and December 31, 2010, respectively)	7	7
Additional paid-in capital	33,448	49,609
Retained earnings	6,696	1,493
Total shareholders equity	40,201	51,159
Total liabilities and shareholders equity	$ 44,239	$ 55,765

See Notes to Unaudited Financial Statements.

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DIGIMARC CORPORATION

STATEMENTS OF OPERATIONS

(In thousands, except per share data)

(UNAUDITED)

	Three Months Ended September 30, 2011	Three Months Ended September 30, 2010	Nine Months Ended September 30, 2011	Nine Months Ended September 30, 2010
Revenue:				
Service	$ 3,108	$ 2,761	$ 9,342	$ 9,193
License and subscription	5,442	2,476	17,772	11,484
Total revenue	8,550	5,237	27,114	20,677
Cost of revenue:				
Service	1,665	1,410	4,863	4,693
License and subscription	77	59	218	173
Total cost of revenue	1,742	1,469	5,081	4,866
Gross profit	6,808	3,768	22,033	15,811
Operating expenses:				
Sales and marketing	1,166	953	3,285	2,453
Research, development and engineering	1,958	1,471	5,617	4,051
General and administrative	2,000	1,842	7,117	5,414
Intellectual property	259	315	826	891
Total operating expenses	5,383	4,581	16,845	12,809
Operating income (loss)	1,425	(813)	5,188	3,002
Net loss from joint ventures	(695)	(558)	(1,930)	(1,576)
Interest income, net	43	62	149	184
Income (loss) before provision for income taxes	773	(1,309)	3,407	1,610
(Provision) benefit for income taxes	(134)	(151)	1,796	(190)
Net income (loss)	$ 639	$ (1,460)	$ 5,203	$ 1,420
Earnings (loss) per share:				
Net income (loss) per share basic	$ 0.10	$ (0.21)	$ 0.77	$ 0.20
Net income (loss) per share diluted	$ 0.09	$ (0.21)	$ 0.71	$ 0.19
Weighted average shares outstanding basic	6,706	7,098	6,755	7,097
Weighted average shares outstanding diluted	7,344	7,098	7,366	7,497

See Notes to Unaudited Financial Statements.

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DIGIMARC CORPORATION

STATEMENTS OF SHAREHOLDERS EQUITY

(In thousands, except share data)

(UNAUDITED)

	Preferred stock		Common stock				
	Shares	Amount	Shares	Amount	Additional paid-in capital	Retained Earnings (Accumulated Deficit)	Total shareholders equity
BALANCE AT DECEMBER 31, 2009	10,000	$ 50	7,205,701	$ 7	$ 49,283	$ (2,681)	$ 46,659
Exercise of stock options			313,832		3,045		3,045
Issuance of restricted common stock			124,560				
Purchase and retirement of common stock			(200,643)		(5,824)		(5,824)
Stock-based compensation					3,105		3,105
Net income						4,174	4,174
BALANCE AT DECEMBER 31, 2010	10,000	$ 50	7,443,450	$ 7	$ 49,609	$ 1,493	$ 51,159
Exercise of stock options			159,420		1,555		1,555
Issuance of restricted common stock			123,400				
Purchase and retirement of common stock			(760,693)		(21,594)		(21,594)
Stock-based compensation					3,086		3,086
Excess tax benefit from stock-based awards					792		792
Net income						5,203	5,203
BALANCE AT SEPTEMBER 30, 2011	10,000	$ 50	6,965,577	$ 7	$ 33,448	$ 6,696	$ 40,201

See Notes to Unaudited Financial Statements.

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DIGIMARC CORPORATION

STATEMENTS OF CASH FLOWS

(In thousands)

(UNAUDITED)

	Nine Months Ended September 30, 2011	Nine Months Ended September 30, 2010
Cash flows from operating activities:		
Net income	$ 5,203	$ 1,420
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization, property and equipment	474	430
Amortization, intangibles	86	54
Stock-based compensation	3,038	2,287
Net loss from joint ventures	1,930	1,576
Deferred income tax benefit	(2,633)	
Tax benefit from stock-based awards	792	
Excess tax benefit from stock-based compensation	(792)	
Changes in operating assets and liabilities:		
Trade accounts receivable, net	61	469
Other current assets	131	(111)
Other assets, net	34	(35)
Accounts payable and other accrued liabilities	73	(63)
Deferred revenue	(641)	(180)
Net cash provided by operating activities	7,756	5,847
Cash flows from investing activities:		
Purchase of property and equipment	(612)	(236)
Capitalized patent costs	(525)	(811)
Investments in joint ventures	(2,100)	(2,100)
Sale or maturity of marketable securities	60,304	78,965
Purchase of marketable securities	(49,797)	(83,256)
Net cash provided by (used in) investing activities	7,270	(7,438)
Cash flows from financing activities:		
Issuance of common stock	1,555	8
Purchase of common stock	(21,594)	(40)
Excess tax benefit from stock-based awards	792	
Net cash used in financing activities	(19,247)	(32)
Net decrease in cash and cash equivalents	(4,221)	(1,623)
Cash and cash equivalents at beginning of period	6,340	8,884
Cash and cash equivalents at end of period	$ 2,119	$ 7,261
Supplemental disclosure of cash flow information:		
Cash paid for income taxes	$ 13	$ 62

Supplemental schedule of non-cash investing activities:				
Stock-based compensation capitalized to patent costs	$	48	$	31

See Notes to Unaudited Financial Statements.

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DIGIMARC CORPORATION

NOTES TO FINANCIAL STATEMENTS

(Dollar amounts in thousands, except per share data)

(UNAUDITED)

1. Description of Business and Summary of Significant Accounting Policies

Description of Business

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

The Company

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

Interim Financial Statements

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

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

Use of Estimates

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

Cash Equivalents

The Company considers all highly liquid marketable securities with original maturities of 90 days or less at the date of acquisition to be cash equivalents. Cash equivalents include money market funds, certificates of deposit, commercial paper, and investments in government bonds totaling $2,024 and $6,036 at September 30, 2011 and December 31, 2010, respectively. Cash equivalents are carried at cost or amortized cost, which approximates market.

Marketable Securities

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

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

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

Fair Value of Financial Instruments

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

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

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

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

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

	September 30, 2011	December 31, 2010
Marketable securities, at amortized cost	$ 28,707	$ 43,898
Cash equivalents, included above	$	$ 4,294
Money market funds	$ 2,413	$ 1,742

Concentrations of Business and Credit Risk

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

Equity Method Investments

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

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

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Impairment of Long-Lived Assets

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

Research and Development

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

Software Development Costs

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

Patent Costs

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

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

Revenue Recognition

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

Stock-Based Compensation

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

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

Income Taxes

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

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2. Recent Accounting Standards Update

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

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

In October 2009, the FASB issued ASU No. 2009-13, *Revenue Recognition: Multiple-Deliverable Revenue Arrangements a consensus of the FASB Emerging Issues Task Force*, which eliminates the use of the residual method for allocating consideration, as well as the criteria that requires objective and reliable evidence of fair value of undelivered elements in order to separate the elements in a multiple-element arrangement. By removing the criterion requiring the use of objective and reliable evidence of fair value in separately accounting for deliverables, the recognition of revenue will more closely align with the economics of the revenue arrangements. The standard also replaces the term fair value in the revenue allocation guidance with selling price to clarify that the allocation of revenue is based on entity-specific assumptions rather than assumptions of a marketplace participant. ASU No. 2009-13 is effective for revenue arrangements entered or materially modified in fiscal years beginning on or after June 15, 2010. The Company has adopted the provisions of this standard and noted no material impact on the financial condition or results of operations of the Company.

3. Revenue Recognition

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

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

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

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

(i) persuasive evidence of an arrangement exists,

(ii) delivery has occurred,

(iii) the fee is fixed or determinable, and

(iv) collection is probable.

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

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

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

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

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

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

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

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

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

4. Segment Information

Geographic Information

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

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

	Three Months Ended September 30, 2011	Three Months Ended September 30, 2010	Nine Months Ended September 30, 2011	Nine Months Ended September 30, 2010
Domestic	$ 5,221	$ 1,868	$ 17,321	$ 11,211
International	3,329	3,369	9,793	9,466
Total	$ 8,550	$ 5,237	$ 27,114	$ 20,677

Major Customers

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

	Three Months	Three Months	Nine Months	Nine Months

	Ended September 30, 2011	Ended September 30, 2010	Ended September 30, 2011	Ended September 30, 2010
Intellectual Ventures Affiliates	35%		33%	
Central Banks	30%	45%	27%	35%
The Nielsen Company	12%	17%	11%	13%
Verance	*	*	10%	*
Civolution	*	17%	*	*
TVaura LLC	*	12%	*	10%
Arbitron				22%

* Less than 10%

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5. Stock-Based Compensation

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

Determining Fair Value

Preferred Stock

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

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

Stock Options

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

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

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

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

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

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

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

	Three Months Ended September 30, 2011	Three Months Ended September 30, 2010	Nine Months Ended September 30, 2011	Nine Months Ended September 30, 2010
Fair value of stock options granted	$	$	$ 954	$ 1,159

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

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Restricted Stock

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

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

Stock-based Compensation

	Three Months Ended September 30, 2011	Three Months Ended September 30, 2010	Nine Months Ended September 30, 2011	Nine Months Ended September 30, 2010
Stock-based compensation:				
Cost of revenue	$ 158	$ 84	$ 446	$ 272
Sales and marketing	87	50	248	141
Research, development and engineering	174	79	440	225
General and administrative	590	542	1,761	1,576
Intellectual property	48	27	143	73
Stock-based compensation expense	1,057	782	3,038	2,287
Capitalized to patent costs	22	9	48	31
Total stock-based compensation	$ 1,079	$ 791	$ 3,086	$ 2,318

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

	As of September 30, 2011	As of December 31, 2010
Unrecognized compensation costs	$ 7,795	$ 6,212

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

The Company expects to recognize these compensation costs for stock options and restricted stock over weighted average periods through September 2015 as follows:

	Stock Options	Restricted Stock
Weighted average period	0.94 years	1.62 years

Stock Option Activity

As of September 30, 2011, under all of the Company s stock-based compensation plans, options to purchase an additional 1,000,014 shares were authorized for future grants under the plans. The Company issues new shares upon option exercises.

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

Three-months ended September 30, 2011:	Options	Weighted Average Exercise Price	Weighted Average Grant Date Fair Value	Aggregate Intrinsic Value
Outstanding at June 30, 2011	994,323	$ 11.99	$ 7.03	
Options granted				
Options exercised	(85,252)	$ 9.64	$ 6.30	
Options canceled or expired				
Outstanding at September 30, 2011	909,071	$ 12.21	$ 7.09	$ 12,318
Exercisable at September 30, 2011	491,535	$ 11.11		$ 7,073
Unvested at September 30, 2011	417,536	$ 13.51		$ 5,245

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Nine-months ended September 30, 2011:	Options	Weighted Average Exercise Price	Weighted Average Grant Date Fair Value	Aggregate Intrinsic Value
Outstanding at December 31, 2010	993,491	$ 10.47	$ 6.55	
Options granted	75,000	$ 30.01	$ 12.72	
Options exercised	(159,420)	$ 9.75	$ 6.34	
Options canceled or expired				
Outstanding at September 30, 2011	909,071	$ 12.21	$ 7.09	$ 12,318
Exercisable at September 30, 2011	491,535	$ 11.11		$ 7,073
Unvested at September 30, 2011	417,536	$ 13.51		$ 5,245

The aggregate intrinsic value is based on the closing price of $25.38 per share of Digimarc common stock on September 30, 2011, which would have been received by the optionees had all of the options with exercise prices less than $25.38 per share been exercised on that date.

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

	Options Outstanding			Options Exercisable		
Range of Exercise Prices	Number Outstanding	Remaining Contractual Life (Years)	Weighted Average Price	Number Exercisable	Remaining Contractual Life (Years)	Weighted Average Price
$9.64	671,155	7.08	$ 9.64	380,284	7.08	$ 9.64
$9.91	30,000	7.58	$ 9.91	30,000	7.58	$ 9.91
$14.99	102,916	8.26	$ 14.99	38,751	8.26	$ 14.99
$18.01	30,000	8.58	$ 18.01	30,000	8.58	$ 18.01
$30.01	75,000	9.26	$ 30.01	12,500	9.26	$ 30.01
$9.64 - $30.01	909,071	7.46	$ 12.21	491,535	7.35	$ 11.11

Restricted Stock Activity

The following table reconciles the unvested balance of restricted stock:

Three-months ended September 30, 2011:	Number of Shares	Weighted Average Grant Date Fair Value
Unvested balance, June 30, 2011	283,860	$ 20.42
Granted	9,220	$ 36.24
Vested	(12,100)	$ 19.23
Canceled	(200)	$ 30.01
Unvested balance, September 30, 2011	280,780	$ 20.98

Nine-months ended September 30, 2011:	Number of Shares	Weighted Average Grant Date Fair Value

Unvested balance, December 31, 2010	197,760	$ 14.25
Granted	123,400	$ 30.23
Vested	(39,785)	$ 16.10
Canceled	(595)	$ 25.73
Unvested balance, September 30, 2011	280,780	$ 20.98

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6. Trade Accounts Receivable

Trade Accounts Receivable

Trade accounts receivable are recorded at the invoiced amount.

	September 30, 2011	December 31, 2010
Trade accounts receivable	$ 3,420	$ 3,481
Allowance for doubtful accounts		
Trade accounts receivable, net	$ 3,420	$ 3,481
Unpaid deferred revenues included in accounts receivable	$ 1,069	$ 2,045

Allowance for doubtful accounts

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

Unpaid deferred revenues

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

Major customers

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

	September 30, 2011	December 31, 2010
Central Banks	45%	43%
The Nielsen Company	29%	29%
Civolution	11%	11%

7. Property and Equipment

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

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

	September 30, 2011	December 31, 2010

Office furniture fixtures	$	376	$	294
Equipment		1,842		1,365
Leasehold improvements		1,039		986
		3,257		2,645
Less accumulated depreciation and amortization		(1,789)		(1,315)
	$	1,468	$	1,330

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8. Intangible Assets Purchased and Capitalized Patent Costs

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

	September 30, 2011	December 31, 2010
Gross intangible assets	$ 2,863	$ 2,290
Accumulated amortization	(202)	(116)
Intangible assets, net	$ 2,661	$ 2,174

9. Joint Venture and Related Party Transactions

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

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

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

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

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

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

Related Party Transactions

	Three Months Ended September 30, 2011	Three Months Ended September 30, 2010	Nine Months Ended September 30, 2011	Nine Months Ended September 30, 2010
TVaura LLC:				
Capital contributions	$ 400	$ 400	$ 1,200	$ 1,200
Revenue(1)	$ 622	$ 652	$ 2,033	$ 2,026
TVaura Mobile LLC:				

Capital contributions	$ 300	$ 300	$ 900	$ 900
Total:				
Capital contributions	$ 700	$ 700	$ 2,100	$ 2,100
Revenue(1)	$ 622	$ 652	$ 2,033	$ 2,026

(1) Technical and development services

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	September 30, 2011	December 31, 2010
TVaura LLC:		
Accounts receivable	$ 189	$ 255

Summarized financial data for TVaura LLC are as follows:

	September 30, 2011	December 31, 2010
Current assets	$ 1,040	