

DIGIMARC CORP  
Form 10-Q  
November 02, 2007

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended September 30, 2007

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_  
Commission File Number: 000-28317

**DIGIMARC CORPORATION**

(Exact name of registrant as specified in its charter)

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

**94-3342784**  
(I.R.S. Employer  
Identification No.)

**9405 SW Gemini Drive, Beaverton, Oregon 97008**  
(Address of principal executive offices) (Zip Code)

**(503) 469-4800**  
(Registrant's telephone number, including area code)  
Securities registered pursuant to Section 12(b) of the Act:

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

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

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

As of October 31, 2007, there were 21,786,461 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**  
**CONSOLIDATED BALANCE SHEETS**

(In thousands, except share data)

(UNAUDITED)

	September 30, 2007	December 31, 2006(1)
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 19,233	\$ 23,135
Restricted cash		378
Short-term investments	3,758	
Trade accounts receivable, net	14,367	14,403
Inventory, net	5,992	6,600
Other current assets	2,703	2,273
	<u>46,053</u>	<u>46,789</u>
Total current assets	46,053	46,789
Restricted cash	9,563	9,560
Property and equipment, net	67,486	61,898
Intangibles, net	13,966	15,374
Other assets, net	1,259	1,010
	<u>138,327</u>	<u>134,631</u>
Total assets	\$ 138,327	\$ 134,631
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 4,091	\$ 5,708
Accrued payroll and related costs	2,025	3,894
Deferred revenue	5,406	5,050
Other current liabilities	2,244	2,258
	<u>13,766</u>	<u>16,910</u>
Total current liabilities	13,766	16,910
Long-term deferred revenue, net of current portion	7,196	5,345
Other long-term liabilities	1,645	885
	<u>22,607</u>	<u>23,140</u>
Total liabilities	22,607	23,140
Commitments and contingencies (Note 5)		
Stockholders' equity:		
Common stock (21,790,618 and 21,191,918 shares issued and outstanding at September 30, 2007 and December 31, 2006, respectively)	22	22
Additional paid-in capital	215,901	211,072
Accumulated other comprehensive income	137	137
Accumulated deficit	(100,340)	(99,740)
	<u>115,720</u>	<u>111,491</u>
Total stockholders' equity	115,720	111,491
	<u>\$ 138,327</u>	<u>\$ 134,631</u>
Total liabilities and stockholders' equity	\$ 138,327	\$ 134,631

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September 30,  
2007

December 31,  
2006(1)

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(1)

Derived from the Company's December 31, 2006 audited consolidated financial statements

See Notes to Unaudited Consolidated Financial Statements.

## DIGIMARC CORPORATION

## CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share data)

(UNAUDITED)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
<b>Revenue:</b>				
Service	\$ 23,625	\$ 22,414	\$ 67,462	\$ 65,223
Product and subscription	3,507	4,319	13,880	13,610
<b>Total revenue</b>	<b>27,132</b>	<b>26,733</b>	<b>81,342</b>	<b>78,833</b>
<b>Cost of revenue:</b>				
Service	15,160	15,138	44,964	47,239
Product and subscription	1,207	1,581	5,295	5,805
<b>Total cost of revenue</b>	<b>16,367</b>	<b>16,719</b>	<b>50,259</b>	<b>53,044</b>
<b>Gross profit</b>	<b>10,765</b>	<b>10,014</b>	<b>31,083</b>	<b>25,789</b>
<b>Operating expenses:</b>				
Sales and marketing	4,103	3,440	12,745	12,664
Research, development and engineering	1,691	2,158	5,616	8,388
General and administrative	3,724	3,684	11,631	13,066
Amortization of intangibles	451	537	1,460	1,660
Intellectual property	429	460	1,404	1,372
Restructuring charges, net				547
<b>Total operating expenses</b>	<b>10,398</b>	<b>10,279</b>	<b>32,856</b>	<b>37,697</b>
<b>Operating income (loss)</b>	<b>367</b>	<b>(265)</b>	<b>(1,773)</b>	<b>(11,908)</b>
<b>Other income (expense):</b>				
Interest income	355	342	1,129	1,008
Interest expense	(18)	(29)	(33)	(73)
Other	129	223	154	266
<b>Total other income, net</b>	<b>466</b>	<b>536</b>	<b>1,250</b>	<b>1,201</b>
<b>Income (loss) before provision for income taxes</b>	<b>833</b>	<b>271</b>	<b>(523)</b>	<b>(10,707)</b>
<b>(Provision) benefit for income taxes</b>	<b>(61)</b>	<b>(58)</b>	<b>(222)</b>	<b>(121)</b>
<b>Net income (loss)</b>	<b>\$ 772</b>	<b>\$ 213</b>	<b>\$ (745)</b>	<b>\$ (10,828)</b>
<b>Net income (loss) per share basic</b>	<b>\$ 0.04</b>	<b>\$ 0.01</b>	<b>\$ (0.04)</b>	<b>\$ (0.52)</b>
<b>Net income (loss) per share diluted</b>	<b>\$ 0.04</b>	<b>\$ 0.01</b>	<b>\$ (0.04)</b>	<b>\$ (0.52)</b>
<b>Weighted average shares outstanding basic</b>	<b>21,036</b>	<b>20,670</b>	<b>20,910</b>	<b>20,635</b>
<b>Weighted average shares outstanding diluted</b>	<b>21,470</b>	<b>21,470</b>	<b>20,910</b>	<b>20,635</b>

See Notes to Unaudited Consolidated Financial Statements.

## DIGIMARC CORPORATION

## CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

(In thousands, except share data)

(UNAUDITED)

	Common stock		Additional paid-in capital	Deferred stock compensation	Accumulated other comprehensive income	Accumulated Deficit	Total stockholders' equity
	Shares	Amount					
<b>BALANCE AT DECEMBER 31, 2005</b>	20,808,994	\$ 21	\$ 209,337	\$ (1,519)	137	\$ (88,000)	119,976
Initial adjustment to adopt SFAS 123R (Note 3)			(1,519)	1,519			
Exercise of stock options	44,584	1	201				202
Issuance of employee stock purchase plan shares	52,957		248				248
Issuance of restricted common stock	312,365						
Purchase and retirement of common stock	(26,982)		(208)				(208)
Stock-based compensation expense			3,013				3,013
Net loss						(11,740)	(11,740)
<b>BALANCE AT DECEMBER 31, 2006</b>	21,191,918	22	211,072		137	(99,740)	111,491
Initial adjustment to adopt FIN 48 (Note 10)						145	145
Exercise of stock options	279,257		1,399				1,399
Issuance of employee stock purchase plan shares	85,621		664				664
Issuance of restricted common stock	309,490						
Purchase and retirement of common stock	(75,668)		(141)				(141)
Stock-based compensation expense			2,907				2,907
Net loss						(745)	(745)
<b>BALANCE AT SEPTEMBER 30, 2007</b>	21,790,618	\$ 22	\$ 215,901	\$	137	\$ (100,340)	115,720

See Notes to Unaudited Consolidated Financial Statements.

## DIGIMARC CORPORATION

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(UNAUDITED)

	Nine Months Ended	
	September 30, 2007	September 30, 2006
Cash flows from operating activities:		
Net loss	\$ (745)	\$ (10,828)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	11,942	11,595
Stock-based compensation expense	2,907	2,283
Increase (decrease) in allowance for doubtful accounts	1	(173)
Other non-cash charges	(24)	(286)
Changes in operating assets and liabilities:		
Restricted cash	375	(2,659)
Trade accounts receivable, net	(5)	898
Inventory, net	608	1,435
Other current assets	(430)	765
Other assets, net	(249)	101
Accounts payable	(1,617)	(1,927)
Accrued payroll and related costs	(1,869)	364
Deferred revenue	2,207	2,346
Other liabilities	267	(236)
	<u>13,368</u>	<u>3,678</u>
Net cash provided by (used in) operating activities	13,368	3,678
Cash flows from investing activities:		
Purchase of property and equipment, including capitalized labor costs, and intangibles	(14,942)	(6,970)
Sale or maturity of short-term investments	105,284	92,350
Purchase of short-term investments	(109,042)	(92,612)
	<u>(18,700)</u>	<u>(7,232)</u>
Net cash provided by (used in) investing activities	(18,700)	(7,232)
Cash flows from financing activities:		
Issuance of common stock	2,063	321
Purchase of common stock	(141)	
Principal payments under capital lease obligations	(492)	(480)
	<u>1,430</u>	<u>(159)</u>
Net cash provided by (used in) financing activities	1,430	(159)
Net increase (decrease) in cash and cash equivalents	(3,902)	(3,713)
Cash and cash equivalents at beginning of period	23,135	23,964
	<u>19,233</u>	<u>20,251</u>
Cash and cash equivalents at end of period	\$ 19,233	\$ 20,251
Supplemental disclosure of cash flow information:		
Cash paid for interest	\$ 56	\$ 73
Cash paid for income taxes	\$ 463	\$ 134
Summary of non-cash investing and financing activities:		
Equipment acquired or exchanged under capital lease obligations	\$ 1,174	\$ 582

See Notes to Unaudited Consolidated Financial Statements.





**DIGIMARC CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**(UNAUDITED)**

**1. The Company, Basis of Presentation**

*Description of Business*

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

*Principles of Consolidation*

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

*Interim Financial Statements*

The accompanying consolidated financial statements have been prepared from the Company's records without audit and, in management's opinion, include all adjustments (consisting of only normal recurring adjustments) necessary to fairly reflect the financial condition and the results 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 under the rules and regulations of the Securities and Exchange Commission (the "SEC").

These consolidated financial statements should be read in conjunction with the audited consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2006, which was filed with the SEC on March 8, 2007. The results of operations for the interim periods presented in these consolidated financial statements are not necessarily indicative of the results for the full year.

*Use of Estimates*

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

*Reclassifications*

Certain amounts in the 2006 consolidated financial statements and notes thereon have been reclassified to conform to the current period presentation. These reclassifications had no material effect on the results of operations or financial position for any period presented.

**2. Net Income (Loss) Per Share Computation**

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
	(in 000's)			
<b>Basic EPS</b>				
Weighted average shares outstanding	21,036	20,670	20,910	20,635
<b>Effect of Dilutive Securities</b>				
Options	324	285		
Restricted stock and performance vesting shares	110	515		
<b>Diluted EPS</b>				
Weighted average shares outstanding	21,470	21,470	20,910	20,635

Common stock equivalents related to stock options of 4,433 and 4,359 were excluded from diluted net loss per share calculations for the three- and nine-month periods ended September 30, 2007, respectively, as their exercise price was higher than the average market price of the underlying common stock for the period and therefore their impact would be anti-dilutive. In addition, common stock equivalents related to stock options and restricted stock of 434 for the three-month period ended September 30, 2007 were included in diluted net income per share; however, 575 common stock equivalents for the nine-month period ended September 30, 2007 were excluded from diluted net loss per share as the Company was in a loss position and the inclusion would be anti-dilutive.

The effect of 5,428 and 5,144 outstanding stock options for the three- and nine-months periods ended September 30, 2006, respectively, were excluded from the calculation of diluted net loss per share because their exercise price was higher than the average market price of the underlying common stock for the period and therefore their inclusion would be anti-dilutive. In addition, common stock equivalents related to stock options and restricted stock of 800 for the three-month period ended September 30, 2006 were included in diluted net income per share; however, 841 common stock

equivalents for the nine-month period ended September 30, 2006 were excluded from diluted net loss per share as the Company was in a loss position and their inclusion would be anti-dilutive.

### 3. Stock-Based Compensation

Stock-based compensation includes expense charges for all stock-based awards to employees and directors. Such awards include option grants, restricted stock awards, and shares expected to be purchased under an employee stock purchase plan. On January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123(R), *Share-Based Payment (Revised 2004)*, which requires the measurement and recognition of compensation for all stock-based awards made to employees and directors including stock options and employee stock purchases under a stock purchase plan based on estimated fair values. SFAS 123(R) supersedes previous accounting under Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, for periods beginning in fiscal 2006. In March 2005, the SEC issued Staff Accounting Bulletin No. 107 relating to application of SFAS 123(R). The Company has applied the provisions of Staff Accounting Bulletin ("SAB") 107 in the adoption of SFAS 123(R).

The Company adopted SFAS 123(R) using the modified prospective transition method, which requires the application of the accounting standard as of January 1, 2006, the first day of its 2006 fiscal year. In accordance with the modified prospective transition method, the Company's consolidated financial statements for periods prior to fiscal year 2006 have not been restated to reflect this change. Stock-based compensation recognized in the three- and nine-month periods ended September 30, 2007 and 2006 is based on the value of the portion of the stock-based award that will vest during the period, adjusted for expected forfeitures. Stock-based compensation recognized in the Company's consolidated financial statements in the three- and nine-month periods ended September 30, 2007 and 2006 includes compensation cost for stock-based awards granted prior to, but not fully vested as of, December 31, 2005 and stock-based awards granted subsequent to December 31, 2005. The compensation cost for awards granted prior to January 1, 2006 is based on the grant date fair value estimated in accordance with the pro forma provisions of SFAS 123 while awards granted on or after January 1, 2006 follow the provisions of SFAS 123(R) to determine the grant date fair value and compensation cost. Compensation cost for all stock-based awards is recognized using the straight-line method.

Upon adoption of SFAS 123(R), the Company continued to use 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 the Company's stock price as well as assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to, the expected life of the award, the Company's expected stock price volatility over the term of the award and actual and projected exercise behaviors. Although the fair value of stock-based awards is determined in accordance with SFAS 123(R) and SAB 107, the Black-Scholes option pricing model requires the input of highly subjective assumptions, and other reasonable assumptions could provide differing results.

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

*Valuation and Amortization Method.* The Company estimates the fair value of stock option awards on the 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. The Company determines the expected life based on historical experience with similar awards, giving consideration to the contractual terms, vesting schedules and pre-vesting and post-vesting forfeitures. Stock options granted during the three- and nine-months ended September 30, 2007 and 2006 generally vest over four years and have contractual terms of ten years.

*Expected Volatility.* The expected volatility used in the Black-Scholes option valuation model at the date of grant is established based on the historical volatility of the Company's common stock. The volatility factor represents management's best estimate of volatility for the 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 the implied yield currently available on U.S. Treasury zero-coupon issues with an equivalent remaining term approximately equal to the expected life of the award.

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

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
Expected life (in years)	5.8	6.0	5.8	6.0
Expected volatility	44%	53%	44%	53%
Risk-free interest rate	4.7%	4.7%	4.7%	4.7%
Expected dividend yield	0%	0%	0%	0%
Expected forfeiture rate	16%	14%	16%	14%
Fair value	\$ 4.84	\$ 3.51	\$ 4.39	\$ 3.56

*Employee Stock Purchase Plans*

The Company also recognizes stock-based compensation in connection with its 1999 Employee Stock Purchase Plan. The plan, before being amended in November 2006, allowed employees to purchase shares of Digimarc common stock through payroll deductions of up to 15% of their base compensation during each six-month plan period, up to a maximum deduction of \$10.6 for each plan period, not to exceed \$21 per year. Plan periods were generally from December 1 to May 31 and from June 1 to November 30. The price an employee paid for the shares was 85% of the lower of (i) the fair market value of Digimarc common stock at the beginning of the plan period or (ii) the fair market value at the end of the plan period. There were 52,957 shares purchased under the Company's stock purchase plan during the three- and nine-month periods ended September 30, 2006. The plan was suspended effective June 1, 2006.

An amended plan was reinstated effective November 2, 2006 which slightly modified the earlier plan. The modifications included changing the plan periods from six to three months and the maximum deduction to \$5.3 for each plan period. The three-month plan periods begin December 1, March 1, June 1 and September 1. Employees purchased 31,502 shares and 85,621 shares under the plan during the three- and nine-month periods ended September 30, 2007, respectively.

*Restricted Stock and Performance Vesting Shares*

During 2007 and 2006 the Compensation Committee of the Board of Directors awarded restricted stock shares under the Company's 1999 Stock Incentive Plan, as amended, to certain officers, employees and directors. The shares subject to the restricted stock awards vest over a certain period, usually one to four years, following the date of the grant. In addition the Compensation Committee awarded performance vesting shares under the 1999 Stock Incentive Plan, as amended, to certain officers and employees. The performance vesting shares vest in full (or terminate) based on the achievement of specified performance goals. Specific terms of the restricted stock awards and performance vesting share awards are governed by restricted stock agreements and performance vesting share 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.

The fair value of performance vesting share awards granted is based on a Monte Carlo valuation model that results in a factor applied to the fair market value of the Company's common stock on the date of the grant (measurement date), and is recognized over the derived service period, which is shorter than the performance period, using the straight-line method.

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

The following table summarizes stock-based compensation expense related to stock-based awards under SFAS 123(R) for the three- and nine-month periods ended September 30, 2007 and 2006, which was incurred as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
Stock-based compensation:				
Cost of revenue	\$ 114	\$ 76	\$ 329	\$ 214
Sales and marketing	65	117	457	373
Research, development and engineering	103	71	276	261
General and administrative	598	434	1,805	1,408
Intellectual property	15	9	40	27
<b>Total stock-based compensation</b>	<b>\$ 895</b>	<b>\$ 707</b>	<b>\$ 2,907</b>	<b>\$ 2,283</b>

At September 30, 2007, the Company had 1.3 million non-vested stock options that had a weighted average grant date price of \$7.16. As of September 30, 2007, the Company had \$7,952 of total unrecognized compensation cost related to non-vested stock-based awards granted under all equity compensation plans, including options, restricted stock, and employee stock purchase plan, which are expected to be expensed through fiscal 2011. Total unrecognized compensation cost will be adjusted for any future changes in estimated forfeitures. The Company expects to recognize this cost over a weighted average period of 1.4 years.

*Stock Option Activity*

As of September 30, 2007, under all of the Company's stock-based compensation plans, options to purchase an aggregate of 6.9 million shares were outstanding, and options to purchase an additional 7.3 million shares were authorized for future grants under the plans. The Company issues new shares upon option exercises.

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

<b>Three-months ended September 30, 2007:</b>	<b>Options</b>	<b>Weighted Average Exercise Price</b>	<b>Weighted Average Remaining Contractual Life</b>
Outstanding at June 30, 2007	7,236,208	\$ 13.56	
Options granted	24,525	10.02	
Options exercised	(181,858)	4.47	
Options canceled	(136,741)	9.40	
Options expired			
	<b>6,942,134</b>	<b>\$ 13.87</b>	<b>5.84 years</b>
Exercisable at September 30, 2007	5,613,280	\$ 15.46	5.19 years
		<b>Weighted Average Exercise Price</b>	<b>Weighted Average Remaining Contractual Life</b>
<b>Nine-months ended September 30, 2007:</b>	<b>Options</b>	<b>Price</b>	<b>Life</b>
Outstanding at December 31, 2006	7,045,751	\$ 13.67	
Options granted	477,500	9.09	
Options exercised	(279,257)	5.01	
Options canceled	(301,860)	9.84	
Options expired			
	<b>6,942,134</b>	<b>\$ 13.87</b>	<b>5.84 years</b>
Exercisable at September 30, 2007	5,613,280	\$ 15.46	5.19 years



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The following table summarizes information about stock options outstanding at September 30, 2007:

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Number Outstanding	Remaining Contractual Life (Years)	Weighted Average Price	Number Exercisable	Weighted Average Price
\$ 0.50 - \$ 5.96	689,163	7.60	\$ 5.41	386,823	\$ 5.07
\$ 6.00 - \$ 6.15	467,345	7.74	\$ 6.06	247,941	\$ 6.05
\$ 6.16 - \$ 6.99	464,273	8.43	\$ 6.51	162,627	\$ 6.54
\$ 7.11 - \$ 8.97	729,833	8.22	\$ 8.41	329,506	\$ 8.28
\$ 9.00 - \$12.23	892,293	6.79	\$ 10.93	787,156	\$ 11.06
\$12.40 - \$13.25	572,720	5.35	\$ 12.82	572,720	\$ 12.82
\$13.38 - \$14.13	786,500	3.40	\$ 14.07	786,500	\$ 14.07
\$14.40 - \$15.24	559,580	5.22	\$ 15.10	559,580	\$ 15.10
\$15.25 - \$17.00	648,277	5.20	\$ 16.24	648,277	\$ 16.24
\$17.88 - \$26.25	757,900	3.66	\$ 21.03	757,900	\$ 21.03
\$27.50 - \$53.94	374,250	2.42	\$ 46.74	374,250	\$ 46.74
\$ 0.50 - \$53.94	6,942,134	5.84	\$ 13.87	5,613,280	\$ 15.46

At December 31, 2006, 5,559,602 options were exercisable at a weighted average price of \$15.62.

At September 30, 2007, the aggregate intrinsic value of outstanding and exercisable stock options was \$5,527 and \$2,936, respectively. The aggregate intrinsic value is based on the Company's closing price of \$9.04 on September 28, 2007, which would have been received by the optionees had all of the options with exercise prices less than \$9.04 been exercised on that date.

*Restricted Stock and Performance Vesting Shares Activity*

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

	<b>Number of Shares</b>
<b>Three-months ended September 30, 2007:</b>	
Unvested balance, June 30, 2007	683,083
Granted	
Vested	(280)
Canceled	(50,080)
Unvested balance, September 30, 2007	632,723
<b>Nine-months ended September 30, 2007:</b>	
Unvested balance, December 31, 2006	444,032
Granted	309,490
Vested	(59,940)
Canceled	(60,859)
Unvested balance, September 30, 2007	632,723

**4. Segment Information**

*Geographic Information*

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

Revenue by geographic areas is as follows:

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
Domestic	\$ 22,902	\$ 22,508	\$ 64,641	\$ 63,815
International	4,230	4,225	16,701	15,018
<b>Total</b>	<b>\$ 27,132</b>	<b>\$ 26,733</b>	<b>\$ 81,342</b>	<b>\$ 78,833</b>

*Major Customers*

No single customer accounted for more than 10% of total revenue for the three- and nine-month periods ended September 30, 2007 and September 30, 2006, respectively.

**5. Commitments and Contingencies**

Beginning in September 2004, three purported class action lawsuits were filed in the U.S. District Court for the District of Oregon against the Company and certain of its current and former directors and officers on behalf of purchasers of the Company's securities during the period April 17, 2002 to July 28, 2004. These lawsuits were later consolidated into one action for all purposes. The amended complaint, which sought unspecified damages, asserted claims under the federal securities laws relating to the Company's restatement of its financial statements for 2003 and the first two quarters of 2004 and alleged that the Company issued false and misleading financial statements and issued misleading public statements about the Company's operations and prospects. On August 4, 2006, the court granted the Company's motion to dismiss the lawsuit with prejudice and entered judgment in the Company's favor. Plaintiffs have filed a notice of appeal in the Ninth Circuit Court of Appeals. The appeal was stayed pending the recent U.S. Supreme Court's determination in another case of issues relating to the Private Securities Litigation Reform Act, and briefing is scheduled to be completed by the end of the year. The Company anticipates oral argument and a decision in 2008. However, due to the inherent uncertainties of litigation, the Company cannot accurately predict the ultimate timing or outcome of the matter.

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

Beginning in May 2001, a number of substantially identical class action complaints alleging violations of the federal securities laws were filed in the United States District Court for the Southern District of New York naming approximately 300 companies, including Digimarc, certain of its officers

and directors, and certain underwriters of the Company's initial public offering as defendants. The complaints have since been consolidated into a single action, and a consolidated amended complaint was filed in April 2002. The amended complaint alleges, among other things, that the underwriters of the Company's initial public offering violated securities laws by failing to disclose certain alleged compensation arrangements (such as undisclosed commissions or stock stabilization practices) in the Company's initial public offering registration statement and by engaging in manipulative practices to artificially inflate the price of the Company's stock in the after-market subsequent to the Company's initial public offering. The Company and certain of its officers and directors are named in the amended complaint pursuant to Section 11 of the Securities Act of 1933, and Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 on the basis of an alleged failure to disclose the underwriters' alleged compensation arrangements and manipulative practices. The complaint seeks unspecified damages. The individual officer and director defendants entered into tolling agreements and, pursuant to a court order dated October 9, 2002, were dismissed from the litigation without prejudice. Furthermore, in July 2002, the Company and the other defendants in the consolidated cases filed motions to dismiss the amended complaint for failure to state a claim. The motion to dismiss claims under Section 11 was denied as to virtually all the defendants in the consolidated actions, including the Company. The claims against the Company under Section 10(b), however, were dismissed. In June 2003, a committee of the Company's board of directors conditionally approved a proposed partial settlement with the plaintiffs in this matter. In June 2004, an agreement of settlement was submitted to the court for preliminary approval. The settlement would have provided, among other things, a release of the Company and of the individual defendants for the alleged wrongful conduct in the amended complaint in exchange for a guarantee from the Company's insurers regarding recovery from the underwriter defendants and other consideration from the Company regarding its underwriters, including agreeing to assign away, not assert, or release certain potential claims the Company may have against its underwriters. The plaintiffs have continued to litigate against the underwriter defendants. The district court directed that the litigation proceed within a number of "focus cases" rather than in all of the 310 cases that have been consolidated. The Company's case is not one of these focus cases. On October 13, 2004, the district court certified the focus cases as class actions. The underwriter defendants appealed that ruling, and on December 5, 2006, the Court of Appeals for the Second Circuit reversed the district court's class certification decision. On April 6, 2007, the Second Circuit denied plaintiffs' petition for rehearing. In light of the Second Circuit opinion, the Company has informed the district court that this settlement cannot be approved because the defined settlement class, like the litigation class, cannot be certified. The Company cannot predict whether the Company will be able to renegotiate a settlement that complies with the Second Circuit's mandate. Due to the inherent uncertainties of litigation, the Company cannot accurately predict the ultimate outcome of the matter.

On October 10, 2007, a shareholder of the Company filed a lawsuit in the United States District Court for the Western District of Washington against several companies that acted as lead underwriters on the initial public offering of the Company. The complaint, which also named the Company as a nominal defendant but did not assert any claims against the Company, asserted claims against the underwriters under Section 16(b) of the Securities Exchange Act of 1934 for recovery of alleged short-swing profits on trades of the Company's stock.

The Company's contracts for driver license and other identification issuance systems and their related products typically include provisions imposing (i) development, delivery and installation schedules and milestones, (ii) customer acceptance and testing requirements and (iii) other performance requirements. Such provisions are common in large scale government contracts at the state and federal levels. To the extent these provisions involve performance over extended periods of time, there may be increased risk of noncompliance. The Company from time to time experiences delays in identification system implementation, timely acceptance for identification systems programs, concerns regarding identification system program performance, and other contractual disputes. Customers have asserted from time to time, and may in the future assert, claims for compensatory or liquidated damages or breach of contract, or other claims alleging that the Company has failed to meet timing or other delivery requirements and milestones pursuant to the terms of such contracts. Management believes that these assertions are often part of the resolution process involving commercial disagreements over the terms of these contracts. Such disputes are not uncommon and tend to be resolved over time. However, the Company's failure to meet contractual milestones or other performance requirements as promised, or to successfully resolve customer disputes, could result in the Company incurring liability for damages, as well as increased costs, lower margins, or compensatory obligations in addition to other losses, such as harm to the Company's reputation. Such circumstances could have a material adverse effect on the Company's business and financial results. The Company anticipates that future contracts will continue to have such provisions unless and until industry practices change.

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

A significant portion of the Company's business depends on a limited number of large, public-sector contracts, which are generally subject to termination for convenience, as determined by the subject agency, or for lack of budgetary appropriation provided for the subject agency. Some government contracts also may be one-time events, such as in the case of some personal identification systems in non-U.S. markets involving voter registration programs. In such cases, the Company may generate substantial revenue that may not be subject to future renewal. Further, the Company may face competitive bids for a number of the Company's major accounts in 2007 and 2008. Moreover, government contracts result from purchasing decisions made by public sector agencies that may be subject to political influence, unusual procurement procedures, strict legal requirements, budget changes and cutbacks during economic downturns, variations in appropriations cycles, and protests of contract awards.

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Certain of the Company's product license and services agreements include an indemnification provision for claims from third parties relating to the Company's intellectual property. Such indemnification provisions are accounted for in accordance with SFAS No. 5, *Accounting for Contingencies*. To date, there have been no law suits filed or amounts payable under such indemnification provisions, but from time to time, in the normal course of business, potential claims may be raised with and reviewed by the Company.

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, 2007, the final disposition of these proceedings will not have a material adverse effect on the consolidated financial position, results of operations, or liquidity of the Company. No accrual has been recorded because the amounts are not probable or reasonably estimatable in accordance with SFAS No. 5, *Accounting for Contingencies*.

A portion of the Company's revenue each year is generated from licensing of technology. In the competitive environment in which the Company operates, product generation, development and marketing processes relating to technology are uncertain and complex, requiring accurate prediction of demand as well as successful management of various development risks inherent in technology development. In light of these dependencies, it is possible that failure to successfully manage future changes in technology with respect to the Company's technology could have a long-term impact on the Company's growth and results of operations.

### *Performance Bonds*

Some governmental authorities require performance bonds that the Company is obligated to maintain during the life of the contract. Often, the terms of these bonds require that the Company obtain letters of credit to secure the Company's obligations under the bonds. The letters of credit may in turn require us to maintain large restricted cash reserves as security, reducing the Company's ability to use these funds for the Company's other business purposes. Even with the availability of such cash reserve guarantees, the Company may not be able to obtain such performance bond underwriting at a favorable rate or at all. The Company's failure to be able to provide such performance bonds may preclude us from bidding on new government contracts or maintaining the Company's existing contracts for their full terms. In addition, these performance bonds may provide for security interests covering the Company's receivables or other assets, which could cause additional financing to be more difficult or more expensive to obtain. The size, nature and purpose of, and the risks and uncertainties associated with, public sector contracts can potentially cause the Company's quarterly results to fluctuate and anticipated revenue to decrease significantly.

## **6. Recent Accounting Pronouncements**

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value. This statement does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify

the source of the information. SFAS No. 157 is effective for first fiscal year beginning after November 15, 2007. The Company is currently assessing the potential impact that adoption of this standard will have on the Company's financial statements.

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

## **7. Revenue Recognition**

The Company's revenue is comprised of service revenue from its government-issued credentials systems and related maintenance, installation and system integration services as well as product and subscription revenue, including 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 SEC SAB No. 104 *"Revenue Recognition"*, 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,"* SOP 81-1 *"Accounting for the Performance of Construction Type and Certain Production-Type Contracts,"* and Emerging Issues Task Force ("EITF") Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables*.

Certain customer arrangements encompass multiple deliverables, such as software, hardware sales, consumables sales, maintenance fees, and software development fees. The Company accounts for these arrangements in accordance with EITF Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables*. If the deliverables meet the criteria in EITF Issue No. 00-21, the deliverables are divided into separate units of accounting and revenue is allocated to the deliverables based on their relative fair values. The criteria specified in EITF Issue No. 00-21 are as follows (i) the delivered item has value to the customer on a stand-alone basis, (ii) there is objective and reliable evidence of the fair value of the undelivered item, and (iii) if the arrangement includes a general right of return relative to the delivered item, delivery or performance of the undelivered item is considered probable and substantially in the control of the vendor. For 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 EITF Issue No. 00-21, including value allocation among multiple deliverables, determination of whether undelivered elements are essential to the functionality of delivered elements and timing of revenue recognition, among others.

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

arrangement fee and the amount deferred for the undelivered elements is recognized as revenue related to the delivered elements.

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

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

Revenue related to an enhancement of, or upgrade to, an existing system is generally deferred and recognized over the remaining life of the contract. However, if VSOE can be established for the delivered items and title passes to those items and all obligations are completed, then the Company recognizes revenue at acceptance.

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

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

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

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.



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

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

Revenue earned which has not been invoiced is classified as unbilled trade receivables, which is included in the balance of trade accounts receivable, net in the consolidated balance sheets. Billing for services rendered generally occurs within one month following when the services are provided.

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

### 8. Trade Accounts Receivable

Trade accounts receivable are recorded at the invoiced amount and do not bear interest. Revenue earned that has not been invoiced is classified as unbilled trade receivables in the consolidated balance sheets.

	September 30, 2007	December 31, 2006
Billed trade receivables	\$ 8,175	\$ 8,990
Unbilled trade receivables	6,379	5,599
Trade accounts receivable	14,554	14,589
Allowance for doubtful accounts	(187)	(186)
Trade accounts receivable, net	\$ 14,367	\$ 14,403

Trade accounts receivable, net includes \$1,152 at September 30, 2007 and \$2,195 at December 31, 2006 of deferred revenue, billed in accordance with the provisions of the contracts with the Company's customers.

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. The Company does not have an off-balance sheet credit exposure related to its customers.

*Major Customers*

No single customer accounted for more than 10% of the Company's trade and unbilled accounts receivable, net at September 30, 2007 and at December 31, 2006.

**9. Inventory**

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

	<b>September 30, 2007</b>	<b>December 31, 2006</b>
Equipment and deferred contract costs	\$ 1,424	\$ 1,046
Consumable materials	4,714	5,654
<b>Inventory</b>	<b>6,138</b>	<b>6,700</b>
Reserve for slow moving and obsolete items	(146)	(100)
<b>Inventory, net</b>	<b>\$ 5,992</b>	<b>\$ 6,600</b>

While the Company does not currently expect to be able to sell or otherwise use the reserved inventory on hand based upon the Company's forecast and backlog, it is possible that a customer or customers will decide in the future to purchase a portion of the reserved inventory.

**10. Income Taxes**

*Provision for Income Taxes.* The provision for income taxes reflects expected tax expense in certain foreign jurisdictions. The Company has recorded a full valuation allowance against the Company's domestic net deferred tax assets at September 30, 2007 due to the uncertainty of realization of the Company's domestic net operating losses. The Company has recorded a foreign deferred tax asset of \$169 at September 30, 2007 that it believes is more likely than not to be realized. The Company will continue to evaluate the realizability of the Company's domestic and other foreign net deferred tax assets and may record additional benefits in future earnings if the Company determines the realization of these assets is more likely than not.

The Company adopted the provisions of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes - an Interpretation of FASB Statement 109* ("FIN 48"), on January 1, 2007. The Company's consolidated financial statements for 2007 reflect the impact of FIN 48, but the consolidated financial statements for 2006 have not been restated to reflect, and do not include, the impact of FIN 48.

As a result of the implementation of FIN 48, the Company recognized a \$145 reduction in the Company's net liability for uncertain tax positions previously recorded, which was accounted for as an adjustment to the January 1, 2007 retained earnings balance. As part of the FIN 48 implementation,

the Company adopted a policy to record accrued interest and penalties associated with uncertain tax positions in income tax expense in the accompanying consolidated statements of operations. On initial adoption of FIN 48, the Company recognized an additional \$52 of accrued interest and penalties associated with uncertain tax positions in prior years, which reduced the overall adjustment to the January 1, 2007 retained earnings.

A summary reconciliation of the Company's uncertain tax positions is listed below:

Beginning balance at January 1, 2007	\$ 289
Additions for tax positions of prior years (interest and penalties)	52
Reductions for net tax positions of prior years	(197)
	<hr/>
Revised balance at January 1, 2007	\$ 144
	<hr/>

The Company's tax years for its foreign jurisdictions are subject to review for up to seven years after filing tax returns. Federal, state and foreign loss carryforwards and credits can generally be adjusted by taxing authorities at any time in the future. The entire amount of the uncertain tax positions if recognized would affect the effective tax rate.

#### 11. Software Development Costs

Under SFAS No. 86, *Accounting for the Cost of Computer Software to Be Sold, Leased, or Otherwise Marketed*, software development costs are to be capitalized beginning when a product's technological feasibility has been established and ending when a product is made available for general release to customers. To date, the establishment of technological feasibility of the Company's products has occurred shortly before general release and, therefore, software development costs qualifying for capitalization have been immaterial. Accordingly, the Company has not capitalized any software development costs and has charged all such costs to research and development expense.

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

#### 12. Related Party Transactions

During the three- and nine-month periods ended September 30, 2007, the Company recognized revenue of \$157 and \$611, respectively, from a holder of common stock pursuant to a license agreement. In addition the Company recognized revenue of \$168 and \$413 for the three- and nine-month periods ended September 30, 2006, respectively, from this stockholder. Net accounts receivable from this customer were \$19 at September 30, 2007 and \$329 at December 31, 2006. Deferred revenue from this customer was \$138 at September 30, 2007 and \$288 at December 31, 2006.

**13. Quarterly Selected Financial Information**

The following table shows the quarterly reported numbers.

Quarter ended:	March 31	June 30	September 30	December 31
<b>2007</b>				
Total revenue	\$ 26,846	\$ 27,364	\$ 27,132	
Total cost of revenue	16,815	17,077	16,367	
Gross profit	10,031	10,287	10,765	
Sales and marketing	4,277	4,365	4,103	
Research, development and engineering	2,042	1,883	1,691	
General and administrative	4,098	3,809	3,724	
Amortization of intangibles	500	509	451	
Intellectual property	499	476	429	
Restructuring charges, net				
Operating income (loss)	(1,385)	(755)	367	
Net income (loss)	(1,022)	(495)	772	
Net income (loss) per share basic	(0.05)	(0.02)	0.04	
Net income (loss) per share diluted	(0.05)	(0.02)	0.04	
<b>2006</b>				
Total revenue	\$ 27,193	\$ 24,907	\$ 26,733	\$ 25,414
Total cost of revenue	19,648	16,677	16,719	15,725
Gross profit	7,545	8,230	10,014	9,689
Sales and marketing	4,539	4,685	3,440	3,691
Research, development and engineering	3,236	2,994	2,158	1,881
General and administrative	5,210	4,172	3,684	4,418
Amortization of intangibles	573	550	537	511
Intellectual property	431	481	460	402
Restructuring charges, net		547		
Operating income (loss)	(6,444)	(5,199)	(265)	(1,214)
Net income (loss)	(6,172)	(4,869)	213	(912)
Net income (loss) per share basic	(0.30)	(0.24)	0.01	(0.04)
Net income (loss) per share diluted	(0.30)	(0.24)	0.01	(0.04)

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

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

*The following discussion should be read in conjunction with our consolidated financial statements and the related notes and other financial information appearing elsewhere in this Form 10-Q. Readers are also urged to carefully review and consider the various disclosures made by us which attempt to advise interested parties of the factors which affect our business, including without limitation the disclosures made in Part II, Item 1A (Risk Factors) of this Form 10-Q and in the audited consolidated financial statements and related notes included in our Annual Report on Form 10-K for the year ended December 31, 2006, filed on March 8, 2007, and other reports and filings made with the Securities and Exchange Commission ("SEC").*

**Overview**

Digimarc ("Digimarc," "the Company," "our" or "we") is a supplier of secure identification documents ("IDs") and digital watermarking technology for use in media management. Our secure ID solutions enable governments and businesses around the world to enhance traffic safety and national security, combat identity theft and fraud and facilitate the effectiveness of voter identification programs. We are also a pioneer and leading owner of intellectual property in a signal processing technology innovation known as "digital watermarking," which allows imperceptible digital information to be embedded in all forms of digitally designed, produced or distributed media content, including personal identification documents, financial instruments, photographs, movies, music, television and product packages. The embedded data within various types of media content can be detected and read by software or hardware detectors in personal computers and other digital devices.

The majority of our revenue is generated pursuant to long-term contracts (normally five or more years) with government agencies primarily state government agencies responsible for driver license issuance, a consortium of central banks, and national governments of foreign countries. These customers rely on our expertise in systems design, integration and materials science, and proprietary technologies such as digital watermarking, to implement issuance systems and processes that improve the security of identity documents and banknotes. The remainder of our revenue is generated through commercial applications of our digital watermarking and related technologies, primarily from patent and technology license fees paid by business partners.

*Secure ID Solutions*

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

In North America, most of our revenue is generated through the issuance of state driver licenses and other IDs and is paid in the form of a fixed price per credential issued. In North America, we are generally a prime contractor, providing full issuance systems to federal, state, and provincial departments of motor vehicles or other government issuing authorities. These systems typically include hardware (including specialized cameras, printers, personal computers and servers), software, consumable supplies (such as ribbons, blank or preprinted card materials and laminated and related consumables) and ongoing support services. These systems may also involve software and/or hardware development, integration services, and implementation services. When we provide a full issuance system

to a customer, we generally retain title to all equipment, software and consumables associated with the system and are responsible for maintaining the system over the contractual period.

In the United States, Federal legislation, such as the federal legislation passed in May 2005 known as the REAL ID Act (the "REAL ID Act") imposes certain federal requirements for State-issued driver licenses. These requirements will increase the security of driver licenses, require validation of applicants prior to issuance, and mandate certain changes in business processes relating to security and the sharing and storage of data.

The Company's strategy regarding the anticipated opportunities relating to the REAL ID Act is to provide solutions that embody the key elements of the REAL ID Act: identity verification; document scanning and archiving; individual background checking; data and image sharing; and migration to and production of REAL ID Act compliant driver license documents. These solutions are available to customers as upgrades or complete issuance systems. Digimarc will also offer the States program management assistance to safely migrate to REAL ID Act compliance.

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

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

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

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

*Depreciation.* Starting January 1, 2006, we changed our policy for depreciating fixed assets that were specifically used to provide services under long-term contracts to the shorter of the original contract term plus 2.75 years or estimated useful life. Through December 31, 2005, we depreciated these assets over the shorter of the original contract term or estimated useful life. This change in estimate was supported by an analysis we completed during the first quarter of 2006 which showed that historically 95% of contracts were extended beyond the original contract term, that the average contract had at least two contract extensions during its life and that these extensions added on average 2.75 years to the length of the contracts' original terms.

Since contract-specific program assets are tracked on a contract basis, the finding that contracts are routinely extended beyond the original term and that these extensions are not generally accompanied by significant incremental capital investment indicates that the useful life of contract-related assets is generally longer than the original term of the contract. Given these findings, we concluded that it was appropriate to change the estimated useful lives of these assets for purposes of depreciation. In addition, the change in useful lives achieves a better matching of the utility of these assets with the resulting revenues. For the year ended December 31, 2006, we performed an updated analysis on contract specific assets which resulted in no change to our previous conclusions. We will continue to analyze the useful lives of contract specific assets in future periods.

#### *Backlog*

Based on projected government-issued credential production volumes and other commitments we have for the periods under contract with our respective customers, we anticipate our current contracts as of September 30, 2007 will generate approximately \$215 million in revenue during the contractual terms of such contracts, currently up to seven years. We expect more than \$20 million of this amount to be recognized as revenue during the remainder of 2007. This amount includes production volumes reasonably expected to be achieved under currently effective contracts and government orders that are firm but not yet funded.

Some factors that lead to increased backlog are:

- competitive bid wins,
- renewals with current customers,
- add-on sales to current customers, and
- contracts with longer contractual periods replacing contracts with shorter contractual periods.

Some factors that lead to decreased backlog are:

- recognition of revenue associated with backlog currently in place,
- low bid activity,
- contracts with shorter contractual periods replacing contracts with longer contractual periods, and
- the revenue model utilized for a particular customer (e.g., a "price-per-card" model with a large associated backlog vs. a "hardware and consumables" model with a small associated backlog).

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

Over the next few years, we anticipate several States to request bids on their driver license issuance system programs. This period of expected high bid activity could lead to additional backlog if we are successful with our bids. Another factor that could affect backlog in this period is the revenue model utilized for a particular customer. From time to time, we have sales to our customers that are





not made on a price-per-card basis, but instead include hardware and consumable sales. Although these types of revenue models are positive growth indicators for our business, they can lead to lower reported backlog.

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

#### *Restructuring*

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

#### **Additional Information**

A more detailed discussion of our business is contained in our Annual Report on Form 10-K for the fiscal year ended December 31, 2006.

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

The preparation of consolidated financial statements in accordance with accounting principles generally accepted in the United States of America requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate our estimates, including those related to bad debts, inventories, intangible assets, income taxes, restructuring, long-term service contracts, warranties, investments, contingencies and litigation, and inputs related to stock-based compensation calculations. We base our estimates on historical experience and on various other assumptions we believe to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions.

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

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

estimation through our approval and monitoring processes related to accounting estimates. We also evaluate contracts for multiple elements and account for these items under the appropriate accounting literature.

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

**Impairments and estimation of useful lives of long-lived assets:** We periodically assess long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable, in accordance with the provisions of Statement of Financial Accounting Standards ("SFAS") No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. This statement requires that long-lived assets and certain identifiable intangibles be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future net undiscounted cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Fair value is determined based on discounted cash flows or appraised values, depending on the nature of the asset. Also, we periodically review the useful lives of long-lived assets whenever events or changes in circumstances indicate that the useful life may have changed. If the estimated useful lives of such assets do change, we adjust the depreciation or amortization period to a shorter or longer period, based on the circumstances identified.

**Inventory valuation:** Inventory consists primarily of consumable supplies that are used in the production of driver licenses and products held for resale to customers. We value inventory at the lower of cost or market value (which lower amount is the net realizable value). We reduce the value of our inventory for estimated obsolescence or unmarketable inventory equal to the difference between the cost of inventory and the estimated market value based upon assumptions about future demand and market conditions. If actual market conditions are less favorable than those projected by management, additional inventory write-downs may be required.

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

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

reasonably possible, we will disclose the nature of the contingency and provide an estimate of the possible loss or range of loss, or state that such an estimate cannot be made.

**Stock-Based Compensation:** We account for stock-based compensation in accordance with SFAS 123(R), *Share-Based Payment (Revised 2004)*, which requires the measurement and recognition of compensation for all stock-based awards made to employees and directors including stock options and employee stock purchases under a stock purchase plan based on estimated fair values. We use the Black-Scholes option pricing model as our method of valuation for stock options and employee stock purchases. Our determination of the fair value of these 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 these stock-based awards is determined in accordance with SFAS 123(R), the Black-Scholes option pricing model requires the input of highly subjective assumptions, and other reasonable assumptions could provide differing results. The fair value of restricted stock awards granted is based on the fair market value of the Company's common stock on the date of the grant (measurement date), and is being recognized over the vesting period of the related restricted stock using the straight-line method. The fair value of performance vesting share awards granted is based on a Monte Carlo valuation model that resulted in a factor applied to the fair market value of the Company's common stock on the date of the grant (measurement date), and is being recognized over the derived service period using the straight-line method.

**Results of Operations**

The following table presents our consolidated statements of operations data for the periods indicated as a percentage of total revenue. Unless otherwise indicated, all references to the three and nine-month periods relate to the three- and nine-month periods ended September 30, 2007 and all changes discussed with respect to such period reflect changes as compared to the three- and nine-month periods ended September 30, 2006.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
<b>Revenue:</b>				
Service	87%	84%	83%	83%
Product and subscription	13	16	17	17
Total revenue	100	100	100	100
<b>Cost of revenue:</b>				
Service	56	57	55	60
Product and subscription	4	6	7	7
Total cost of revenue	60	63	62	67
Gross profit	40	37	38	33
<b>Operating expenses:</b>				
Sales and marketing	15	13	15	16
Research, development and engineering	6	8	7	11
General and administrative	14	13	14	16
Amortization of intangibles	2	2	2	2
Intellectual property	2	2	2	2
Restructuring charges, net	0	0	0	1
Total operating expenses	39	38	40	48
Operating income (loss)	1	(1)	(2)	(15)
<b>Other income (expense):</b>				
Interest income	1	1	1	1
Interest expense	0	0	0	0
Other	1	1	0	0
Total other income, net	2	2	1	1
Income (loss) before provision for income taxes	3	1	(1)	(14)
Provision for income taxes	0	0	0	0
Net income (loss)	3%	1%	(1)%	(14)%

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Revenue

	Three Months Ended September 30,		Dollar Increase (Decrease)	Percent Increase (Decrease)	Nine Months Ended September 30,		Dollar Increase (Decrease)	Percent Increase (Decrease)
	2007	2006			2007	2006		
(in 000's)								
<b>Revenue:</b>								
Service	\$ 23,625	\$ 22,414	\$ 1,211	5%	\$ 67,462	\$ 65,223	\$ 2,239	3%
Product and subscription	3,507	4,319	(812)	(19)%	13,880	13,610	270	2%
<b>Total</b>	<b>\$ 27,132</b>	<b>\$ 26,733</b>	<b>\$ 399</b>	<b>1%</b>	<b>\$ 81,342</b>	<b>\$ 78,833</b>	<b>\$ 2,509</b>	<b>3%</b>
<b>Revenue (as % of total revenue):</b>								
Service	87%	84%			83%	83%		
Product and subscription	13%	16%			17%	17%		
<b>Total</b>	<b>100%</b>	<b>100%</b>			<b>100%</b>	<b>100%</b>		

*Service.* Service revenue consists primarily of:

card production on a price-per-card basis,

software development services, and

hardware and software maintenance.

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

Service revenue increased for the three-month period ended September 30, 2007, as compared to the corresponding three-month period ended September 30, 2006, primarily due to increased service revenue from our Mexico operation, higher production revenues in our Canada operations from the implementation of services to additional provinces under our Atlantic Canada contract which was signed in 2006 and higher revenues from certain states that changed their driver license renewal periods. Offsetting these increases were lower revenues due to a combination of price and volume mix from various states.

The increase in service revenue for the nine-month period ended September 30, 2007, as compared to the corresponding nine-month period ended September 30, 2006, was due primarily to increased project work from the consortium of central banks, increased revenue following the hiatus in our Mexico plant and the commencement of services to additional provinces under our Atlantic Canada contract. These increases were offset by lower production volumes from Haiti's one-time voter identification project completed in the first quarter of fiscal year 2006, lower revenue from Latvia as a result of a non-recurring transaction in 2006, and lower revenues from various states from a combination of price and volume mix.

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

Product and subscription revenue decreased for the three-month period ended September 30, 2007, as compared to the corresponding three-month period ended September 30, 2006, primarily due to lower revenue from the United Kingdom contract which ended in the second

quarter, and decreased

sales in a couple of domestic and international markets that occur from time to time. These decreases were offset by a non-recurring sale to one of our African customers and additional payments from certain cash basis customers.

The increase in product and subscription revenue for the nine-month period ended September 30, 2007, as compared to the corresponding nine-month period ended September 30, 2006, was due primarily to additional payments from certain cash basis customers and a net increase in non-recurring sales to various domestic and international customers.

Revenue by Geography

	Three Months Ended September 30,		Dollar Increase (Decrease)	Percent Increase (Decrease)	Nine Months Ended September 30,		Dollar Increase (Decrease)	Percent Increase (Decrease)
	2007	2006			2007	2006		
(in 000's)								
Revenue by geography:								
Domestic	\$ 22,902	\$ 22,508	\$ 394	2%	\$ 64,641	\$ 63,815	\$ 826	1%
International	4,230	4,225	5	<1%	16,701	15,018	1,683	11%
Total	\$ 27,132	\$ 26,733	\$ 399	1%	\$ 81,342	\$ 78,833	\$ 2,509	3%
Revenue (as % of total revenue):								
Domestic	84%	84%			79%	81%		
International	16%	16%			21%	19%		
Total	100%	100%			100%	100%		

The increase in domestic revenue for the three-month period ended September 30, 2007, as compared to the corresponding three-month period ended September 30, 2006, was due primarily to increased payments from certain cash basis customers and higher revenues from certain states that changed their driver license renewal periods. Offsetting these increases was a decreased sale to a domestic customer that occurs from time to time.

The increase in domestic revenue for the nine-month period ended September 30, 2007, as compared to the corresponding nine-month period ended September 30, 2006, was due primarily to increased payments from certain cash basis customers and increased project work from the consortium of central banks. These increases were offset by lower revenues from a combination of price and volume mix from various states.

The slight increase in international revenue for the three-month period ended September 30, 2007, as compared to the corresponding three-month period ended September 30, 2006, was due primarily to increased revenue from our operation in Mexico following a hiatus there during the 2006 national elections, increased production revenues in Canada and increased product sales to an African customer. Offsetting these increases were lower revenue from the United Kingdom contract ending in the second quarter and decreased sale from a international customer that occur from time to time.

The increase in international revenue for the nine-month period ended September 30, 2007, as compared to the corresponding nine-month period ended September 30, 2006, was due primarily to increased revenue from our operation in Mexico following a hiatus there during the 2006 national elections, increased production revenues in Canada and increased product sales to Ghana. These increases were offset by lower production volumes as a result of Haiti's one-time voter identification project which ended in fiscal year 2006 and lower revenue from Latvia due to a non-recurring transaction in fiscal year 2006.

Cost of Revenue

	Three Months Ended September 30,		Dollar Increase (Decrease)	Percent Increase (Decrease)	Nine Months Ended September 30,		Dollar Increase (Decrease)	Percent Increase (Decrease)
	2007	2006			2007	2006		
(in 000's)								
Cost of Revenue:								
Service	\$ 15,160	\$ 15,138	\$ 22	<1%	\$ 44,964	\$ 47,239	\$ (2,275)	(5)%
Product and subscription	1,207	1,581	(374)	(24)%	5,295	5,805	(510)	(9)%
Total	\$ 16,367	\$ 16,719	\$ (352)	(2)%	\$ 50,259	\$ 53,044	\$ (2,785)	(5)%
Cost of Revenue (as % of related revenue components):								
Service	64%	68%			67%	72%		
Product and subscription	34%	37%			38%	43%		

Service. Cost of service revenue primarily includes:

costs of consumables used in delivering a service,

compensation for software developers, quality assurance personnel, product managers, field operations personnel, and outside contractors,

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

deployment costs used specifically for service delivery,

provisions for obsolete and excess inventories,

travel costs directly attributable to service and development contracts,

stock-based compensation expense, and

charges for infrastructure and centralized costs.

Cost of service revenue remained relatively constant for the three-month period ended September 30, 2007, as compared to the corresponding three-month period ended September 30, 2006. The lower cost as a percentage of revenues in 2007 is primarily attributable to improved yields in the manufacturing process related to new supplies and equipment.

Cost of service revenue decreased for the nine-month period ended September 30, 2007, as compared to the corresponding nine-month period ended September 30, 2006, primarily due to:



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decreased employee compensation-related expenses of \$2.3 million as part of the restructuring initiative,

decreased contract and temporary labor of \$0.5 million as part of the cost cutting initiative under which a number of contractors were terminated or converted to employees at lower average costs,

decreased costs of approximately \$0.6 million related to resource allocations (for example, in 2006 resources were allocated to projects that were of an operating expense nature and in 2007 resources were allocated to capital projects), offset by

increased depreciation expense of \$0.6 million related to programs completed in the 2nd half of 2006 or in fiscal year 2007, and

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increased allocated infrastructure and centralized costs of \$0.4 million primarily due to the redeployment of resources to program activities as part of our restructuring initiative during the prior year.

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

Cost of product and subscription revenue decreased for the three-month period ended September 30, 2007, as compared to the corresponding three-month period ended September 30, 2006, primarily due to lower material costs relating to the United Kingdom contract ending in the second quarter.

Cost of product and subscription revenue slightly decreased for the nine-month period ended September 30, 2007, as compared to the corresponding nine-month period ended September 30, 2006, primarily due to lower material costs of \$0.8 million related to consumable sales, offset by higher hardware costs to African customers.

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

### Cost of Revenue Components

	<u>Three Months Ended</u> <u>September 30,</u>		<u>Dollar</u> <u>Increase</u> <u>(Decrease)</u>	<u>Percent</u> <u>Increase</u> <u>(Decrease)</u>	<u>Nine Months Ended</u> <u>September 30,</u>		<u>Dollar</u> <u>Increase</u> <u>(Decrease)</u>	<u>Percent</u> <u>Increase</u> <u>(Decrease)</u>
	<u>2007</u>	<u>2006</u>			<u>2007</u>	<u>2006</u>		
(in 000's)								
Cost of revenue:								
Variable	\$ 7,275	\$ 7,295	\$ (20)	(<1)%	\$ 22,657	\$ 22,066	\$ 591	3%
Fixed field support and manufacturing	6,102	6,754	(652)	(10)%	19,127	23,092	(3,965)	(17)%
Program depreciation	2,990	2,670	320	12%	8,475	7,886	589	7%
<b>Total</b>	<b>\$ 16,367</b>	<b>\$ 16,719</b>	<b>\$ (352)</b>	<b>(2)%</b>	<b>\$ 50,259</b>	<b>\$ 53,044</b>	<b>\$ (2,785)</b>	<b>(5)%</b>
Cost of revenue (as % of total revenue):								
Variable	27%	28%			28%	28%		
Fixed field support and manufacturing	22%	25%			24%	29%		
Program depreciation	11%	10%			10%	10%		
<b>Total</b>	<b>60%</b>	<b>63%</b>			<b>62%</b>	<b>67%</b>		

*Variable.* Variable costs include:

the price of materials to produce an identification card,

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

other costs that are variable in nature.

The slight decrease in variable costs for the three-month period ended September 30, 2007, as compared to the corresponding three-month period ended September 30, 2006, was primarily due to improved manufacturing yields. Offsetting the increased margins were increased material costs in Mexico related to increased revenues and higher material costs for the non-recurring sale to an African customer.

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The increase in variable costs for the nine-month period ended September 30, 2007, as compared to the corresponding nine-month period ended September 30, 2006, was primarily due to higher

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material and hardware costs to African customers, offset by improved margins on sales to certain customers related to improved yields in the manufacturing process.

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

field operations and support costs,

manufacturing costs, and

supply chain costs.

The decrease in support costs for the three- and nine-month periods ended September 30, 2007, as compared to the three- and nine-month periods ended September 30, 2006, was primarily due to the costs associated with our focus on improving certain programs during the three- and nine-month periods ended September 30, 2006. As a result of these actions, fewer expenditures were capitalized to the balance sheet and fixed support costs increased. After improving the efficiencies in these programs, our fixed costs returned to more normal levels.

*Program depreciation.* Program depreciation primarily consists of amortization and depreciation of costs incurred during the delivery process, where such costs are capitalized and then amortized or depreciated over the useful lives of the assets to which the costs relate.

The increase in program depreciation for the three- and nine-month periods ended September 30, 2007, as compared to the three- and nine-month periods ended September 30, 2006, was primarily due to delivery of new and upgrade programs, including under the Atlantic Canada contract and to Indiana and Oregon.

### *Gross Profit*

	<b>Three Months Ended September 30,</b>		<b>Dollar Increase (Decrease)</b>	<b>Percent Increase (Decrease)</b>	<b>Nine Months Ended September 30,</b>		<b>Dollar Increase (Decrease)</b>	<b>Percent Increase (Decrease)</b>
	<b>2007</b>	<b>2006</b>			<b>2007</b>	<b>2006</b>		
(in 000's)								
<b>Gross Profit:</b>								
Service	\$ 8,465	\$ 7,276	\$ 1,189	16%	\$ 22,498	\$ 17,984	\$ 4,514	25%
Product and subscription	2,300	2,738	(438)	(16)%	8,585	7,805	780	10%
<b>Total</b>	<b>\$ 10,765</b>	<b>\$ 10,014</b>	<b>\$ 751</b>	<b>8%</b>	<b>\$ 31,083</b>	<b>\$ 25,789</b>	<b>\$ 5,294</b>	<b>21%</b>
<b>Gross Profit (as % of related revenue components):</b>								
Service	36%	32%			33%	28%		
Product and subscription	66%	63%			62%	57%		
<b>Total</b>	<b>40%</b>	<b>37%</b>			<b>38%</b>	<b>33%</b>		

The changes in gross profit as a percentage of revenue, for both the revenue components and overall gross profit, for the three- and nine-month periods September 30, 2007, as compared to the three- and nine-month periods ended September 30, 2006, was primarily due to commensurate changes in revenues and costs of revenues, as described above.

Operating Expenses

Sales and marketing

	Three Months Ended September 30,		Dollar Increase (Decrease)	Percent Increase (Decrease)	Nine Months Ended September 30,		Dollar Increase (Decrease)	Percent Increase (Decrease)
	2007	2006			2007	2006		
	(in 000's)							
Sales and marketing	\$ 4,103	\$ 3,440	\$ 663	19%	\$ 12,745	\$ 12,664	\$ 81	<1%
Sales and marketing (as % of total revenue)	15%	13%			15%	16%		

Sales and marketing expenses consist primarily of:

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

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

stock-based compensation expense, and

charges for infrastructure and centralized costs.

The increase in sales and marketing expense for the three-month period ended September 30, 2007, as compared to the corresponding three-month period ended September 30, 2006, resulted primarily from:

increased professional fees and marketing costs of \$0.2 million in connection with business initiatives relating to the REAL ID Act, and

increased sales and marketing expenses of \$0.3 million due to increased bid activity.

The slight increase in sales and marketing expense for the nine-month period ended September 30, 2007, as compared to the corresponding nine-month period ended September 30, 2006, resulted primarily from:

increased professional fees and marketing costs of \$0.5 million in connection with business initiatives relating to the REAL ID Act,

increased sales and marketing expenses of \$0.3 million due to increased bid activity, offset by

decreased employee compensation-related expenses of \$0.5 million due to a reduction in headcount as part of the restructuring initiative that was accelerated in the second quarter of 2006.

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

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*Research, development and engineering*

	Three Months Ended September 30,		Dollar Increase (Decrease)	Percent Increase (Decrease)	Nine Months Ended September 30,		Dollar Increase (Decrease)	Percent Increase (Decrease)
	2007	2006			2007	2006		
	(in 000's)							
Research, development and engineering	\$ 1,691	\$ 2,158	\$ (467)	(22)%	\$ 5,616	\$ 8,388	\$ (2,772)	(33)%
Research, development and engineering (as % of total revenue)	6%	8%			7%	11%		

Research, development and engineering expenses consist primarily of:

compensation, benefits and related costs of software developers and quality assurance personnel

payments to outside contractors,

the purchase of materials and services for product development, primarily in the card systems area,

stock-based compensation expense, and

charges for infrastructure and centralized costs.

The decrease for the three-month period ended September 30, 2007, as compared to the corresponding three-month period ended September 30, 2006, resulted primarily from:

increased research, development and engineering costs of \$1.0 million capitalized to various programs, resulting in lower operating expenses, offset by

increased research, development and engineering general and administrative expenses of \$0.3 million.

The decrease for the nine-month period ended September 30, 2007, as compared to the corresponding nine-month period ended September 30, 2006, resulted primarily from:

lower headcount and increased research, development and engineering costs capitalized to various programs, resulting in lower operating expenses.

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

*General and administrative*

	Three Months Ended September 30,	Dollar Increase (Decrease)	Percent Increase (Decrease)	Nine Months Ended September 30,	Dollar Increase (Decrease)	Percent Increase (Decrease)
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	Three Months Ended September 30, 2007			Nine Months Ended September 30, 2007		
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(in 000's)

General and administrative	\$ 3,724	\$ 3,684	\$ 40	1%	\$ 11,631	\$ 13,066	\$ (1,435)	(11)%
General and administrative (as % of total revenue)	14%	13%			14%	16%		

General and administrative expenses consist primarily of:

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

legal, human resources and other professional fees,

stock-based compensation expense, and

charges for infrastructure and centralized costs.

The slight increase for the three-month period ended September 30, 2007, as compared to the corresponding three-month period ended September 30, 2006, resulted primarily from increased audit, tax and consulting fees of \$0.1 million for expense reduction initiatives and strategic planning due to timing.

The decrease for the nine-month period ended September 30, 2007, as compared to the corresponding nine-month period ended September 30, 2006, resulted primarily from decreased audit, consulting and legal fees of \$1.1 million due to improved efficiencies in our operations, including less reliance on outside consultants.

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

*Amortization of intangible assets*

	Three Months Ended September 30,		Dollar Increase (Decrease)	Percent Increase (Decrease)	Nine Months Ended September 30,		Dollar Increase (Decrease)	Percent Increase (Decrease)
	2007	2006			2007	2006		
	(in 000's)							
Amortization of intangibles	\$ 451	\$ 537	\$ (86)	(16)%	\$ 1,460	\$ 1,660	\$ (200)	(12)%
Amortization of intangibles (as % of total revenue)	2%	2%			2%	2%		

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

The slight decrease in amortization of intangible assets for the three- and nine-month periods ended September 30, 2007, as compared to the corresponding three- and nine-month periods ended September 30, 2006, resulted primarily from extended amortization periods from contract extensions with several domestic customers and the impact of reaching full amortization of values associated with the United Kingdom contract during the second quarter of 2007.



*Intellectual property*

	Three Months Ended September 30,		Dollar Increase (Decrease)	Percent Increase (Decrease)	Nine Months Ended September 30,		Dollar Increase (Decrease)	Percent Increase (Decrease)
	2007	2006			2007	2006		
	(in 000's)							
Intellectual property	\$ 429	\$ 460	\$ (31)	(7)%	\$ 1,404	\$ 1,372	\$ 32	2%
Intellectual property (as % of total revenue)	2%	2%			2%	2%		

Intellectual property costs primarily consist of:

employee-related expenses, such as salaries, benefits, recruiting costs, and incentive plans,

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

stock-based compensation expense, and

charges for infrastructure and centralized costs.

Intellectual property costs remained relatively consistent for the three- and nine-month periods ended September 30, 2007, as compared to the corresponding three- and nine-month periods ended September 30, 2006.

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

*Restructuring charges, net.*

	Nine Months Ended September 30, 2006
	(in 000's)
Cost of revenue	\$ 159
Sales and marketing	93
Research, development and engineering	248
General and administrative	47
<b>Total</b>	<b>\$ 547</b>

During the second quarter of 2006, we accelerated productivity improvement initiatives and significantly reduced fixed costs in order to facilitate our effort to achieve profitability. The reduction in fixed costs included reduction of our workforce by nearly 20% since the beginning of 2006. The restructuring charge for the nine-month period ended September 30, 2006 totaled \$547, primarily due to employee severance and related costs. These restructuring charges were allocated out of the departments as noted above.

*Stock-based compensation.* Stock-based compensation includes expense charges for all stock-based awards to employees and directors. Such awards include option grants, restricted stock awards, performance vesting shares and shares expected to be purchased under an employee stock purchase plan. We account for stock-based compensation in accordance with SFAS No. 123(R), *Share-Based Payment (Revised 2004)*, which requires the measurement and recognition of compensation for all stock-based awards made to employees and directors including stock options and employee stock purchases under a stock purchase plan based on estimated fair values. SFAS 123(R) supersedes previous accounting



*Employees*, for periods beginning in fiscal 2006. In March 2005, the SEC issued Staff Accounting Bulletin No. 107 relating to application of SFAS 123(R). The Company has applied the provisions of Staff Accounting Bulletin ("SAB") 107 in our adoption of SFAS 123(R).

The Company adopted SFAS 123(R) using the modified prospective transition method, which requires the application of the accounting standard as of January 1, 2006, the first day of our 2006 fiscal year. In accordance with the modified prospective transition method, the Company's consolidated financial statements for periods prior to fiscal year 2006 have not been restated to reflect this change. Stock-based compensation recognized in the three- and nine-month periods ended September 30, 2007 and 2006 is based on the value of the portion of the stock-based award that will vest during the period, adjusted for expected forfeitures. Stock-based compensation recognized in the Company's consolidated financial statements in the three- and nine-month periods ended September 30, 2007 and 2006 includes compensation cost for stock-based awards granted prior to, but not fully vested as of, December 31, 2005 and stock-based awards granted subsequent to December 31, 2005. The compensation cost for awards granted prior to January 1, 2006 is based on the grant date fair value estimated in accordance with the pro forma provisions of SFAS 123 while awards granted on or after January 1, 2006 follow the provisions of SFAS 123(R) to determine the grant date fair value and compensation cost. Compensation cost for all stock-based awards is recognized using the straight-line method.

Upon adoption of SFAS 123(R), the Company continued to use 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 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. The value of restricted stock and performance vesting share awards is based on the fair market value of the Company's common stock on the date of the grant (measurement date) and a Monte Carlo valuation model that results in a factor applied to the fair market value of the Company's common stock on the date of the grant, respectively. Although the fair value of stock-based awards is determined in accordance with SFAS 123(R) and SAB 107, the pricing models require the input of highly subjective assumptions, and other reasonable assumptions could provide differing results.

Stock-based compensation expense was recorded in the respective statement of operations expense categories for the employees to which it applies, as set forth in the table below:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
	(in 000's)			
Cost of revenue	\$ 114	\$ 76	\$ 329	\$ 214
Sales and marketing	65	117	457	373
Research, development and engineering	103	71	276	261
General and administrative	598	434	1,805	1,408
Intellectual property	15	9	40	27
Total	\$ 895	\$ 707	\$ 2,907	\$ 2,283

The increase in stock-based compensation expense was primarily due to an additional layer of stock-based awards being expensed pursuant to SFAS 123(R). The decrease for the three-month period ended September 30, 2007, as compared to the corresponding three-month period ended September 30, 2006, in sales and marketing resulted primarily from the departure of an executive officer during the quarter and the forfeiture of the related restricted stock and performance vesting share awards.

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We anticipate incurring an additional \$8.0 million in stock-based compensation expense through fiscal 2011 for awards outstanding as of September 30, 2007. The future effect of the adoption of this statement on our financial position and results of operations will be determined by stock-based awards granted in future periods and the assumptions on which the value of those stock-based awards is based. Our tax accounting may also be affected by actual exercise behavior and the relative market prices at exercise.

*Total other income, net.* Total other income, net consists primarily of interest received and paid. Total other income, net was \$0.5 and \$1.3 million for the three- and nine-month periods ended September 30, 2007, respectively, compared to \$0.5 and \$1.2 million for the three- and nine-month periods ended September 30, 2006.

*Provision for Income Taxes.* The provision for income taxes reflects expected tax expense from profitability in certain foreign jurisdictions. We have recorded a full valuation allowance against domestic net deferred tax assets at September 30, 2007 due to the uncertainty of realization of the Company's net domestic operating losses. We recorded a \$169 foreign deferred tax asset as of September 30, 2007 that we believe is more likely than not to be recognized in the future. We will continue to evaluate the realizability of our domestic and foreign net deferred tax assets in future periods and may recognize income tax benefits in future earnings if we determine the realization of these assets is more likely than not.

### Liquidity and Capital Resources

As of September 30, 2007, we had cash and cash equivalents, restricted cash, and short-term investments of \$32.6 million, representing a decrease of approximately \$0.5 million from \$33.1 million at December 31, 2006. The decrease primarily resulted from increased capital investments, including the deployment of fixed assets for the implementation of new programs, offset by higher collections of customer receivable balances as compared to receivable balances in the December quarter. As of September 30, 2007, \$9.6 million of cash and cash equivalents is restricted as a result of the requirements of performance bonds that we are obligated to maintain in connection with some of our long-term contracts in our personal identification systems business. Working capital at September 30, 2007 increased to \$32.3 million, compared to working capital of \$29.9 million at December 31, 2006.

The \$13.4 million of cash provided by operations for the nine-months period ended September 30, 2007 compares favorably to the \$3.7 million of cash provided by operations for the nine-months ended September 30, 2006. The components of operating cash flows were:

	<b>Nine Months Ended September 30,</b>	
	<b>2007</b>	<b>2006</b>
	<b>(in 000's)</b>	
Net loss	\$ (745)	\$ (10,828)
Non-cash items	14,826	13,419
Changes in operating assets and liabilities	(713)	1,087
Net cash provided by (used in) operating activities	\$ 13,368	\$ 3,678

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

an increase in depreciation and amortization from \$11.6 million to \$11.9 million primarily related to delivery of new programs to customers in the later half of 2006 or implemented during the quarter ended March 31, 2007, and

an increase in stock-based compensation expense from \$2.3 million to \$2.9 million primarily related to an additional layer of stock-based awards being expensed pursuant to SFAS 123(R).

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The major changes in the operating assets and liabilities for the nine-month period ended September 30, 2007 primarily related to:

a decrease in accounts payable of \$1.6, million reflecting lower operating expenses,

a decrease in accrued payroll and related costs of \$1.9 million, reflecting payment of accrued benefits related to the prior year, offset by

an increase in deferred revenue of \$2.2 million resulting from advanced billings and cash collected on future revenues.

The major changes in operating assets and liabilities for the nine-month period ended September 30, 2006 primarily related to:

an increase in deferred revenue of \$2.3 million related to increased backlog of future revenues, and

decreases of \$0.9 million in accounts receivable and \$1.4 million in inventory, net, reflecting improved asset management while increasing revenues, offset by

an increase in restricted cash of \$2.7 million associated with renewals of our performance bonds for our major state programs, and

a decrease in accounts payable of \$1.9, million reflecting lower level of operating expenses and inventory during 2006.

The \$18.7 million of cash used in investing activities for the nine-month period ended September 30, 2007 primarily related to \$3.8 million in net purchase of short-term investment activities and \$14.9 million for the purchase of property and equipment related to new customer contracts, including capitalization of labor costs of \$3.9 million.

The \$7.2 million of cash used in investing activities for the nine-month period ended September 30, 2006 primarily related to \$0.3 million in net purchase of short-term investment activities and \$6.9 million for the purchase of property and equipment related to new customer contracts, including capitalization of labor costs of \$2.6 million.

The \$1.4 million of cash provided by financing activities for the nine-month period ended September 30, 2007 resulted primarily from the net issuance of stock of \$1.9 million, offset by principal payments on capital leases of \$0.5 million.

The \$0.2 million of cash used in financing activities for the nine-month period ended September 30, 2006 resulted primarily from the principal payments on capital leases, partially offset by the proceeds from the issuance of stock.

Our significant commitments consist of obligations under non-cancelable operating leases, which totaled \$6.5 million as of September 30, 2007, and are payable in monthly installments through August 2011. Our obligations under non-cancelable capital leases, which totaled \$1.7 million as of September 30, 2007, are payable in monthly installments through May 2011.

Many of our secure identity management contracts have significant capital requirements. The general industry model for supplying driver license issuance systems to state driver license issuers is for the system supplier to develop and install the issuance system using the supplier's capital and to charge the customer on a per-card issued basis. As a result, during times of substantial competitive wins and/or substantial system upgrades, the Company may experience significant working capital needs that may exceed cash flow from operations. To date, the Company has relied upon cash reserves to fund such expenditures.

We have driver license contracts with various states that are not yet fully deployed and we have pending add-on and upgrade orders. In order to complete these contracts and pending orders, we estimate we will incur approximately \$6 million of expenditures through 2008. The estimates are derived from information known to us as of September 30, 2007, the time the estimates were prepared. Actual expenditures may vary from our estimates. We anticipate that these expenditures will be recouped through receipts from the related long-term price-per-card agreements and from the value of the add-on and upgrade orders we have received.

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

We believe that our current cash, cash equivalents, and short-term investment balances will satisfy our projected working capital and capital expenditure requirements for at least the next 12 months. Thereafter, we anticipate continuing to use cash, cash equivalents, and short-term investment balances to satisfy our projected working capital and capital expenditure requirements. However, in the event that we were to win contracts requiring significant capital investment, we may need to seek additional financing.

In order to take advantage of opportunities, we may find it necessary to obtain additional equity financing, debt financing, or credit facilities, although at this time we believe that our long-term working capital is sufficient to cover our foreseeable capital expenditures. If it were necessary to obtain additional financings or credit facilities, we may not be able to do so, or if these funds are available, they may not be available on satisfactory terms.

#### **Off-Balance Sheet Arrangements**

We do not have any off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on our financial condition, changes in financial condition, revenue or expenses, results of operations, liquidity, capital expenditures or capital resources that are material to our business.

#### **Recent Accounting Pronouncements**

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

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

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

Because this Report on Form 10-Q contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, any of the risk factors set forth in Part II, Item 1A or elsewhere in this Report on Form 10-Q or incorporated herein by reference could cause our actual

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results to differ materially from those results projected or suggested in such forward-looking statements. Statements that are not historical facts are hereby identified as "forward-looking statements" for the purposes of the safe harbor provided by Section 21E of the Securities Exchange Act of 1934 and Section 27A of the Securities Act of 1933. Such forward-looking statements include but are not limited to statements relating to:

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

our future level of investment in our business, including investment in development of products and technology, acquisition of new customers and development of new market opportunities;

our ability to improve margins;

anticipated expenses, costs, margins and investment activities in the foreseeable future;

anticipated revenue to be generated from current contracts and as a result of new programs;

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

our profitability in future periods;

business opportunities that could require that we seek additional financing;

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

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

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

the source of our future revenue;

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

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

our use of cash in upcoming quarters;

anticipated levels of backlog and bid activity in future periods;

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

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

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



should not be considered a complete statement of all potential risks and uncertainties. We do not intend to update any forward-looking statements as a result of future events or developments.

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

The market risk disclosures as set forth in Item 7A of our Annual Report on Form 10-K for the year ended December 31, 2006 have not changed materially.

**Item 4. Controls and Procedures.**

**Evaluation of Disclosure Controls and Procedures**

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

**Changes in Internal Controls**

There were no significant changes to the internal controls over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) of the Exchange Act) that occurred during the third quarter ended September 30, 2007 that would materially affect, or are reasonably likely to materially affect, the internal control over financial reporting.

**PART II. OTHER INFORMATION.**

**Item 1. Legal Proceedings.**

Beginning in September 2004, three purported class action lawsuits were filed in the U.S. District Court for the District of Oregon against the Company and certain of its current and former directors and officers on behalf of purchasers of the Company's securities during the period April 17, 2002 to July 28, 2004. These lawsuits were later consolidated into one action for all purposes. The amended complaint, which sought unspecified damages, asserted claims under the federal securities laws relating to the Company's restatement of its financial statements for 2003 and the first two quarters of 2004 and alleged that the Company issued false and misleading financial statements and issued misleading public statements about the Company's operations and prospects. On August 4, 2006, the court granted the Company's motion to dismiss the lawsuit with prejudice and entered judgment in the Company's favor. Plaintiffs have filed a notice of appeal in the Ninth Circuit Court of Appeals. The appeal was stayed pending the recent U.S. Supreme Court's determination in another case of issues relating to the Private Securities Litigation Reform Act, and briefing is scheduled to be completed by the end of the year. The Company anticipates oral argument and a decision in 2008. However, due to the inherent uncertainties of litigation, the Company cannot accurately predict the ultimate timing or outcome of the matter.

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

Beginning in May 2001, a number of substantially identical class action complaints alleging violations of the federal securities laws were filed in the United States District Court for the Southern District of New York naming approximately 300 companies, including Digimarc, certain of its officers and directors, and certain underwriters of the Company's initial public offering as defendants. The complaints have since been consolidated into a single action, and a consolidated amended complaint was filed in April 2002. The amended complaint alleges, among other things, that the underwriters of the Company's initial public offering violated securities laws by failing to disclose certain alleged compensation arrangements (such as undisclosed commissions or stock stabilization practices) in the Company's initial public offering registration statement and by engaging in manipulative practices to artificially inflate the price of the Company's stock in the after-market subsequent to the Company's initial public offering. The Company and certain of its officers and directors are named in the amended complaint pursuant to Section 11 of the Securities Act of 1933, and Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 on the basis of an alleged failure to disclose the underwriters'

alleged compensation arrangements and manipulative practices. The complaint seeks unspecified damages. The individual officer and director defendants entered into tolling agreements and, pursuant to a court order dated October 9, 2002, were dismissed from the litigation without prejudice. Furthermore, in July 2002, the Company and the other defendants in the consolidated cases filed motions to dismiss the amended complaint for failure to state a claim. The motion to dismiss claims under Section 11 was denied as to virtually all the defendants in the consolidated actions, including the Company. The claims against the Company under Section 10(b), however, were dismissed. In June 2003, a committee of the Company's board of directors conditionally approved a proposed partial settlement with the plaintiffs in this matter. In June 2004, an agreement of settlement was submitted to the court for preliminary approval. The settlement would have provided, among other things, a release of the Company and of the individual defendants for the alleged wrongful conduct in the amended complaint in exchange for a guarantee from the Company's insurers regarding recovery from the underwriter defendants and other consideration from the Company regarding its underwriters, including agreeing to assign away, not assert, or release certain potential claims the Company may have against its underwriters. The plaintiffs have continued to litigate against the underwriter defendants. The district court directed that the litigation proceed within a number of "focus cases" rather than in all of the 310 cases that have been consolidated. The Company's case is not one of these focus cases. On October 13, 2004, the district court certified the focus cases as class actions. The underwriter defendants appealed that ruling, and on December 5, 2006, the Court of Appeals for the Second Circuit reversed the district court's class certification decision. On April 6, 2007, the Second Circuit denied plaintiffs' petition for rehearing. In light of the Second Circuit opinion, the Company has informed the district court that this settlement cannot be approved because the defined settlement class, like the litigation class, cannot be certified. Settlement and procedural discussions continue in the matter. The Company cannot predict whether the Company will be able to renegotiate a settlement that complies with the Second Circuit's mandate. Due to the inherent uncertainties of litigation, the Company cannot accurately predict the ultimate outcome of the matter.

On October 10, 2007, a shareholder of the Company filed a lawsuit in the United States District Court for the Western District of Washington against several companies that acted as lead underwriters on the initial public offering of the Company. The complaint, which also named the Company as a nominal defendant but did not assert any claims against the Company, asserted claims against the underwriters under Section 16(b) of the Securities Exchange Act of 1934 for recovery of alleged short-swing profits on trades of the Company's stock.

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 other matters cannot be determined, management believes that, as of September 30, 2007, the final disposition of these proceedings will not have a material adverse effect on the Company's consolidated financial position, results of operations, or liquidity.

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

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

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

Except for the year 2003, we have incurred significant net losses from inception. Our accumulated deficit as of September 30, 2007 was \$100.3 million. In the second half of 2005 and continuing through 2006, we restructured our operations to improve productivity and reduce fixed costs. During the second quarter of 2006, we accelerated those activities significantly, resulting in a reduction of our workforce by nearly 20%. Overall, our workforce has been reduced by 30% since mid 2005. These actions resulted

in an increase in earnings to a near break even level in the second half of 2006. However, in order to achieve sustained profitability, we will need to generate higher revenue than we have in prior years while controlling expenditures. Achieving sustained profitability will depend upon a variety of factors, including the impact of financial accounting mandates requiring us to expense stock options, as well as the extent to which we may be required to increase the size of our workforce in order to execute our business strategy and capitalize on new opportunities. In addition, we evaluate our strategy and market opportunities on an ongoing basis and will adjust our approach to market conditions that prevail from time to time. Finally, various adverse developments including the loss of large contracts or cost overruns on our existing contracts could have a negative impact on our revenue or our margins. Accordingly, increases in our expenses may not be offset by revenue increases and as a result we may not be able to achieve or sustain profitability.

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

Contracts between government agencies and Digimarc have varying duration, generally five or more years in length. Some contracts we enter into contain cancellation clauses. In addition, after a contract period expires, generally the government agency can re-open the contract for competitive bidding. We anticipate that several of our significant customers will award new contracts through such a competitive bidding process during the coming quarters. If we were to lose a contract due to cancellation or in a competitive bidding situation, then, in addition to the loss of revenue and margin on a prospective basis, we could also incur impairment of capital and/or intangible assets related to the customer, which could adversely affect our financial results.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Due to the high level of technical expertise that our industry requires, our ability to successfully develop, market, sell, license and support our products, services, and intellectual property depends to a significant degree upon the continued contributions of our key personnel in engineering, sales, marketing, operations, legal and licensing, many of whom would be difficult to replace. Similarly, without the continued contributions of our key finance personnel, we believe that our ability to meet our reporting obligations and operate successfully as a public company may be limited. We believe our future success will depend in large part upon our ability to retain our current key employees and our ability to attract, integrate and retain such personnel in the future. It may not be practical for us to match the compensation certain of our employees could garner at other employment. In addition, we may encounter difficulties in hiring and retaining employees because of concerns related to our financial performance. In addition, these circumstances may have a negative effect on the market price of our common stock, and employees and prospective employees may factor in the uncertainties

relating to our stability and the value of any equity-based incentives in their decisions regarding employment opportunities and decide to leave our employ. In addition, our business is based in part on patented technology, which is unique and not generally known. New employees require substantial training, involving significant resources and management attention. Competition for experienced personnel in our business can be intense. If we do not succeed in attracting new, qualified personnel or in integrating, retaining and motivating our current personnel, our growth and ability to deliver products and services that our customers require may be hampered. Although our employees generally have executed agreements containing non-competition clauses, there is no assurance that a court would enforce all of the terms of these clauses or the clauses generally. If these clauses were not fully enforced, our employees could be able to freely join our competitors. Although we generally attempt to control access to and distribution of our proprietary information by our employees, there are no assurances that the confidential nature of our proprietary information will be maintained in the course of such future employment. Any of these events could have a material adverse effect on our financial and business prospects.

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

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

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

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

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

Our future success will depend in part on our ability to enhance and improve the responsiveness, functionality and features of our products and services in accordance with regulatory or industry

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

Our market is characterized by new and evolving technologies. The success of our business will depend on our ability to develop and integrate new technologies effectively and address the increasingly sophisticated technological needs of our customers in a timely and cost-effective manner. Our ability to remain competitive will depend in part on our ability to:

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

continue to develop our technical expertise; and

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

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

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

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

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

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

delays in project implementation;

failure to achieve add-on sales to existing customers;

governmental regulation of credentials and issuance policies;

private sector usage trends for driver licenses and other credentials;

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

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

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

variations in costs of materials and manufacturing;



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

seasonality of issuance volumes;

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

sales mix related to domestic sales compared to international sales;

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

strategic decisions on new business;

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

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

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

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

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

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

Our business and strategy rely, in part, on deployment of our digital watermark reader technology by third-party software developers and original equipment manufacturers. For example, one form of our digital watermark reader is commonly deployed in image editing applications to permit users of these products to read watermarks embedded in imagery, and thereby discern the identities of image owners. Another form of our digital watermark reader is used in our anti-counterfeiting product offerings. If third parties who include our technologies in their products cease to do so, or we fail to obtain other partners that will incorporate, embed, integrate or bundle our technologies, or these partners are unsuccessful in their efforts, our efforts to expand deployment of our technologies would be adversely affected and, consequently, our ability to increase revenues would be adversely affected and we may suffer other adverse effects to our business. In addition, if our technologies do not perform according to market expectations, our future sales would suffer as customers seek other providers.

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

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

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

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

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

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

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

changes in foreign government regulations and security requirements;

export license requirements, tariffs and taxes;

trade barriers;

difficulty in protecting intellectual property;

difficulty in collecting accounts receivable;

currency fluctuations;

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

difficulty in managing foreign operations; and

political and economic instability.

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

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

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

Our contracts for driver license and other identification issuance systems and related products typically include terms relating to time-based performance, development and delivery schedules, customer acceptance and testing, and other performance milestones. Because procedures often require compliance over extended periods of time, they give rise to an increased risk that we may fail to meet timing or other delivery requirements and milestones pursuant to the terms of such contracts. If we fail to meet such requirements or milestones, customers may assert against us compensatory or liquidated damages, breach of contract, or other claims. Consequently, our failure to meet contractual milestones or other performance requirements as promised could result in our having to incur increased costs, lower margins, or compensatory obligations, in addition to other losses, such as harm to our reputation. Such unexpected increases in costs to meet our contractual obligations or any other requirements necessary to address claims and damages with regard to our customer contracts could have a material adverse effect on our business and financial results. We anticipate that future contracts will continue to have such provisions.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

We currently are engaged in litigation relating to the initial public offering of our securities, in addition to the actions filed against us in connection with our previously announced accounting errors. These matters are discussed in greater detail in Part II, Item 1 (Legal Proceedings) of this Quarterly Report on Form 10-Q and in Note 5 (Commitments and Contingencies) of the Notes to Consolidated Financial Statements included in this Quarterly Report on Form 10-Q. We have incurred significant costs relating to these matters. Due to the inherent uncertainties of such litigation, the ultimate cost and outcome cannot be predicted.

*If a judgment were to be entered against the Company and our director and officer liability insurance was inadequate or unavailable, the obligation to pay the judgment may materially harm our business and financial condition.*

Our director and officer liability insurance policies provide protection against certain liabilities relating to the securities class action and derivative lawsuits against us and certain of our officers and directors up to prescribed policy limits. If these policies do not adequately cover expenses and certain liabilities relating to these lawsuits, our financial condition could be materially harmed. In addition, if this insurance coverage becomes unavailable to us or premiums increase significantly in the future, it could make it more difficult for us to retain and attract officers and directors and could expose us to potentially self-funding certain future liabilities ordinarily mitigated by director and officer liability insurance.

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

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

#### **Item 6. Exhibits.**

See attached exhibit index.





**EXHIBIT INDEX**

<b>Exhibit Number</b>	<b>Document</b>
3.1	Second Amended and Restated Certificate of Incorporation of the Registrant, as amended (incorporated by reference to Exhibit 3.1 of Exhibits to the Registrant's Annual Report on Form 10-K, as filed with the Securities and Exchange Commission on March 13, 2006)
3.2	Amended and Restated Bylaws of the Registrant (incorporated by reference to Exhibit 3.3 of Exhibits to Registrant's Quarterly Report on Form 10-Q, as filed with the Securities and Exchange Commission on August 9, 2005)
31.1	Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer
31.2	Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer
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