

Digimarc CORP
Form 10-Q
October 31, 2013
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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, 2013

OR

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

For the transition period from to

Commission File Number: 001-34108

DIGIMARC CORPORATION

(Exact name of registrant as specified in its charter)

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Oregon
(State or other jurisdiction of
incorporation or organization)

26-2828185
(I.R.S. Employer
Identification No.)

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

(503) 469-4800
(Registrant's telephone number, including area code)

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

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

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

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

As of October 21, 2013, there were 7,289,288 shares of the registrant's common stock, par value \$0.001 per share, outstanding.

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

| | September 30, 2013 | December 31, 2012 |
|--|-----------------------|----------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 5,079 | \$ 6,866 |
| Marketable securities | 27,935 | 25,403 |
| Trade accounts receivable, net | 5,117 | 4,216 |
| Other current assets | 1,507 | 1,016 |
| Total current assets | 39,638 | 37,501 |
| Marketable securities | 5,097 | 6,787 |
| Property and equipment, net | 2,472 | 1,453 |
| Intangibles, net | 6,700 | 6,721 |
| Goodwill | 1,114 | 1,114 |
| Deferred tax assets, net | 3,217 | 3,589 |
| Other assets | 265 | 166 |
| Total assets | \$ 58,503 | \$ 57,331 |
| LIABILITIES AND SHAREHOLDERS EQUITY | | |
| Current liabilities: | | |
| Accounts payable and other accrued liabilities | \$ 1,482 | \$ 1,143 |
| Deferred revenue | 2,784 | 2,512 |
| Total current liabilities | 4,266 | 3,655 |
| Deferred rent and other long-term liabilities | 405 | 673 |
| Total liabilities | 4,671 | 4,328 |
| Commitments and contingencies (Note 13) | | |
| Shareholders' equity: | | |
| Preferred stock (par value \$0.001 per share, 2,500,000 authorized, 10,000 shares issued and outstanding at September 30, 2013 and December 31, 2012) | 50 | 50 |
| Common stock (par value \$0.001 per share, 50,000,000 authorized, 7,289,288 and 7,168,359 shares issued and outstanding at September 30, 2013 and December 31, 2012, respectively) | 7 | 7 |
| Additional paid-in capital | 42,320 | 39,869 |
| Retained earnings | 11,455 | 13,077 |
| Total shareholders' equity | 53,832 | 53,003 |
| Total liabilities and shareholders' equity | \$ 58,503 | \$ 57,331 |

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

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DIGIMARC CORPORATION
CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share data)

(UNAUDITED)

| | Three Months Ended September 30, 2013 | Three Months Ended September 30, 2012 | Nine Months Ended September 30, 2013 | Nine Months Ended September 30, 2012 |
|--|---|---|--|--|
| Revenue: | | | | |
| Service | \$ 3,030 | \$ 2,616 | \$ 8,981 | \$ 8,273 |
| Subscription | 1,424 | 327 | 4,241 | 922 |
| License | 2,971 | 5,960 | 14,916 | 25,866 |
| Total revenue | 7,425 | 8,903 | 28,138 | 35,061 |
| Cost of revenue: | | | | |
| Service | 1,232 | 1,362 | 4,067 | 4,544 |
| Subscription | 625 | 46 | 1,848 | 138 |
| License | 98 | 59 | 294 | 178 |
| Total cost of revenue | 1,955 | 1,467 | 6,209 | 4,860 |
| Gross profit | 5,470 | 7,436 | 21,929 | 30,201 |
| Operating expenses: | | | | |
| Sales and marketing | 1,482 | 937 | 4,322 | 2,914 |
| Research, development and engineering | 3,277 | 2,320 | 8,824 | 6,464 |
| General and administrative | 2,456 | 2,282 | 6,990 | 7,231 |
| Intellectual property | 278 | 309 | 816 | 919 |
| Total operating expenses | 7,493 | 5,848 | 20,952 | 17,528 |
| Operating income (loss) | (2,023) | 1,588 | 977 | 12,673 |
| Net loss from joint ventures | | | | (1,107) |
| Other income, net | 33 | 48 | 81 | 139 |
| Income (loss) before income taxes | (1,990) | 1,636 | 1,058 | 11,705 |
| (Provision) benefit for income taxes | 1,195 | (633) | (280) | (4,487) |
| Net income (loss) | \$ (795) | \$ 1,003 | \$ 778 | \$ 7,218 |
| Earnings (loss) per common share: | | | | |
| Earnings (loss) per common share basic | \$ (0.12) | \$ 0.14 | \$ 0.09 | \$ 1.02 |
| Earnings (loss) per common share diluted | \$ (0.12) | \$ 0.14 | \$ 0.09 | \$ 0.98 |
| Weighted average common shares outstanding basic | 6,860 | 6,761 | 6,850 | 6,745 |
| Weighted average common shares outstanding diluted | 6,860 | 6,984 | 7,080 | 6,997 |
| Cash dividends declared per common share | \$ 0.11 | \$ 0.11 | \$ 0.33 | \$ 0.22 |

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

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DIGIMARC CORPORATION
CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY

(In thousands, except share data)

(UNAUDITED)

| | Preferred Stock | | Common Stock | | Additional Paid-in Capital | Retained Earnings | Total Shareholders Equity |
|---|-----------------|--------|--------------|--------|----------------------------------|----------------------|---------------------------------|
| | Shares | Amount | Shares | Amount | | | |
| BALANCE AT DECEMBER 31, 2011 | 10,000 | \$ 50 | 7,008,031 | \$ 7 | \$ 34,511 | \$ 7,149 | \$ 41,717 |
| Exercise of stock options | | | 150,250 | | 1,448 | | 1,448 |
| Issuance of restricted common stock | | | 146,020 | | | | |
| Forfeiture of restricted common stock | | | (9,575) | | | | |
| Purchase and retirement of common stock | | | (158,103) | | (3,899) | | (3,899) |
| Stock-based compensation | | | | | 4,279 | | 4,279 |
| Tax benefit from stock-based awards | | | | | 1,801 | | 1,801 |
| Net income | | | | | | 7,218 | 7,218 |
| Cash dividends declared | | | | | | (1,561) | (1,561) |
| BALANCE AT SEPTEMBER 30, 2012 | 10,000 | \$ 50 | 7,136,623 | \$ 7 | \$ 38,140 | \$ 12,806 | \$ 51,003 |
| BALANCE AT DECEMBER 31, 2012 | 10,000 | \$ 50 | 7,168,359 | \$ 7 | \$ 39,869 | \$ 13,077 | \$ 53,003 |
| Exercise of stock options | | | 18,300 | | | | |
| Issuance of restricted common stock | | | 217,090 | | | | |
| Forfeiture of restricted common stock | | | (67,360) | | | | |
| Purchase and retirement of common stock | | | (47,101) | | (854) | | (854) |
| Stock-based compensation | | | | | 3,305 | | 3,305 |
| Net income | | | | | | 778 | 778 |
| Cash dividends declared | | | | | | (2,400) | (2,400) |
| BALANCE AT SEPTEMBER 30, 2013 | 10,000 | \$ 50 | 7,289,288 | \$ 7 | \$ 42,320 | \$ 11,455 | \$ 53,832 |

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

Table of Contents**DIGIMARC CORPORATION****CONSOLIDATED STATEMENTS OF CASH FLOWS****(In thousands)****(UNAUDITED)**

| | Nine Months Ended September 30, 2013 | Nine Months Ended September 30, 2012 |
|--|---|---|
| Cash flows from operating activities: | | |
| Net income | \$ 778 | \$ 7,218 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization of property and equipment | 513 | 444 |
| Amortization and write-off of intangibles | 931 | 213 |
| Gain on reversal of contingent merger consideration | (190) | |
| Stock-based compensation | 3,219 | 4,152 |
| Net loss from joint ventures | | 1,107 |
| Deferred income taxes | 354 | (77) |
| Tax benefit from stock-based awards | | 2,385 |
| Excess tax benefit from stock-based awards | | (1,801) |
| Increase in allowance for doubtful accounts | 22 | |
| Changes in operating assets and liabilities: | | |
| Trade accounts receivable, net | (923) | (128) |
| Other current assets | (577) | (45) |
| Other assets | (99) | 167 |
| Accounts payable and other accrued liabilities | 286 | (119) |
| Income taxes payable | 88 | 875 |
| Deferred revenue | 263 | (512) |
| Net cash provided by operating activities | 4,665 | 13,879 |
| Cash flows from investing activities: | | |
| Purchase of property and equipment | (1,532) | (376) |
| Capitalized patent costs and purchased intellectual property | (824) | (898) |
| Investments in joint ventures, net | | (692) |
| Sale or maturity of marketable securities | 47,344 | 117,680 |
| Purchase of marketable securities | (48,186) | (122,132) |
| Net cash used in investing activities | (3,198) | (6,418) |
| Cash flows from financing activities: | | |
| Issuance of common stock | | 1,448 |
| Purchase of common stock | (854) | (3,899) |
| Cash dividends paid | (2,400) | (1,561) |
| Excess tax benefit from stock-based awards | | 1,801 |
| Net cash used in financing activities | (3,254) | (2,211) |
| Net increase (decrease) in cash and cash equivalents | (1,787) | 5,250 |
| Cash and cash equivalents at beginning of period | 6,866 | 3,419 |

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| | | | | |
|--|----|-------|----|-------|
| Cash and cash equivalents at end of period | \$ | 5,079 | \$ | 8,669 |
| Supplemental disclosure of cash flow information: | | | | |
| Cash paid for income taxes | \$ | 46 | \$ | 1,260 |
| Supplemental schedule of non-cash investing activities: | | | | |
| Stock-based compensation capitalized to patent costs | \$ | 86 | \$ | 77 |
| Supplemental schedule of non-cash financing activities: | | | | |
| Exercise of stock options | \$ | 176 | \$ | 1,448 |

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

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DIGIMARC CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except share and per share data)

(UNAUDITED)

1. Description of Business and Significant Accounting Policies

Description of Business

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

Interim Consolidated Financial Statements

The Company has adhered to the accounting policies set forth in its Annual Report on Form 10-K for the year ended December 31, 2012 in preparing the accompanying interim consolidated financial statements.

The accompanying interim 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 note disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States (the U.S.) have been condensed or omitted in accordance with the rules and regulations of the Securities and Exchange Commission (SEC).

These interim 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, 2012, which was filed with the SEC on February 22, 2013. 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.

Reclassifications

Certain prior period amounts in the accompanying interim consolidated financial statements and notes thereto have been reclassified to conform to current period presentation. These reclassifications had no material effect on the results of operations or financial position for any period presented. The Company has historically combined license and subscription revenue on the consolidated statement of operations, but given the increase in subscription revenue in the current year, the Company is now presenting license revenue and subscription revenue separately.

Goodwill

The Company tests goodwill for impairment annually in June and whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Such reviews assess the fair value of the Company s assets compared to their carrying value.

The Company operates as one reporting unit. The Company estimated the fair value of its single reporting unit using a market approach. The market approach estimates fair value in part on market capitalization plus an estimated control premium.

In connection with the Company s annual impairment test of goodwill as of June 30, 2013, it was concluded that there was no impairment as the estimated fair value of the Company s reporting unit substantially exceeded the carrying value.

Recent Accounting Pronouncements

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In July 2013, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2013-11, *Income Taxes (Topic 740): Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Credit Carryforward Exists*. ASU No 2013-11 provides explicit guidance on the financial statement presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar tax loss, or a tax credit carry forward exists. The amendments in this update are effective for fiscal years and interim reporting periods beginning after December 15, 2013. Early adoption is permitted. The amendments should be applied prospectively for all unrecognized tax benefits that exist as of the effective date. Retrospective application is permitted. The Company does not expect the adoption of this standard to have a material impact on the Company's financial condition or results of operations.

Table of Contents**2. Fair Value of Financial Instruments**

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

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

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

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

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

The Company's fair value hierarchy for its cash equivalents and marketable securities as of September 30, 2013 and December 31, 2012, respectively, was as follows:

| September 30, 2013 | Level 1 | Level 2 | Level 3 | Total |
|----------------------------------|-----------------|------------------|----------------|------------------|
| Money market securities | \$ 4,352 | \$ | \$ | \$ 4,352 |
| U.S. federal agency notes | | 332 | | 332 |
| Pre-refunded municipal bonds (1) | | 30,106 | | 30,106 |
| Other municipal bonds | | 154 | | 154 |
| Corporate notes | | 2,440 | | 2,440 |
| Total | \$ 4,352 | \$ 33,032 | \$ | \$ 37,384 |
| | | | | |
| December 31, 2012 | Level 1 | Level 2 | Level 3 | Total |
| Money market securities | \$ 901 | \$ | \$ | \$ 901 |
| Certificates of deposits | | 491 | | 491 |
| U.S. treasuries | | 289 | | 289 |
| U.S. federal agency notes | | 1,637 | | 1,637 |
| Pre-refunded municipal bonds (1) | | 21,878 | | 21,878 |
| Other municipal bonds | | 158 | | 158 |
| Corporate notes | | 10,100 | | 10,100 |
| Commercial paper | | 2,614 | | 2,614 |
| Total | \$ 901 | \$ 37,167 | \$ | \$ 38,068 |

(1) Pre-refunded municipal bonds are collateralized by U.S. treasuries.

The fair value maturities of the Company's cash equivalents and marketable securities as of September 30, 2013 were as follows:

| | Maturities by Period | | | | |
|--|-----------------------------|-----------------------------|------------------|-------------------|-------------------------------|
| | Total | Less than 1 year | 1-5 years | 5-10 years | More than 10 years |
| Cash equivalents and marketable securities | \$ 37,384 | \$ 32,287 | \$ 5,097 | \$ | \$ |

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The Company considers all highly liquid marketable securities with original maturities of 90 days or less at the date of acquisition to be cash equivalents. Cash equivalents include mostly money market funds and pre-refunded municipal bonds totaling \$4,352 and \$5,878 at September 30, 2013 and December 31, 2012, respectively. Cash equivalents are carried at cost or amortized cost, which approximates fair value, due to their short maturities.

3. Acquisition of Contributor Corporation (Contributor)

The Company accounted for the acquisition of Contributor in December 2012 using the acquisition method of accounting. Under the acquisition method of accounting, the total purchase price was allocated to the tangible and identifiable intangible assets acquired and liabilities assumed based on their estimated fair values. The purchase price was allocated using the information available, pending the completion of the Company's review of the acquired tax assets and liabilities. This review was completed with the filing of the Contributor 2012 tax return in the third quarter and resulted in no changes to the purchase price allocation as disclosed in Note 4 of the audited consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2012.

The Company recorded a \$190 liability in the preliminary purchase price allocation reflecting the estimated fair value of the contingent merger consideration on the acquisition date, which was presented in deferred rent and other long-term liabilities at December 31, 2012. At March 31, 2013, the Company determined that the estimated fair value of the contingent merger consideration was \$0 based on the Company's most recent projections and therefore reversed the liability. As of September 30, 2013, the Company continued to believe the estimated fair value of the contingent merger consideration was \$0. The reversal of the \$190 liability is reflected as a reduction in general and administrative expense within the consolidated statements of operations for the nine-month period ended September 30, 2013.

4. Revenue Recognition

The Company derives its revenue primarily from development services, subscriptions and licensing of its patent portfolio:

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

Subscription revenue includes subscriptions for products and services, is generally recurring, paid in advance and recognized over the term of the subscription.

License revenue, including royalty revenue, originates primarily from licensing the Company's technology and patents where the Company receives royalties as its income stream.

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

- (i) persuasive evidence of an arrangement exists,
- (ii) delivery has occurred,
- (iii) the fee is fixed or determinable, and
- (iv) collection is reasonably assured.

Some customer arrangements encompass multiple deliverables, such as patent license, professional services, software subscriptions, and maintenance fees. For arrangements that include multiple deliverables, the Company identifies separate units of accounting at inception based on the consensus reached under ASC 605-25 *Multiple-Element Arrangements*, which provides that revenue arrangements with multiple deliverables

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should be divided into separate units of accounting if certain criteria are met. The consideration for the arrangement is allocated to the separate units of accounting using the relative selling price method.

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

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

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

Subscription revenue, which includes subscriptions for products and services, is generally paid in advance and recognized over the term of the subscription, which is generally one month to twenty-four months.

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

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

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

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

5. Segment Information

Geographic Information

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

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

| | Three Months Ended September 30, 2013 | Three Months Ended September 30, 2012 | Nine Months Ended September 30, 2013 | Nine Months Ended September 30, 2012 |
|------------------|--|--|---|---|
| Domestic | \$ 3,536 | \$ 5,830 | \$ 15,902 | \$ 24,923 |
| International(1) | 3,889 | 3,073 | 12,236 | 10,138 |
| Total | \$ 7,425 | \$ 8,903 | \$ 28,138 | \$ 35,061 |

(1) Revenue from the Central Banks, comprised of a consortium of central banks around the world, is classified as international revenue. Reporting revenue by country for this customer is not practicable.

Major Customers

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

| Three Months | Three Months | Nine Months | Nine Months |
|-------------------------|-------------------------|------------------------|------------------------|
|-------------------------|-------------------------|------------------------|------------------------|

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| | Ended September 30, 2013 | Ended September 30, 2012 | Ended September 30, 2013 | Ended September 30, 2012 |
|---------------------------------|--------------------------------|--------------------------------|--------------------------------|--------------------------------|
| Central Banks | 37% | 27% | 31% | 22% |
| The Nielsen Company (Nielsen) | 13% | 12% | 11% | * |
| Verance Corporation (Verance) | 12% | 11% | * | 31% |
| Intellectual Ventures (IV) | * | 40% | 27% | 29% |

* Less than 10%

On May 15, 2013, IV made the last quarterly payment of the license issuance fee related to the patent license agreement dated October 5, 2010. No profit sharing under the patent license agreement has been earned to date.

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

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6. Stock-Based Compensation

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

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

Determining Fair Value

Preferred Stock

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

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

Stock Options

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

Expected Life. The expected life of awards granted represents the period of time that they are expected to be outstanding. The Company determines the expected life based on historical experience with similar awards, giving consideration to the contractual terms, vesting schedules and pre-vesting and post-vesting forfeitures. Stock options granted generally vest over three to four years for employee grants and one to two years for director grants, and have contractual terms of ten years.

Expected Volatility. The Company estimates the volatility of its common stock at the date of grant based on the historical volatility of its common stock based on historical prices over the most recent period commensurate with the expected life of the award.

Risk-Free Interest Rate. The Company determines the risk-free interest rate using current U.S. treasury yields for bonds with a maturity commensurate with the expected life of the award.

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

There were no stock options granted during the three- or nine-month periods ended September 30, 2013 and 2012.

The Company records stock-based compensation expense for stock option awards only for those awards that are expected to vest.

Restricted Stock

The Compensation Committee of the Board of Directors has awarded restricted stock shares under the Company's 2008 Stock Incentive Plan to certain employees and directors. The shares subject to the restricted stock awards generally vest over three to four years for employees and one year for directors. Specific terms of the restricted stock awards are governed by Restricted Stock Agreements between the Company and the award recipients. Restricted stock awards are treated as outstanding when granted.

The fair value of restricted stock awarded 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 using the straight-line method.

The Company records stock-based compensation expense for restricted stock awards only for those awards that are expected to vest.

Table of Contents**Stock-based Compensation**

| | Three Months Ended September 30, 2013 | Three Months Ended September 30, 2012 | Nine Months Ended September 30, 2013 | Nine Months Ended September 30, 2012 |
|---|--|--|---|---|
| Stock-based compensation: | | | | |
| Cost of revenue | \$ 78 | \$ 141 | \$ 374 | \$ 479 |
| Sales and marketing | 103 | 98 | 298 | 331 |
| Research, development and engineering | 278 | 242 | 766 | 639 |
| General and administrative | 529 | 844 | 1,595 | 2,508 |
| Intellectual property | 62 | 70 | 186 | 195 |
| Stock-based compensation expense | 1,050 | 1,395 | 3,219 | 4,152 |
| Capitalized to patent costs | 22 | 27 | 86 | 77 |
| Total stock-based compensation | \$ 1,072 | \$ 1,422 | \$ 3,305 | \$ 4,229 |

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

| | As of September 30, 2013 | As of December 31, 2012 |
|--|---|--|
| Unrecognized compensation costs | \$ 8,409 | \$ 8,333 |

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

The Company expects to recognize the unrecognized compensation costs as of September 30, 2013 for stock options and restricted stock over a weighted average period through September 2017 as follows:

| | Stock Options | Restricted Stock |
|--------------------------------|--------------------------|-----------------------------|
| Weighted average period | 0.82 years | 1.23 years |

Stock Option Activity

As of September 30, 2013, under all of the Company's stock-based compensation plans, equity awards to purchase an additional 696,786 shares were authorized for future grants under the plans. The Company issues new shares upon option exercises.

The following table reconciles the outstanding balance of stock options:

| Three-months ended September 30, 2013: | Options | Weighted Average Exercise | Weighted Average Grant Date | Aggregate Intrinsic Value |
|---|----------------|--|--|--|
|---|----------------|--|--|--|

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| | | Price | Fair Value | |
|-----------------------------------|---------|--------------|-------------------|----------|
| Outstanding at June 30, 2013 | 842,688 | \$ 15.24 | \$ 7.90 | |
| Options granted | | | | |
| Options exercised | (5,000) | \$ 9.64 | \$ 6.30 | |
| Options canceled or expired | | | | |
| Outstanding at September 30, 2013 | 837,688 | \$ 15.28 | \$ 7.91 | \$ 5,766 |

| | | Weighted Average Exercise Price | Weighted Average Grant Date Fair Value | Aggregate Intrinsic Value |
|--|----------------|--|---|--|
| Nine-months ended September 30, 2013: | Options | | | |
| Outstanding at December 31, 2012 | 855,988 | \$ 15.16 | \$ 7.88 | |
| Options granted | | | | |
| Options exercised | (18,300) | \$ 9.64 | \$ 6.30 | |
| Options canceled or expired | | | | |
| Outstanding at September 30, 2013 | 837,688 | \$ 15.28 | \$ 7.91 | \$ 5,766 |
| Exercisable at September 30, 2013 | 742,135 | \$ 13.86 | | \$ 5,718 |

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| | | Weighted Average Exercise Price | Weighted Average Grant Date Fair Value | Aggregate Intrinsic Value |
|--|---------|--|---|---------------------------------|
| Nine-months ended September 30, 2013: | | | | |
| Unvested at September 30, 2013 | Options | \$ 26.26 | | \$ 48 |
| | 95,553 | | | |

The aggregate intrinsic value is based on the closing price of \$20.20 per share of Digimarc common stock on September 30, 2013, which would have been received by the optionees had all of the options with exercise prices less than \$20.20 per share been exercised on that date. The following table summarizes information about stock options outstanding at September 30, 2013:

| Range of Exercise Prices | Options Outstanding | | | Options Exercisable | | |
|--------------------------|-----------------------|---|--|-----------------------|--|--|
| | Number Outstanding | Remaining Contractual Life (Years) | Weighted Average Exercise Price | Number Exercisable | Remaining Contractual Life (Years) | Weighted Average Exercise Price |
| \$9.64 - \$9.91 | 489,772 | 5.11 | \$ 9.66 | 489,772 | 5.11 | \$ 9.66 |
| \$14.99 - \$18.01 | 132,916 | 6.33 | \$ 15.67 | 123,751 | 6.34 | \$ 15.72 |
| \$24.35 - 30.01 | 215,000 | 7.82 | \$ 27.84 | 128,612 | 7.79 | \$ 28.10 |
| \$9.64 - \$30.01 | 837,688 | 6.00 | \$ 15.28 | 742,135 | 5.78 | \$ 13.86 |

Restricted Stock Activity

The following table reconciles the unvested balance of restricted stock:

| | Number of Shares | Weighted Average Grant Date Fair Value |
|---|---------------------|---|
| Three-months ended September 30, 2013: | | |
| Unvested balance, June 30, 2013 | 407,423 | \$ 22.11 |
| Granted | 32,700 | \$ 20.38 |
| Vested | (12,040) | \$ 20.41 |
| Canceled | (5,505) | \$ 22.22 |
| Unvested balance, September 30, 2013 | 422,578 | \$ 23.19 |

| | Number of Shares | Weighted Average Grant Date Fair Value |
|--|---------------------|---|
| Nine-months ended September 30, 2013: | | |
| Unvested balance, December 31, 2012 | 369,083 | \$ 21.72 |
| Granted | 217,090 | \$ 21.64 |
| Vested | (96,235) | \$ 16.60 |
| Canceled | (67,360) | \$ 19.55 |
| Unvested balance, September 30, 2013 | 422,578 | \$ 23.19 |

7. Earnings (Loss) Per Common Share

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

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Basic earnings per common share excludes dilution and is calculated by dividing earnings to common shares by the weighted-average number of common shares outstanding for the period. Diluted earnings per common share is calculated by dividing earnings to common shares by the weighted-average number of common shares, as adjusted for the potential dilutive of stock options outstanding as of the balance sheet date. The following table reconciles earnings (loss) per common share for the three- and nine-month periods ended September 30, 2013 and 2012:

| | Three Months Ended September 30, 2013 | Three Months Ended September 30, 2012 | Nine Months Ended September 30, 2013 | Nine Months Ended September 30, 2012 |
|---|---|---|--|--|
| Basic Earnings (Loss) per Common Share: | | | | |
| <i>Numerator:</i> | | | | |
| Net income (loss) | \$ (795) | \$ 1,003 | \$ 778 | \$ 7,218 |
| Distributed earnings to common shares | 754 | 741 | 2,260 | 1,471 |
| Distributed earnings to participating securities | 46 | 41 | 142 | 90 |
| Total distributed earnings | 800 | 782 | 2,402 | 1,561 |
| Undistributed earnings (loss) allocable to common shares | (1,595) | 210 | (1,624) | 5,378 |
| Undistributed earnings (loss) allocable to participating securities | | 11 | | 279 |
| Total undistributed earnings (loss) | (1,595) | 221 | (1,624) | 5,657 |
| Earnings (loss) to common shares basic | \$ (841) | \$ 951 | \$ 636 | \$ 6,849 |
| <i>Denominator:</i> | | | | |
| Weighted average common shares outstanding basic (in thousands) | 6,860 | 6,761 | 6,850 | 6,745 |
| Basic earnings (loss) per common share | \$ (0.12) | \$ 0.14 | \$ 0.09 | \$ 1.02 |

| | Three Months Ended September 30, 2013 | Three Months Ended September 30, 2012 | Nine Months Ended September 30, 2013 | Nine Months Ended September 30, 2012 |
|--|---|---|--|--|
| Diluted Earnings (Loss) per Common Share: | | | | |
| <i>Numerator:</i> | | | | |
| Earnings (loss) to common shares basic | \$ (841) | \$ 951 | \$ 636 | \$ 6,849 |
| Undistributed earnings allocated to participating securities | | 11 | | 279 |
| Undistributed earnings reallocated to participating securities | | (10) | | (269) |
| Earnings (loss) to common shares diluted | \$ (841) | \$ 952 | \$ 636 | \$ 6,859 |
| <i>Denominator:</i> | | | | |
| Weighted average common shares outstanding basic (in thousands) | 6,860 | 6,761 | 6,850 | 6,745 |
| Dilutive effect of stock options | | 223 | 230 | 252 |
| Weighted average common shares outstanding dilutive (in thousands) | 6,860 | 6,984 | 7,080 | 6,997 |
| Diluted earnings (loss) per common share | \$ (0.12) | \$ 0.14 | \$ 0.09 | \$ 0.98 |

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Common stock equivalents related to stock options of 228,158 are antidilutive in a net loss period and, therefore, are not included in the diluted per common share calculation for the three-month period ended September 30, 2013.

There were 215,000 common stock equivalents related to stock options that were anti-dilutive and excluded from diluted earnings per common share calculation for the three- and nine-month period ended September 30, 2013 and 2012 because their exercise prices were higher than the average market price of the underlying common stock for the period.

Table of Contents**8. Trade Accounts Receivable and Allowance for Doubtful Accounts***Trade Accounts Receivable*

Trade accounts receivable are recorded at the invoiced amount.

| | September 30, 2013 | December 31, 2012 |
|---|-----------------------|----------------------|
| Trade accounts receivable | \$ 5,139 | \$ 4,216 |
| Allowance for doubtful accounts | (22) | |
| Trade accounts receivable, net | \$ 5,117 | \$ 4,216 |
| Unpaid deferred revenue included in trade accounts receivable | \$ 1,668 | \$ 1,589 |

Allowance for doubtful accounts

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

Unpaid deferred revenue

The unpaid deferred revenue that is included in trade accounts receivable is billed in accordance with the provisions of the contracts with the Company's customers. Unpaid deferred revenue from the Company's cash-basis customers is not included in either trade accounts receivable or deferred revenue accounts.

Major customers

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

| | September 30, 2013 | December 31, 2012 |
|---------------|-----------------------|----------------------|
| Central Banks | 31% | 30% |
| Nielsen | 20% | 24% |
| Civolution | 12% | 14% |
| IV | 12% | * |

* Less than 10%

9. Property and Equipment

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

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

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| | September 30, 2013 | December 31, 2012 |
|--|-----------------------|----------------------|
| Office furniture and fixtures | \$ 586 | \$ 420 |
| Equipment | 3,155 | 1,886 |
| Leasehold improvements | 1,180 | 1,083 |
| Gross property and equipment | 4,921 | 3,389 |
| Less accumulated depreciation and amortization | (2,449) | (1,936) |
| Property and equipment, net | \$ 2,472 | \$ 1,453 |

10. Intangibles

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

Amortization of capitalized patent costs associated with the application and award of patents in the U.S. and various other countries are capitalized and amortized on a straight-line basis over the term of the patents as determined at the award date, which varies depending on the pendency period of the application, generally approximating seventeen years.

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Amortization of intangible assets acquired is calculated using the straight-line method over the estimated useful lives of the assets.

| | September 30, 2013 | December 31, 2012 |
|---|-----------------------|----------------------|
| Capitalized patent costs | \$ 4,858 | \$ 3,973 |
| Intangible assets acquired: | | |
| Purchased patents and intellectual property | 250 | 250 |
| Existing technology | 1,560 | 1,560 |
| Customer relationships | 290 | 290 |
| Backlog | 760 | 760 |
| Tradenames | 290 | 290 |
| Non-solicitation agreements | 120 | 120 |
| | | |
| Gross intangible assets | 8,128 | 7,243 |
| Accumulated amortization | (1,428) | (522) |
| | | |
| Intangibles, net | \$ 6,700 | \$ 6,721 |

11. Joint Venture and Related Party Transactions

In March 2012, Digimarc and Nielsen decided to reduce the investments in their two joint ventures to minimal levels while assessing alternative approaches to achieving each of their goals in the emerging market opportunity of synchronized second screen television. In connection with this plan for the suspension of operations, the joint ventures accrued estimated expenses for the first quarter's operations and severance costs for joint venture employees. Digimarc's share of the one-time severance and suspension costs was approximately \$500. Pursuant to the plan of suspending operations of the joint ventures with Nielsen, in April 2012 the Company received \$104 of remaining cash from TVaura LLC (in which Digimarc holds a 51% ownership) and contributed \$796 to TVaura Mobile LLC (in which Digimarc holds a 49% ownership) to fund both the first quarter's operating expenses as well as the suspension related costs. Payment of all expenses incurred after the suspension of operations of each joint venture is unconditionally the responsibility of the majority owner, which expenses for TVaura LLC, if any, will be paid by Digimarc. As of September 30, 2013, both Digimarc and Nielsen continued to assess the market opportunities of each of the joint ventures.

Summarized financial information for the joint ventures has not been provided as the disclosures are immaterial to the Company's filing given the operations of the joint ventures have been suspended and the Company's investment in each joint venture is \$0 as of September 30, 2013 and December 31, 2012.

12. Income Taxes

The provision for income taxes for the three- and nine-month periods ended September 30, 2013 reflect income taxes for federal and state jurisdictions reduced by available tax credit carry-forwards and tax credits claimed during the period. The effective tax rate for the nine-month period ended September 30, 2013 was 26%. The effective tax rate is lower than the statutory tax rate due to the impact of permanent items, primarily research and experimentation credits. The effective tax rate for the nine-month period ended September 30, 2012 was 38%.

13. Commitments and Contingencies

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

Our subsidiary, Attributor, is a defendant in a patent infringement lawsuit brought by Blue Spike, LLC (E.D. Texas, Civil Action No: 6:12-cv-540). The case was brought against Attributor in August 2012, and was consolidated with other lawsuits brought by Blue Spike into Civil Action No. 6:12-cv-00499.

Blue Spike asserted infringement by Attributor of four patents. Attributor filed an answer denying that it has infringed any valid claim of the patents in suit, and asserting specified defenses, including non-infringement and invalidity. The court has consolidated the cases that Blue Spike

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has brought against over ninety defendants into one case. A schedule for the case has not yet been set. Blue Spike has not alleged a specific amount of monetary damages in its complaint.

On May 31, 2013, Digimarc triggered arbitration under the provisions of its Patent License Agreement (Agreement) with IV to resolve ongoing disputes relating to IV s calculation of potential profit sharing payments under the Agreement. For more information regarding the arbitration process, refer to Section 11.9(c) of the Agreement, filed as Exhibit 10.12 to Digimarc s Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 3, 2011.

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The Company is subject from time to time to other legal proceedings and claims arising in the ordinary course of business.

14. Stock Repurchases

Summary of common stock shares repurchased:

| | Three Months Ended September 30, 2013 | Three Months Ended September 30, 2012 | Nine Months Ended September 30, 2013 | Nine Months Ended September 30, 2012 |
|--|--|--|---|---|
| Repurchase program | | 12,663 | | 40,210 |
| Exercise of stock options | 2,301 | 35,755 | 7,917 | 58,535 |
| Tax withholding obligations on stock options | 982 | 20,891 | 3,777 | 35,012 |
| Tax withholding obligations on restricted shares | 4,488 | 3,775 | 35,407 | 24,346 |
| Total | 7,771 | 73,084 | 47,101 | 158,103 |

Value of common stock shares repurchased:

| | Three Months Ended September 30, 2013 | Three Months Ended September 30, 2012 | Nine Months Ended September 30, 2013 | Nine Months Ended September 30, 2012 |
|--|--|--|---|---|
| Repurchase program | \$ 287 | \$ 287 | \$ 998 | \$ 998 |
| Exercise of stock options | \$ 48 | \$ 846 | \$ 177 | \$ 1,448 |
| Tax withholding obligations on stock options | \$ 20 | \$ 495 | \$ 85 | \$ 870 |
| Tax withholding obligations on restricted shares | \$ 92 | \$ 84 | \$ 769 | \$ 583 |
| Total | \$ 160 | \$ 1,712 | \$ 1,031 | \$ 3,899 |

In November 2011, the Board of Directors approved a stock repurchase program authorizing the purchase, at the discretion of management, of up to \$5,000 of the Company's common stock through either periodic open-market or private transactions at then-prevailing market prices through November 30, 2012. In December 2012, the program was extended through December 31, 2013. As of September 30, 2013, the Company had repurchased 43,293 shares under this program at an aggregate purchase price of \$1,002.

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

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

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

15. Subsequent Events

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

On October 22, 2013, the Board of Directors declared a quarterly dividend of \$0.11 per share, payable on November 12, 2013 to shareholders of record on November 4, 2013.

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

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

The following discussion should be read in conjunction with our interim consolidated financial statements and the related notes and other financial information appearing elsewhere in this Quarterly Report on Form 10-Q. Readers are also urged to carefully review and consider the disclosures made in Part II, Item 1A (Risk Factors) of this Quarterly Report on Form 10-Q and our Annual Report on Form 10-K for the year ended December 31, 2012 filed on February 22, 2013 (the 2012 Annual Report) and in the audited consolidated financial statements and related notes included in our 2012 Annual Report, and other reports and filings made with the Securities and Exchange Commission (SEC).

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

All dollar amounts are in thousands, unless otherwise noted. Percentages within the following tables may not foot due to rounding.

Digimarc Discover is a registered trademark of Digimarc Corporation. This Quarterly Report on Form 10-Q also includes trademarks and trade names owned by other parties, and all other such trademarks and trade names mentioned in this Quarterly Report on Form 10-Q are the property of their respective owners.

Overview

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

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

Quickly and reliably identify and effectively manage music, movies, television programming, digital images, e-books, documents and other printed materials, especially in light of new non-linear distribution over the Internet;

Deter counterfeiting of money, media and goods, and piracy of e-books, movies and music;

Support new digital media distribution models and methods to monetize media content;

Leverage the power of ubiquitous computing to instantly link consumers to a wealth of information and/or interactive experiences related to the media and objects they encounter each day;

Provide consumers with more choice and access to media content when, where and how they want it;

Enhance imagery and video by associating metadata or authenticating media content for government and commercial uses; and

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Better secure identity documents to enhance national security and combat identity theft and fraud.

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

Digital watermarking allows our customers to embed digital data into any media content that is digitally processed at some point during its lifecycle. The technology can be applied to printed materials, video, audio, and images. The inclusion of these digital signals enables a wide range of improvements in security and media management, and new business models for distribution and consumption of media content. Over the years our technology and intellectual property portfolios have grown to encompass many related technologies.

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

Our business has further expanded in e-commerce with our acquisition of Attributor Corporation (Attributor) the global leader in protecting e-books from online piracy. Attributor's software and services protect book revenue and authors' rights by finding, reporting on, and assisting in removing pirated content found on the Internet. Online book piracy is a growing and global problem, and with emerging e-book standards and the growing popularity of iPads, Kindles and other e-readers, book piracy is expected to grow dramatically.

Our patent portfolio contains a number of innovations in digital watermarking, pattern recognition (sometimes referred to as fingerprinting), digital rights management and related fields. To protect our significant efforts in creating our technology, we have implemented an extensive intellectual property protection program that relies on a combination of patent, copyright, trademark and trade secret laws, and nondisclosure agreements and other contracts. As a result, we believe we have one of the world's most extensive patent portfolios in digital watermarking and related fields, with greater than 1,300 granted and pending U.S. and foreign filings as of September 30, 2013. We continue to develop and broaden our portfolio of patented technology in the fields of media identification and management technology and related applications and systems. We devote significant resources to developing and protecting our inventions and continuously seek to identify and evaluate potential licensees for our patents.

For a discussion of activities and costs related to our research and development, see Research, development and engineering.

Critical Accounting Policies and Estimates

Detailed information on our critical accounting policies and estimates is set forth in our 2012 Annual Report in Management's Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies and Estimates, which is incorporated by reference into this Quarterly Report on Form 10-Q.

Results of Operations

The following table presents statements of operations data for the periods indicated as a percentage of total revenue. Unless otherwise indicated, all references in this Management's Discussion and Analysis of Financial Condition and Results of Operations to the three- and nine-month periods relate to the three- and nine-month periods ended September 30, 2013 and all changes discussed with respect to such period reflect changes compared to the three- and nine-month periods ended September 30, 2012.

| | Three Months Ended September 30, 2013 | Three Months Ended September 30, 2012 | Nine Months Ended September 30, 2013 | Nine Months Ended September 30, 2012 |
|------------------------------|--|--|---|---|
| Revenue: | | | | |
| Service | 41% | 29% | 32% | 24% |
| Subscription | 19 | 4 | 15 | 3 |
| License | 40 | 67 | 53 | 74 |
| Total revenue | 100 | 100 | 100 | 100 |
| Cost of revenue: | | | | |
| Service | 17 | 15 | 14 | 13 |
| Subscription | 8 | 1 | 7 | |
| License | 1 | 1 | 1 | 1 |
| Total cost of revenue | 26 | 16 | 22 | 14 |

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| | | | | |
|---------------------------------------|----|----|----|----|
| Gross profit | 74 | 84 | 78 | 86 |
| Operating expenses: | | | | |
| Sales and marketing | 20 | 11 | 15 | 8 |
| Research, development and engineering | 44 | 26 | 31 | 18 |
| General and administrative | 33 | 26 | 25 | 21 |
| Intellectual property | 4 | 3 | 3 | 3 |

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| | Three Months Ended September 30, 2013 | Three Months Ended September 30, 2012 | Nine Months Ended September 30, 2013 | Nine Months Ended September 30, 2012 |
|--------------------------------------|---|---|--|--|
| Total operating expenses | 101 | 66 | 74 | 50 |
| Operating income (loss) | (27) | 18 | 3 | 36 |
| Net loss from joint ventures | | | | (3) |
| Other income, net | | 1 | | |
| Income (loss) before income taxes | (27) | 18 | 4 | 33 |
| (Provision) benefit for income taxes | 16 | (7) | (1) | (13) |
| Net income (loss) | (11)% | 11% | 3% | 21% |

Summary

During the third quarter, we continued to increase our resource allocation to accelerate our product development initiatives, including our audio and packaging initiatives, while also continuing to invest in our sales growth initiatives, focusing on our Digimarc Discover and Digimarc Guardian product offerings. We also continued research efforts to explore strategic opportunities in the mobile payment market.

Total revenue for the three-month period ended September 30, 2013, compared to the corresponding three-month period ended September 30, 2012, decreased 17% to \$7.4 million primarily as a result of the end of the quarterly license payments from Intellectual Ventures (IV) in May 2013, partially offset by increased subscription revenue due to the inclusion of Attributor s operations. Total revenue for the nine-month period ended September 30, 2013, compared to the corresponding nine-month period ended September 30, 2012, decreased 20% to \$28.1 million primarily as a result of the \$8.0 million past due royalties payment received from Verance Corporation (Verance) in the first quarter of 2012 and the end of the quarterly license payments from IV in May 2013, partially offset by increased subscription revenue due to the inclusion of Attributor s operations and higher service revenue from the Central Banks.

Total operating expense for the three- and nine-month periods ended September 30, 2013, compared to the corresponding three- and nine-month periods ended September 30, 2012, increased primarily as a result of increased compensation cost due to higher headcount as we accelerated our product development and sales growth initiatives as well as the impact of Attributor s operations and related acquisition and integration costs.

Revenue

| | Three Months Ended September 30, 2013 | Three Months Ended September 30, 2012 | Dollar Increase (Decrease) | Percent Increase (Decrease) | Nine Months Ended September 30, 2013 | Nine Months Ended September 30, 2012 | Dollar Increase (Decrease) | Percent Increase (Decrease) |
|--------------|---|---|----------------------------------|-----------------------------------|--|--|----------------------------------|-----------------------------------|
| Revenue: | | | | | | | | |
| Service | \$ 3,030 | \$ 2,616 | \$ 414 | 16% | \$ 8,981 | \$ 8,273 | \$ 708 | 9% |
| Subscription | 1,424 | 327 | 1,097 | 335% | 4,241 | 922 | 3,319 | 360% |
| License | 2,971 | 5,960 | (2,989) | (50)% | 14,916 | 25,866 | (10,950) | (42)% |
| Total | \$ 7,425 | \$ 8,903 | \$ (1,478) | (17)% | \$ 28,138 | \$ 35,061 | \$ (6,923) | (20)% |

Revenue (as % of total revenue):

| | | | | |
|---------|-----|-----|-----|-----|
| Service | 41% | 29% | 32% | 24% |
|---------|-----|-----|-----|-----|

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| | | | | |
|--------------|------|------|------|------|
| Subscription | 19% | 4% | 15% | 3% |
| License | 40% | 67% | 53% | 74% |
| Total | 100% | 100% | 100% | 100% |

Service. Service revenue consists primarily of software development and consulting services. The majority of service revenue arrangements are structured as time and materials consulting agreements, or fixed price consulting agreements. The majority of our service revenue is derived from contracts with the Central Banks, IV and government agency contractors. The agreements range from several months to several years in length, and our longer term contracts are subject to work plans that are reviewed and agreed upon at

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least annually. These contracts generally provide for billing hours worked at predetermined rates and, to a lesser extent, reimbursement for third party costs and services. Increases or decreases in the services provided under these contracts are generally subject to both volume and price changes. The volume of work is generally negotiated at least annually and can be modified as the customer's needs change. We also have provisions in our longer term contracts that allow for specific hourly rate price increases on an annual basis to account for cost of living variables. Contracts with government agency contractors are generally shorter term in nature, less linear in billings and less predictable than our longer term contracts because the contracts with government agency contractors are subject to government budgets and funding.

The increase in service revenue for the three- and nine-month periods ended September 30, 2013, compared to the corresponding three- and nine-month periods ended September 30, 2012, was due primarily to higher billing rates under our new agreement with the Central Banks, partially offset by the suspension of operations in the joint ventures in the first quarter of 2012.

Subscription. Subscription revenue includes subscriptions for products and services, is generally recurring, paid in advance and recognized over the term of the subscription.

The increase in subscription revenue for the three- and nine-month periods ended September 30, 2013, compared to the corresponding three- and nine-month periods ended September 30, 2012, was due primarily to the inclusion of Attributor's operations.

License. License revenue originates primarily from licensing our technology and patents where we receive royalties as our income stream. The majority of license revenue is derived from contracts with IV, Nielsen, Verance and Civolution. Revenue from our licensed products have minimal associated direct costs, and thus are highly profitable.

The decrease in license revenue for the three- and nine-month periods ended September 30, 2013, compared to the corresponding three- and nine-month periods ended September 30, 2012, was primarily the result of \$8.0 million past due royalties payment received from Verance in the first quarter of 2012 and the end of the quarterly license payments from IV in May 2013.

Revenue by Geography

| | Three Months Ended September 30, 2013 | Three Months Ended September 30, 2012 | Dollar Increase (Decrease) | Percent Increase (Decrease) | Nine Months Ended September 30, 2013 | Nine Months Ended September 30, 2012 | Dollar Increase (Decrease) | Percent Increase (Decrease) |
|---|---|---|----------------------------------|-----------------------------------|--|--|----------------------------------|-----------------------------------|
| Revenue by geography: | | | | | | | | |
| Domestic | \$ 3,536 | \$ 5,830 | \$ (2,294) | (39)% | \$ 15,902 | \$ 24,923 | \$ (9,021) | (36)% |
| International | 3,889 | 3,073 | 816 | 27% | 12,236 | 10,138 | 2,098 | 21% |
| Total | \$ 7,425 | \$ 8,903 | \$ (1,478) | (17)% | \$ 28,138 | \$ 35,061 | \$ (6,923) | (20)% |
| Revenue (as % of total revenue): | | | | | | | | |
| Domestic | 48% | 65% | | | 57% | 71% | | |
| International | 52% | 35% | | | 43% | 29% | | |
| Total | 100% | 100% | | | 100% | 100% | | |

The decrease in domestic revenue for the three-month period ended September 30, 2013, compared to the corresponding three-month period ended September 30, 2012, was due primarily to the end of the quarterly license payments from IV in May 2013, partially offset by the inclusion of Attributor's operations.

The decrease in domestic revenue for the nine-month period ended September 30, 2013, compared to the corresponding nine-month period ended September 30, 2012, was primarily the result of the \$8.0 million past due royalties payment received from Verance, the end of the quarterly license payments from IV in May 2013 and the suspension of operations in the joint ventures in the first quarter of 2012, partially offset by the inclusion of Attributor's operations and increase in government agency related work in 2013.

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The increase in international revenue for the three- and nine-month periods ended September 30, 2013, compared to the corresponding three- and nine-month periods ended September 30, 2012, was due primarily to higher billing rates under our new agreement with the Central Banks and the inclusion of Contributor's operations.

We anticipate a decrease in revenue for the full year 2013 compared to 2012 primarily due to the receipt of the \$8.0 million past due royalties payment from Verance in January 2012, and the end of quarterly license payments from IV in May 2013; partially offset by a full year of revenue from Contributor operations and increased revenue from our existing customers and new customers as we continue to expand the marketing and monetization of our intellectual property portfolio.

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Cost of Revenue

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

compensation, benefits, incentive compensation in the form of stock-based compensation and related costs of our software developers, quality assurance personnel, product managers, business development managers and other personnel where we bill our customers for time and materials costs;

payments to outside contractors that are billed to customers;

charges for equipment directly used by customers;

depreciation and other charges for machinery, equipment and software directly used by customers;

travel costs directly attributable to service and development contracts; and

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

Subscription. Cost of subscription revenue primarily includes:

compensation, benefits, incentive compensation in the form of stock-based compensation and related costs of operations personnel and the cost of contractors to provide our Digimarc Guardian subscription service;

Internet service provider connectivity charges and image search data fees to support the services offered to our subscription customers; and

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

License. Cost of license revenue primarily includes:

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

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

amortization of capitalized patent costs and patent maintenance fees.

Gross Profit

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| | Three Months Ended September 30, 2013 | Three Months Ended September 30, 2012 | Dollar Increase (Decrease) | Percent Increase (Decrease) | Nine Months Ended September 30, 2013 | Nine Months Ended September 30, 2012 | Dollar Increase (Decrease) | Percent Increase (Decrease) |
|----------------------|---|---|----------------------------------|-----------------------------------|--|--|----------------------------------|-----------------------------------|
| Gross Profit: | | | | | | | | |
| Service | \$ 1,798 | \$ 1,254 | \$ 544 | 43% | \$ 4,914 | \$ 3,729 | \$ 1,185 | 32% |
| Subscription | 799 | 281 | 518 | 184% | 2,393 | 784 | 1,609 | 205% |
| License | 2,873 | 5,901 | (3,028) | (51)% | 14,622 | 25,688 | (11,066) | (43)% |
| Total | \$ 5,470 | \$ 7,436 | \$ (1,966) | (26)% | \$ 21,929 | \$ 30,201 | \$ (8,272) | (27)% |

Gross Profit (as % of related revenue components):

| | | | | |
|--------------|-----|-----|-----|-----|
| Service | 59% | 48% | 55% | 45% |
| Subscription | 56% | 86% | 56% | 85% |
| License | 97% | 99% | 98% | 99% |
| Total | 74% | 84% | 78% | 86% |

The decrease in total gross profit for the three-month period ended September 30, 2013, compared to the corresponding three-month period ended September 30, 2012, was due primarily to the end of the quarterly license payments from IV in May 2013, partially offset by higher billing rates under our new agreement with the Central Banks and the inclusion of Contributor s operations.

The decrease in total gross profit for the nine-month period ended September 30, 2013, compared to the corresponding nine-month period ended September 30, 2012, was due primarily to the receipt of the \$8.0 million past due royalties payment from Verance in the first quarter of 2012 and the end of the quarterly license payments from IV in May 2013, partially offset by the inclusion of Contributor s operations.

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The decrease in total gross profit as a percentage of revenue for the three- and nine-month period ended September 30, 2013, compared to the corresponding three- and nine-month period ended September 30, 2012, was primarily due to a change in revenue mix including the impact of Contributor's operations, which has a higher cost component than other subscriptions.

The increase in service gross profit as a percentage of service revenue for the three- and nine-month periods ended September 30, 2013, compared to the corresponding three- and nine-month periods ended September 30, 2012, resulted primarily from higher billing rates under our new agreement with the Central Banks and a change in service revenue mix.

The decrease in subscription gross profit as a percentage of subscription revenue for the three- and nine-month periods ended September 30, 2013, compared to the corresponding three- and nine-month periods ended September 30, 2012, resulted primarily from the inclusion of Contributor's operations, which has a higher cost component than other subscriptions.

The slight decrease in license gross profit as a percentage of license revenue for the three- and nine-month periods ended September 30, 2013, compared to the corresponding three- and nine-month periods ended September 30, 2012, was due primarily to lower license revenue.

Operating Expenses

We allocate certain operating costs of sales and marketing, research, development and engineering and intellectual property to cost of service revenue when they relate directly to our customer contracts.

We record all remaining, or residual, operating costs as sales and marketing, research, development and engineering, general and administrative, and intellectual property expenses.

We expect operating expenses for the full year 2013 to be higher than 2012, primarily due to a full year of Contributor's operations, which is estimated to include \$1.1 million of non-cash charges for amortization of acquired intangibles and stock compensation expense. In addition, we plan to continue to increase spending in engineering, sales and marketing to accelerate our product development initiatives and our sales growth initiatives.

Sales and marketing

| | Three Months Ended September 30, 2013 | Three Months Ended September 30, 2012 | Dollar Increase | Percent Increase | Nine Months Ended September 30, 2013 | Nine Months Ended September 30, 2012 | Dollar Increase | Percent Increase |
|--|--|--|----------------------------|-----------------------------|---|---|----------------------------|-----------------------------|
| Sales and marketing | \$ 1,482 | \$ 937 | \$ 545 | 58% | \$ 4,322 | \$ 2,914 | \$ 1,408 | 48% |
| Sales and marketing (as % of total revenue) | 20% | 11% | | | 15% | 8% | | |
| Sales and marketing expenses consist primarily of: | | | | | | | | |

compensation, benefits, incentive compensation in the form of stock-based compensation and related costs of sales and marketing employees and product managers;

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

professional services and outside contractors for product and marketing initiatives; and

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

The increases in sales and marketing expenses for the three-month period ended September 30, 2013, compared to the corresponding three-month period ended September 30, 2012 resulted primarily from:

increased headcount and compensation-related expenses of \$0.2 million to accelerate our sales growth initiatives;

increased marketing and professional fees of \$0.1 million related to certain product initiatives; and

amortization of acquired intangible assets of \$0.1 million related to the Attributor acquisition.

The increases in sales and marketing expenses for the nine-month period ended September 30, 2013, compared to the corresponding nine-month period ended September 30, 2012, resulted primarily from:

increased headcount and compensation-related expenses of \$0.5 million to accelerate our sales growth initiatives;

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increased marketing and professional fees of \$0.4 million related to certain product initiatives; and

amortization of acquired intangible assets of \$0.4 million related to the Attributor acquisition.

We anticipate through 2013 that we will incur sales and marketing costs at higher levels due to the inclusion of Attributor's operations and increased headcount and investments to accelerate our sales growth initiatives.

Research, development and engineering

| | Three Months Ended September 30, 2013 | Three Months Ended September 30, 2012 | Dollar Increase | Percent Increase | Nine Months Ended September 30, 2013 | Nine Months Ended September 30, 2012 | Dollar Increase | Percent Increase |
|---|--|--|----------------------------|-----------------------------|---|---|----------------------------|-----------------------------|
| Research, development and engineering | \$ 3,277 | \$ 2,320 | \$ 957 | 41% | \$ 8,824 | \$ 6,464 | \$ 2,360 | 37% |
| Research, development and engineering (as % of total revenue) | 44% | 26% | | | 31% | 18% | | |

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

Fundamental Research:

investigation of new watermarking algorithms to increase robustness and/or computational efficiency;

mobile device usage models and imaging sub-systems in camera-phones;

industry conference participation and authorship of papers for industry journals;

survey and study of human and computer interaction models with a focus on mobile devices and modeling of intent;

development of new intellectual property, including documentation of claims and production of supporting diagrams and materials;

research in fingerprinting and other content identification technologies; and

metadata ranking algorithms for matching Internet file content against reference database.

Platform Development:

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tuning and optimization of implementation models to improve resistance to non-malicious attacks and routine transformations, such as JPEG, cropping and printing;

mobile platform creation to leverage device specific capabilities (e.g., instruction sets and Graphics Processing Units (GPUs));

tuning big data analytics transformation and metrics aggregation engine;

tuning data-driven Internet crawling infrastructure with policy-driven feedback loop; and

assembly of master book publishing catalog based on aggregation and reconciliation of multiple public data sources.

Product Development:

maintaining the Online Services Portal to provide campaign management and routing services for the Digimarc Discover platform;

maintaining the web-hosted image watermark embedder in support of Digimarc Discover platform;

iterative development and release of the Digimarc Discover application for the iTunes and Android marketplaces;

real-time analytics portal to support anti-piracy services for the book industry; and

consumer book discovery application based on social network connections and shared interests.

Research, development and engineering expenses consist primarily of:

compensation, benefits, incentive compensation in the form of stock-based compensation expense, recruiting and related costs of software and hardware developers and quality assurance personnel;

payments to outside contractors;

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the purchase of materials and services for product development; and

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

The increase in research, development and engineering expenses for the three-month period ended September 30, 2013, compared to the corresponding three-month period ended September 30, 2012 resulted primarily from:

higher headcount and compensation-related expenses of \$0.6 million, of which \$0.3 million primarily related to accelerating our product development initiatives and \$0.3 million related to the operations of Attributor; and

increased contract labor and professional fees of \$0.1 million related to certain product development initiatives.

The increase in research, development and engineering expenses for the nine-month period ended September 30, 2013, compared to the corresponding nine-month period ended September 30, 2012, resulted primarily from:

higher headcount and compensation-related expenses of \$1.6 million, of which \$0.7 million primarily related to accelerating our product development initiatives and \$0.9 million related to the operations of Attributor; and

increased contract labor and professional fees of \$0.2 million related to certain product development initiatives.

We anticipate through 2013 that we will invest in research, development and engineering expenses at higher levels due to the inclusion of Attributor's operations and increased headcount and investments to accelerate our product development initiatives.

General and administrative

| | Three Months Ended September 30, 2013 | Three Months Ended September 30, 2012 | Dollar Increase | Percent Increase | Nine Months Ended September 30, 2013 | Nine Months Ended September 30, 2012 | Dollar (Decrease) | Percent (Decrease) |
|---|--|--|----------------------------|-----------------------------|---|---|------------------------------|-------------------------------|
| General and administrative | \$ 2,456 | \$ 2,282 | \$ 174 | 8% | \$ 6,990 | \$ 7,231 | \$ (241) | (3)% |
| General and administrative (as % of total revenue) | 33% | 26% | | | 25% | 21% | | |

We incur general and administrative costs in the functional areas of finance, legal, human resources, executive and board of directors. Costs for facilities and information technology are also managed as part of the general and administrative processes and are allocated based on headcount to this area as well as each of the areas in costs of services, sales and marketing, research, development and engineering and intellectual property.

General and administrative expenses consist primarily of:

compensation, benefits and incentive compensation in the form of stock-based compensation expense and related costs of general and administrative personnel;

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third party and professional fees associated with legal, accounting, human resources and costs associated with being a public company; and

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

The increase in general and administrative expenses for the three-month period ended September 30, 2013, compared to the corresponding three-month period ended September 30, 2012, resulted primarily from:

increased legal fees of \$0.2 million related to licensing audits of IV and other licensees;

increase of \$0.3 million related to the operations of Contributor; partially offset by

decreased compensation related expenses of \$0.1 million, primarily related to the initial new hire stock based awards granted in October 2008 that became fully vested in October 2012.

The decreases in general and administrative expenses for the nine-month period ended September 30, 2013, compared to the corresponding nine-month period ended September 30, 2012, resulted primarily from:

decreased compensation related expenses of \$0.9 million, primarily related to the initial new hire stock based awards granted in October 2008 that became fully vested in October 2012;

decrease of \$0.2 million due to the reversal of the liability for contingent merger consideration related to the acquisition of Contributor;

decreased legal fees of \$0.1 million due to settlement with Verance in 2012, partially offset by legal costs associated with the licensing audit of IV in 2013; partially offset by

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increase of \$0.7 million related to the operations of Attributor; and

increased accounting and tax fees of \$0.2 million associated with the Attributor acquisition.

We anticipate through 2013 that we will continue to incur general and administrative expenses at approximately existing levels while continuing to examine means to reduce general and administrative expenses as a percentage of revenue in the longer term.

Intellectual property

| | Three Months Ended September 30, 2013 | Three Months Ended September 30, 2012 | Dollar (Decrease) | Percent (Decrease) | Nine Months Ended September 30, 2013 | Nine Months Ended September 30, 2012 | Dollar (Decrease) | Percent (Decrease) |
|--|---|---|----------------------|-----------------------|--|--|----------------------|-----------------------|
| Intellectual property | \$ 278 | \$ 309 | \$ (31) | (10)% | \$ 816 | \$ 919 | \$ (103) | (11)% |
| Intellectual property (as % of total revenue) | 4% | 3% | | | 3% | 3% | | |

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

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

compensation, benefits and incentive compensation in the form of stock-based compensation expense and related costs of attorneys and legal assistants;

third party costs, including filing and governmental regulatory fees and fees for outside legal counsel and translation costs, each incurred in the patent process; and

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

Intellectual property expenses can vary from period to period based on:

the level of capitalized patent activity, and

prosecution costs and direct labor hours (compensation, benefits and incentive compensation) related to the patents that were exclusively licensed to IV that are allocated to cost of revenue.

Intellectual property expenses remained relatively consistent for the three- and nine-month periods.

We anticipate through 2013 that we will incur intellectual property expenses at existing levels.

Stock-based compensation

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| | Three Months Ended | Three Months Ended | Dollar | Percent | Nine Months Ended | Nine Months Ended | Dollar | Percent |
|---------------------------------------|-----------------------------------|-----------------------------------|--------------------------------|--------------------------------|----------------------------------|----------------------------------|--------------------------------|--------------------------------|
| | September 30, 2013 | September 30, 2012 | Increase (Decrease) | Increase (Decrease) | September 30, 2013 | September 30, 2012 | Increase (Decrease) | Increase (Decrease) |
| Cost of revenue | \$ 78 | \$ 141 | \$ (63) | (45)% | \$ 374 | \$ 479 | \$ (105) | (22)% |
| Sales and marketing | 103 | 98 | 5 | 5% | 298 | 331 | (33) | (10)% |
| Research, development and engineering | 278 | 242 | 36 | 15% | 766 | 639 | 127 | 20% |
| General and administrative | 529 | 844 | (315) | (37)% | 1,595 | 2,508 | (913) | (36)% |
| Intellectual property | 62 | 70 | (8) | (11)% | 186 | 195 | (9) | (5)% |
| Total | \$ 1,050 | \$ 1,395 | \$ (345) | (25)% | \$ 3,219 | \$ 4,152 | \$ (933) | (22)% |

The decrease in total stock-based compensation expense for the three- and nine-month periods ended September 30, 2013, compared to the corresponding three- and nine-month periods ended September 30, 2012, was primarily due to the initial new hire stock-based awards that were granted in October 2008 that became fully vested in October 2012, partially offset by an additional layer of stock-based awards in 2013. We anticipate incurring an additional \$8.4 million in stock-based compensation expense through September 2017 for awards outstanding as of September 30, 2013.

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| | Three Months Ended September 30, 2013 | Three Months Ended September 30, 2012 | Dollar Increase (Decrease) | Percent Increase (Decrease) | Nine Months Ended September 30, 2013 | Nine Months Ended September 30, 2012 | Dollar (Decrease) | Percent (Decrease) |
|------------------------------|---|---|----------------------------------|-----------------------------------|--|--|----------------------|-----------------------|
| Net loss from joint ventures | \$ | \$ | \$ | | \$ | \$ (1,107) | \$ (1,107) | (100)% |

Net loss from joint venture (as % of total revenue)

3%

There was no activity from the joint ventures during the three- and nine-months ended September 30, 2013 due to the suspension of operations of both joint ventures in March 2012.

Other income, net

| | Three Months Ended September 30, 2013 | Three Months Ended September 30, 2012 | Dollar (Decrease) | Percent (Decrease) | Nine Months Ended September 30, 2013 | Nine Months Ended September 30, 2012 | Dollar (Decrease) | Percent (Decrease) |
|---|---|---|----------------------|-----------------------|--|--|----------------------|-----------------------|
| Other income, net | \$ 33 | \$ 48 | (15) | (31)% | \$ 81 | \$ 139 | (58) | (42)% |
| Other income, net (as % of total revenue) | * | * | | | * | * | | |

* Less than 1%

The decreases in other income, net for the three- and nine-month periods ended September 30, 2013, compared to the corresponding three- and nine-month periods ended September 30, 2012, were primarily due to lower interest income resulting from a combination of lower cash balances and interest rates on cash and investments, and gains and losses on foreign currency.

Provision for Income Taxes

The provision for income taxes for the three- and nine-month periods ended September 30, 2013 and 2012 reflects income taxes for federal and state jurisdictions reduced by available tax credit carry-forwards and tax credits claimed during the period. The effective tax rate for the nine-month period ended September 30, 2013 was 26%. The effective tax rate is lower than the statutory tax rate due to the impact of permanent items, primarily research and experimentation credits. The effective tax rate for the period ended September 30, 2012 was 38%.

We continually assess the applicability of a valuation allowance. Based upon the positive and negative evidence available as of September 30, 2013 and December 31, 2012, and due to Contributor's history of losses and the inability to utilize Contributor losses to offset Digimarc income for state tax purposes, we concluded that it is not more likely than not that the Contributor state deferred tax assets will be realized, and consequently, a full valuation allowance has been recorded with respect to the state deferred tax assets of Contributor.

Liquidity and Capital Resources

| | September 30, 2013 | December 31, 2012 |
|-----------------|-----------------------|----------------------|
| Working capital | \$ 35,372 | \$ 33,846 |

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| | | | |
|---|----|--------|-----------|
| Current (liquidity) ratio (1) | | 9.3:1 | 10.3:1 |
| Cash, cash equivalents and short-term marketable securities | \$ | 33,014 | \$ 32,269 |
| Long-term marketable securities | \$ | 5,097 | \$ 6,787 |
| Total cash, cash equivalents and all marketable securities | \$ | 38,111 | \$ 39,056 |

(1) The current (liquidity) ratio is calculated by dividing total current assets by total current liabilities. The \$1.0 million decrease in cash, cash equivalents and marketable securities at September 30, 2013 compared to December 31, 2012 resulted primarily from:

investments in our business for both capital and intellectual property initiatives;

payment of dividends;

purchases of common stock related to the vesting of restricted stock; partially offset by

cash flows provided by operating activities.

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Financial instruments that potentially subject us to concentrations of credit risk consist primarily of cash and cash equivalents, marketable securities, and trade accounts receivable. We place our cash and cash equivalents with major banks and financial institutions and at times deposits may exceed insured limits. Both short- and long-term marketable securities include pre-refunded municipal bonds, federal agency notes, corporate notes and commercial paper. Our investment policy requires the portfolio to be invested to ensure that the greater of \$3 million or 7% of the invested funds will be available within 30 days notice.

Other than cash used for operating needs, which may include short-term marketable securities, our investment policy limits our credit exposure to any one financial institution or type of financial instrument by limiting the maximum of 5% of our cash and cash equivalents and marketable securities or \$1 million, whichever is greater, to be invested in any one issuer except for the U.S. government, U.S. federal agencies and U.S. backed securities, which have no limits, at the time of purchase. Our investment policy also limits our credit exposure by limiting to a maximum of 40% of our cash and cash equivalents and marketable securities, or \$15 million, whichever is greater, to be invested in any one industry category, e.g., financial or energy industries, at the time of purchase. As a result, we believe our credit risk associated with cash and investments to be minimal. A decline in the market value of any security below cost that is deemed to be other-than-temporary results in a reduction in carrying amount to fair value. To determine whether an impairment is other-than-temporary, we consider whether we have the ability and intent to hold the investment until a market price recovery and evidence indicating that the cost of the investment is recoverable outweighs evidence to the contrary. There have been no other-than-temporary impairments identified or recorded.

Operating Cash Flow

The components of operating cash flows were:

| | Nine Months Ended September 30, 2013 | Nine Months Ended September 30, 2012 | Dollar (Decrease) | Percent (Decrease) |
|---|--|--|----------------------|-----------------------|
| Net income | \$ 778 | \$ 7,218 | \$ (6,440) | (89)% |
| Non-cash items | 4,849 | 6,423 | (1,574) | (25)% |
| Changes in operating assets and liabilities | (962) | 238 | (1,200) | (504)% |
| Net cash provided by operating activities | \$ 4,665 | \$ 13,879 | \$ (9,214) | (66)% |

Cash flows provided by operating activities for the nine-month period ended September 30, 2013, compared to the nine-month period ended September 30, 2012, decreased by \$9.2 million primarily as the result of lower net income, no activity from the joint ventures due to suspension of operations in March 2012, and changes in operating assets and liabilities.

Cash flows used in investing activities for the nine-month period ended September 30, 2013, compared to the nine-month period ended September 30, 2012, decreased by \$3.2 million. The decrease was primarily the result of higher net purchases of marketable securities in 2012 compared to 2013, partially offset by increased investments in capital initiatives.

Cash flows used in financing activities for the nine-month period ended September 30, 2013, compared to the nine-month period ended September 30, 2012, increased \$1.0 million. The increase was primarily the result of no excess tax benefits generated on stock-based awards and higher cash dividends paid, partially offset by lower purchases of common stock.

Future Cash Expectations.

In connection with our patent license agreement with IV, the quarterly payments of the license issuance fee by IV have ended. We are not able to estimate the future cash flow impact of any profit sharing we may earn from IV.

In connection with our patent license agreement with Nielsen, the quarterly license payments will end in the first quarter of 2014. The patent license is non-exclusive and covers certain applications specific to Nielsen's business.

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Our Board of Directors has approved a stock repurchase program under which we have \$4.0 million available for repurchase as of September 30, 2013. Shares of our common stock may be purchased in the open market or through privately negotiated transactions, subject to market conditions. This repurchase program does not obligate us to acquire any specific number of shares or to acquire shares over any specified period of time.

On October 22, 2013, the Board of Directors declared a quarterly dividend of \$0.11 per share, payable on November 12, 2013 to shareholders of record on November 4, 2013. The aggregate amount of the quarterly dividend payment is expected to be approximately \$0.8 million.

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We believe that our current cash, cash equivalents, and short-term marketable securities balances will satisfy our projected working capital and capital expenditure requirements for at least the next 12 months.

We may use cash resources to fund acquisitions or investments in complementary businesses, technologies or product lines. In order to take advantage of opportunities, we may find it necessary to obtain additional equity financing, debt financing, or credit facilities. We do not believe at this time, however, that our long-term working capital and capital expenditures would require us to see additional financing. If it were necessary to obtain additional financing 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

Other than the new lease agreement entered into for Contributor headquarters in San Mateo described in our Form 10-Q for the period ended June 30, 2013 and the contractual obligations disclosed in our 2012 Annual Report, 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 investors.

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

This Quarterly Report on Form 10-Q includes forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934 and Section 27A of the Securities Act of 1933. Words such as may, plan, should, could, expect, anticipate, intend, believe, p forecast, estimate, continue, variations of such terms or similar expressions are intended to identify such forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These forward-looking statements, or other statements made by us, are made based on our expectations and beliefs concerning future events impacting us, and are subject to uncertainties and factors (including those specified below), which are difficult to predict and, in many instances, are beyond our control. As a result, our actual results could differ materially from those expressed in or implied by any such forward-looking statements, and investors are cautioned not to place undue reliance on such statements. Forward-looking statements include but are not limited to statements relating to:

concentration of revenue with few customers comprising a large majority of the revenue;

trends and expectations in revenue growth;

our future level of investment in our business, including investment in research, development and engineering of products and technology, development of our intellectual property, the acquisition of new customers and development of new market opportunities;

our ability to improve margins;

anticipated expenses, costs, margins, provision for income taxes and investment activities in the foreseeable future, including estimated increases in stock-based compensation expenses;

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

variability of contracted arrangements;

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our profitability in future periods;

business opportunities that could require that we seek additional financing;

the size and growth of our markets;

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

the sources of our future revenue;

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

our capital expenditure and working capital requirements and our ability to fund our capital expenditure and working capital needs through cash flow from operations;

capital market conditions, including the economic crisis, interest rate volatility and other limitations on the availability of capital, which could have an impact on our cost of capital and our ability to access the capital markets;

our use of cash, cash equivalents and marketable securities in upcoming quarters;

anticipated levels of backlog in future periods;

the success of our arrangements with Intellectual Ventures;

the success of our acquisition and integration of the operations of Contributor Corporation;

protection, development and monetization of our intellectual property portfolio; and

other risks detailed in our filings with the Securities and Exchange Commission, including the risk factors set forth in Part I, Item 1A of our 2012 Annual Report.

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We believe that the risk factors contained in Part I, Item 1A of our 2012 Annual Report could affect our future performance and the liquidity and value of our securities and cause our actual results to differ materially from those expressed or implied by forward-looking statements made by us or on our behalf. Investors should understand that it is not possible to predict or identify all risk factors and that there may be other factors that may cause our actual results to differ materially from the forward-looking statements. All forward-looking statements made by us or by persons acting on our behalf apply only as of the date of this Quarterly Report on Form 10-Q. We do not undertake any obligation to publicly update or revise any forward-looking statements to reflect future events, information or circumstances that arise after the date of the filing of this Quarterly Report on Form 10-Q.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

The market risk disclosures as set forth in Part II, Item 7A of our 2012 Annual Report have not changed materially.

Item 4. Controls and Procedures.

Evaluation of Disclosure Controls and Procedures

We conducted an evaluation (pursuant to Rule 13a-15(b) of the Securities Exchange Act of 1934 (the Exchange Act)), under the supervision and with the participation of management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e)) as of the end of the period covered by this Form 10-Q. These disclosure controls and procedures are designed to ensure that information required to be disclosed in our reports that are filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. Our disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that this information is accumulated and communicated to management, including the principal executive and principal financial officers, or persons performing similar functions, as appropriate, to allow timely decisions regarding required disclosure.

Based on the evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that these disclosure controls and procedures were effective as of the end of the period covered by this Form 10-Q.

Changes in Controls

There was no change in our internal control over financial reporting (as defined in Rule 13a-15(f) and 15d-15(f) of the Exchange Act of 1934) that occurred during the fiscal quarter ended September 30, 2013 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents**PART II. OTHER INFORMATION.****Item 1. Legal Proceedings.**

We are subject from time to time to legal proceedings and claims arising in the ordinary course of business.

Our subsidiary, Attributor, is a defendant in a patent infringement lawsuit brought by Blue Spike, LLC (E.D. Texas, Civil Action No: 6:12-cv-540). The case was brought against Attributor in August 2012, and was consolidated with other lawsuits brought by Blue Spike into Civil Action No. 6:12-cv-00499.

Blue Spike asserted infringement by Attributor of four patents. Attributor filed an answer denying that it has infringed any valid claim of the patents in suit, and asserting specified defenses, including non-infringement and invalidity. The court has consolidated cases that Blue Spike brought against over ninety defendants into one case. A schedule for the case has not yet been set. Blue Spike has not alleged a specific amount of monetary damages in its complaint.

On May 31, 2013, Digimarc triggered arbitration under the provisions of its Patent License Agreement (Agreement) with IV to resolve ongoing disputes relating to IV's calculation of potential profit sharing payments under the Agreement. For more information regarding the arbitration process, refer to Section 11.9(c) of the Agreement, filed as Exhibit 10.12 to Digimarc's Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 3, 2011.

Item 1A. Risk Factors

Our business, financial condition, results of operations and cash flows may be affected by a number of factors. Detailed information about risk factors that may affect Digimarc's actual results are set forth in Part I, Item 1A of our 2012 Annual Report. The risks and uncertainties described in our 2012 Annual Report are those risks of which we are aware and that we consider to be material to our business. If any of the risks and uncertainties develops into actual events, our business, financial condition, results of operations, or cash flows could be materially adversely affected. In that case, the trading price of our common stock could decline. As of September 30, 2013, there have been no material changes to the risk factors set forth in our 2012 Annual Report.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

In November 2011, our Board of Directors approved a stock repurchase program authorizing the purchase, at the discretion of management, of up to \$5.0 million of our common stock for a one year period through periodic open-market or private transactions at then-prevailing market prices. In December 2012, the program was extended through December 31, 2013. As of September 30, 2013, we had repurchased 43,293 shares under this program at an aggregate purchase price of \$1.0 million; however, no shares were repurchased under the program for the three-month period ended September 30, 2013.

In addition to the stock repurchase program described above, from time to time we withhold (purchase) shares of common stock in connection with stock option exercises, to cover the exercise price and tax withholding obligations. For the three-month period ended September 30, 2013, the Company withheld (purchased) 3,283 shares in connection with stock option exercises at an aggregate purchase price of \$0.1 million.

Also, we withhold (purchase) shares of common stock in connection with the vesting of restricted shares to satisfy tax withholding obligations.

The following table sets forth information regarding purchases of our equity securities during the three-month period ended September 30, 2013:

| Period | (a) Total number of shares purchased ⁽¹⁾ | (b) Average price paid per share ⁽¹⁾ | (c) Total number of shares purchased as | (d) Approximate dollar value that may yet be purchased |
|--------|--|--|---|--|
|--------|--|--|---|--|

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| | | | part of publicly announced plans or programs | under the plans or programs |
|---|--------------|-----------|---|--------------------------------|
| Month 1 | | | | |
| July 1, 2013 to July 31, 2013 | | \$ | | \$ 4.0 million |
| Month 2 | | | | |
| August 1, 2013 to August 31, 2013 | 2,626 | \$ | 20.38 | \$ 4.0 million |
| Month 3 | | | | |
| September 1, 2013 to September 30, 2013 | 1,862 | \$ | 20.45 | \$ 4.0 million |
| Total | 4,488 | \$ | 20.41 | |

- (1) Fully vested shares of common stock withheld (purchased) by us in satisfaction of required withholding tax liability upon vesting of restricted stock.

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Item 6. Exhibits.

| Exhibit Number | Exhibit Description |
|-----------------------|---|
| 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 |
| 32.1 | Section 1350 Certification of Chief Executive Officer |
| 32.2 | Section 1350 Certification of Chief Financial Officer |
| 101.INS | XBRL Instance Document |
| 101.SCH | XBRL Taxonomy Extension Schema Document |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase Document |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase Document |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document |

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Date: October 30, 2013

DIGIMARC CORPORATION

By:

/s/ MICHAEL McCONNELL
Michael McConnell
Chief Financial Officer and Treasurer
(Duly Authorized Officer

and Principal Financial and Accounting Officer)