

Digimarc CORP  
Form 10-Q  
October 30, 2015  
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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, 2015**

**OR**

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

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission File Number: 001-34108**

**DIGIMARC CORPORATION**  
**(Exact name of registrant as specified in its charter)**

**Oregon**  
**(State or other jurisdiction of**  
**incorporation or organization)**  
**9405 SW Gemini Drive, Beaverton, Oregon 97008**  
**(Address of principal executive offices) (Zip Code)**  
**(503) 469-4800**  
**(Registrant's telephone number, including area code)**

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

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

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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 26, 2015, there were 8,908,854 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 per share data)****(UNAUDITED)**

|  | <b>September 30,<br/>2015</b> | <b>December 31,<br/>2014</b> |
|--|-------------------------------|------------------------------|
| <b>ASSETS</b>  |                               |                              |
| Current assets:  |                               |                              |
| Cash and cash equivalents  | \$ 11,452                     | \$ 6,122                     |
| Marketable securities  | 31,585                        | 32,201                       |
| Trade accounts receivable, net   | 2,687                         | 4,545                        |
| Other current assets   | 2,862                         | 2,611                        |
| <b>Total current assets</b>  | <b>48,586</b>                 | <b>45,479</b>                |
| Marketable securities  |                               | 749                          |
| Property and equipment, net  | 2,852                         | 2,976                        |
| Intangibles, net   | 6,723                         | 6,720                        |
| Goodwill   | 1,114                         | 1,114                        |
| Other assets   | 312                           | 378                          |
| <b>Total assets</b>  | <b>\$ 59,587</b>              | <b>\$ 57,416</b>             |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>   |                               |                              |
| Current liabilities:   |                               |                              |
| Accounts payable and other accrued liabilities   | \$ 1,814                      | \$ 1,379                     |
| Deferred revenue   | 1,642                         | 3,660                        |
| <b>Total current liabilities</b>   | <b>3,456</b>                  | <b>5,039</b>                 |
| Deferred rent and other long-term liabilities  | 210                           | 203                          |
| <b>Total liabilities</b>   | <b>3,666</b>                  | <b>5,242</b>                 |
| Commitments and contingencies (Note 13)  |                               |                              |
| Shareholders' equity:  |                               |                              |
| Preferred stock (par value \$0.001 per share, 2,500 authorized, 10 shares issued and outstanding at September 30, 2015 and December 31, 2014)      | 50                            | 50                           |
| Common stock (par value \$0.001 per share, 50,000 authorized, 8,906 and 8,427 shares issued and outstanding at September 30, 2015 and December 31, | 9                             | 8                            |

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2014, respectively)

|  |           |           |
|--|-----------|-----------|
| Additional paid-in capital                 | 76,599    | 60,222    |
| Accumulated deficit                        | (20,737)  | (8,106)   |
| Total shareholders' equity                 | 55,921    | 52,174    |
| Total liabilities and shareholders' equity | \$ 59,587 | \$ 57,416 |

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<br>Months<br>Ended<br>September 30,<br>2015 | Three<br>Months<br>Ended<br>September 30,<br>2014 | Nine<br>Months<br>Ended<br>September 30,<br>2015 | Nine<br>Months<br>Ended<br>September 30,<br>2014 |
|---------------------------------------|---|---|--|--|
| Revenue:                              |   |   |  |  |
| Service                               | \$ 3,072  | \$ 3,155  | \$ 9,808   | \$ 8,859   |
| Subscription                          | 1,561   | 1,452   | 4,947  | 4,360  |
| License                               | 753   | 2,320   | 2,418  | 6,576  |
| <b>Total revenue</b>                  | <b>5,386</b>                                      | <b>6,927</b>                                      | <b>17,173</b>                                    | <b>19,795</b>                                    |
| Cost of revenue:                      |   |   |  |  |
| Service                               | 1,204   | 1,224   | 4,279  | 3,807  |
| Subscription                          | 808   | 812   | 2,428  | 2,160  |
| License                               | 86  | 84  | 256  | 250  |
| <b>Total cost of revenue</b>          | <b>2,098</b>                                      | <b>2,120</b>                                      | <b>6,963</b>                                     | <b>6,217</b>                                     |
| <b>Gross profit</b>                   | <b>3,288</b>                                      | <b>4,807</b>                                      | <b>10,210</b>                                    | <b>13,578</b>                                    |
| Operating expenses:                   |   |   |  |  |
| Sales and marketing                   | 2,309   | 1,999   | 6,497  | 5,930  |
| Research, development and engineering | 3,236   | 3,499   | 9,345  | 10,449   |
| General and administrative            | 1,847   | 2,183   | 6,033  | 6,929  |
| Intellectual property                 | 367   | 366   | 1,025  | 1,287  |
| <b>Total operating expenses</b>       | <b>7,759</b>                                      | <b>8,047</b>                                      | <b>22,900</b>                                    | <b>24,595</b>                                    |
| <b>Operating loss</b>                 | <b>(4,471)</b>                                    | <b>(3,240)</b>                                    | <b>(12,690)</b>                                  | <b>(11,017)</b>                                  |
| Other income, net                     | 29  | 3   | 84   | 50   |
| <b>Loss before income taxes</b>       | <b>(4,442)</b>                                    | <b>(3,237)</b>                                    | <b>(12,606)</b>                                  | <b>(10,967)</b>                                  |
| (Provision) benefit for income taxes  | (27)  | 1,252   | (25)   | 4,316  |
| <b>Net loss</b>                       | <b>\$ (4,469)</b>                                 | <b>\$ (1,985)</b>                                 | <b>\$ (12,631)</b>                               | <b>\$ (6,651)</b>                                |
| Earnings (loss) per common share:     |   |   |  |  |
| Loss per common share basic           | \$ (0.54)   | \$ (0.28)   | \$ (1.56)  | \$ (0.95)  |
| Loss per common share diluted         | \$ (0.54)   | \$ (0.28)   | \$ (1.56)  | \$ (0.95)  |
|                                       | 8,309   | 7,176   | 8,101  | 7,097  |

Weighted average common shares  
outstanding basic

|   |       |       |       |       |
|---|-------|-------|-------|-------|
| Weighted average common shares<br>outstanding diluted | 8,309 | 7,176 | 8,101 | 7,097 |
|---|-------|-------|-------|-------|

|  |    |    |    |         |
|--|----|----|----|---------|
| Cash dividends declared per common share | \$ | \$ | \$ | \$ 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)

(UNAUDITED)

|  | Preferred<br>Stock |        | Common<br>Stock |        | Additional<br>Paid-in<br>Capital | Retained<br>Earnings<br>(Accumulated<br>Deficit) | Total<br>Shareholders<br>Equity |
|--|--------------------|--------|-----------------|--------|----------------------------------|--|---------------------------------|
|  | Shares             | Amount | Shares          | Amount |                                  |  |                                 |
| <b>BALANCE AT DECEMBER 31, 2013</b>                | 10                 | \$ 50  | 7,401           | \$ 7   | \$ 41,498                        | \$ 9,368   | \$ 50,923                       |
| Exercise of stock options                          |                    |        | 185             | 1      | 1,318                            |  | 1,319                           |
| Issuance of restricted common stock                |                    |        | 204             |        |                                  |  |                                 |
| Forfeiture of restricted common stock              |                    |        | (13)            |        |                                  |  |                                 |
| Purchase and retirement of<br>common stock         |                    |        | (88)            |        | (1,931)                          |  | (1,931)                         |
| Stock-based compensation                           |                    |        |                 |        | 4,218                            |  | 4,218                           |
| Tax impact from stock-based awards                 |                    |        |                 |        | (1,347)                          |  | (1,347)                         |
| Net loss   |                    |        |                 |        |                                  | (6,651)  | (6,651)                         |
| Cash dividends declared                            |                    |        |                 |        |                                  | (1,654)  | (1,654)                         |
| <b>BALANCE AT SEPTEMBER 30,<br/>2014</b>           | 10                 | \$ 50  | 7,689           | \$ 8   | \$ 43,756                        | \$ 1,063   | \$ 44,877                       |
| <b>BALANCE AT DECEMBER 31, 2014</b>                | 10                 | \$ 50  | 8,427           | \$ 8   | \$ 60,222                        | \$ (8,106)                                       | \$ 52,174                       |
| Issuance of common stock, net of<br>issuance costs |                    |        | 342             | 1      | 12,895                           |  | 12,896                          |
| Exercise of stock options                          |                    |        | 91              |        | 1,321                            |  | 1,321                           |
| Issuance of restricted common stock                |                    |        | 132             |        |                                  |  |                                 |
| Forfeiture of restricted common stock              |                    |        | (29)            |        |                                  |  |                                 |
| Purchase and retirement of<br>common stock         |                    |        | (57)            |        | (1,833)                          |  | (1,833)                         |
| Stock-based compensation                           |                    |        |                 |        | 3,994                            |  | 3,994                           |
| Net loss   |                    |        |                 |        |                                  | (12,631)   | (12,631)                        |
| <b>BALANCE AT SEPTEMBER 30,<br/>2015</b>           | 10                 | \$ 50  | 8,906           | \$ 9   | \$ 76,599                        | \$ (20,737)                                      | \$ 55,921                       |

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

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**DIGIMARC CORPORATION**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

(In thousands)

(UNAUDITED)

|   | <b>Nine<br/>Months<br/>Ended<br/>September 30,<br/>2015</b> | <b>Nine<br/>Months<br/>Ended<br/>September 30,<br/>2014</b> |
|---|---|---|
| Cash flows from operating activities:                                       |   |   |
| Net loss  | \$ (12,631)   | \$ (6,651)  |
| Adjustments to reconcile net loss to net cash used in operating activities: |   |   |
| Depreciation, amortization and write-off of property and equipment          | 930   | 708   |
| Amortization and write-off of intangibles                                   | 794   | 916   |
| Changes in allowance for doubtful accounts                                  | 16  | (13)  |
| Stock-based compensation  | 3,857   | 4,085   |
| Deferred income taxes   |   | (2,874)   |
| Changes in operating assets and liabilities:                                |   |   |
| Trade accounts receivable   | 1,842   | 2,000   |
| Other current assets  | (251)   | (1,559)   |
| Other assets  | 66  | 160   |
| Accounts payable and other accrued liabilities                              | 280   | (340)   |
| Deferred revenue  | (1,929)   | (2,338)   |
| Net cash used in operating activities                                       | (7,026)   | (5,906)   |
| Cash flows from investing activities:                                       |   |   |
| Purchase of property and equipment  | (747)   | (1,010)   |
| Capitalized patent costs  | (646)   | (922)   |
| Maturity of marketable securities   | 79,985  | 47,961  |
| Purchase of marketable securities   | (78,620)  | (38,840)  |
| Net cash provided by (used in) investing activities                         | (28)  | 7,189   |
| Cash flows from financing activities:                                       |   |   |
| Issuance of common stock, net of issuance costs                             | 12,896  | (124)   |
| Exercise of stock options   | 1,321   | 1,319   |
| Purchase of common stock  | (1,833)   | (1,931)   |
| Cash dividends paid   |   | (1,654)   |
| Net cash provided by (used in) financing activities                         | 12,384  | (2,390)   |
| Net increase (decrease) in cash and cash equivalents                        | 5,330   | (1,107)   |
| Cash and cash equivalents at beginning of period                            | 6,122   | 3,811   |

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|  |    |        |    |       |
|--|----|--------|----|-------|
| Cash and cash equivalents at end of period                           | \$ | 11,452 | \$ | 2,704 |
| <b>Supplemental disclosure of cash flow information:</b>             |    |        |    |       |
| Cash paid (received) for income taxes, net                           | \$ | 22     | \$ | (12)  |
| <b>Supplemental schedule of non-cash investing activities:</b>       |    |        |    |       |
| Property and equipment and patent costs included in accounts payable | \$ | 73     | \$ | 194   |
| Stock-based compensation capitalized to patent costs and software    | \$ | 137    | \$ | 133   |

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 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 has developed the Digimarc Discover® and Digimarc Barcode Intuitive Computing Platform that are designed to optimize the identification of all consumer brand impressions, wherever and whenever they may appear, facilitating modern mobile-centric shopping. The platform includes means to embed Digimarc Barcodes, invisible and inaudible barcode-like information that is recognizable by smartphones, industrial scanners, and other computer interfaces into virtually all forms of media content, including consumer products packaging. Digimarc Barcodes have many applications, including facilitating remarkably faster scanning of products at retail checkout as well as improved engagement with smartphone-equipped consumers. The Digimarc Barcode is robust yet imperceptible by people in ordinary use, allowing for reliable, efficient, economical, globally scalable automatic identification of media without visible computer codes like traditional barcodes. Digimarc Discover is a multi-modal discovery software platform that facilitates automatic identification of items by smartphone users. The Company also supplies anti-counterfeiting solutions to Central Banks and anti-piracy solutions to rights-holders of ebooks and digital images.

*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, 2014 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 ( U.S. GAAP ) 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, 2014, which was filed with the SEC on February 20, 2015. 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 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.

*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 a single reporting unit. The Company estimated the fair value of its single reporting unit using a market approach, which takes into account the Company's market capitalization plus an estimated control premium.

In connection with the Company's annual impairment test of goodwill as of June 30, 2015 and 2014, it was concluded that there was no impairment as the estimated fair value of the Company's reporting unit substantially exceeded the carrying value.

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In May 2014, the Financial Accounting Standards Board ( FASB ) issued Accounting Standards Update ( ASU ) No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*. ASU No. 2014-09 provides specific guidance to recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The ASU will replace most existing revenue recognition guidance in U.S. GAAP when it becomes effective. In July 2015, the FASB affirmed its proposal to defer the effective date of the new revenue standard for public entities by one year to annual reporting periods beginning after December 31, 2017, and interim periods beginning in the first interim period within the year of adoption. The amendments in this update permit the use of either the retrospective or cumulative effect transition method. The Company has not yet selected a transition method and is currently assessing the potential future impact of this standard on the financial condition or results of operations of the Company.

**2. Fair Value of Financial Instruments**

The estimated fair values of the Company's financial instruments, which include 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, 2015 and December 31, 2014, respectively, was as follows:

| <b>September 30, 2015</b>        | <b>Level 1</b>  | <b>Level 2</b>   | <b>Level 3</b> | <b>Total</b>     |
|----------------------------------|-----------------|------------------|----------------|------------------|
| Money market securities          | \$ 3,423        | \$               | \$             | \$ 3,423         |
| Corporate notes                  |                 | 17,220           |                | 17,220           |
| Federal agency notes             |                 | 6,591            |                | 6,591            |
| Commercial paper                 |                 | 6,304            |                | 6,304            |
| Pre-refunded municipal bonds (1) |                 | 5,928            |                | 5,928            |
| Certificates of deposits         |                 | 2,038            |                | 2,038            |
| <b>Total</b>                     | <b>\$ 3,423</b> | <b>\$ 38,081</b> | <b>\$</b>      | <b>\$ 41,504</b> |
| <b>December 31, 2014</b>         | <b>Level 1</b>  | <b>Level 2</b>   | <b>Level 3</b> | <b>Total</b>     |
| Money market securities          | \$ 3,556        | \$               | \$             | \$ 3,556         |
| Corporate notes                  |                 | 19,245           |                | 19,245           |
| Pre-refunded municipal bonds (1) |                 | 13,317           |                | 13,317           |
| Certificates of deposits         |                 | 2,176            |                | 2,176            |
| <b>Total</b>                     | <b>\$ 3,556</b> | <b>\$ 34,738</b> | <b>\$</b>      | <b>\$ 38,294</b> |

(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, 2015 are as follows:

|  | <b>Maturities by Period</b> |                             |                  |                   |                               |
|--|-----------------------------|-----------------------------|------------------|-------------------|-------------------------------|
|  | <b>Total</b>                | <b>Less than<br/>1 year</b> | <b>1-5 years</b> | <b>5-10 years</b> | <b>More than<br/>10 years</b> |
| Cash equivalents and marketable securities | \$ 41,504                   | \$ 41,504                   | \$               | \$                | \$                            |

The Company considers all highly liquid marketable securities with original maturities of 90 days or less at the date of acquisition to be cash equivalents. Cash equivalents include money market funds and certificates of deposit totaling \$9,919 and \$5,344 at September 30, 2015 and December 31, 2014, respectively. Cash equivalents are carried at cost or amortized cost, which approximates fair value.

### **3. Revenue Recognition**

The Company derives its revenue primarily from development services, subscriptions and licensing of its intellectual property:

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

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Subscription revenue includes Digimarc Discover, Barcode and Guardian products and services, is generally recurring, paid in advance and recognized over the term of the subscription.

License revenue originates primarily from licensing the Company's intellectual property where the Company receives license fees and/or 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 licenses, professional services, software licenses, and maintenance and support 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 should be divided into separate units of accounting if certain criteria are met. The Company applies ASC 985 to software deliverables when relevant. The consideration for the arrangement under ASC 605-25 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:

Service revenue is generally determined based on time and materials. Revenue for development and consulting 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 Digimarc Discover, Barcode and Guardian products and services, is generally paid in advance and recognized over the term of the subscription, which is generally one to three years.



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 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 service, subscription and license contracts for which revenue has not been earned.

#### **4. Segment Information**

##### *Geographic Information*

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

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

|                   | <b>Three<br/>Months<br/>Ended<br/>September 30,<br/>2015</b> | <b>Three<br/>Months<br/>Ended<br/>September 30,<br/>2014</b> | <b>Nine<br/>Months<br/>Ended<br/>September 30,<br/>2015</b> | <b>Nine<br/>Months<br/>Ended<br/>September 30,<br/>2014</b> |
|-------------------|--|--|---|---|
| Domestic          | \$ 1,733   | \$ 3,046   | \$ 5,178  | \$ 7,946  |
| International (1) | 3,653  | 3,881  | 11,995  | 11,849  |
| <b>Total</b>      | <b>\$ 5,386</b>  | <b>\$ 6,927</b>  | <b>\$ 17,173</b>  | <b>\$ 19,795</b>  |

(1) Revenue from the Central Banks, consisting 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 10% or more of the Company's revenue are as follows:

|                     | <b>Three<br/>Months<br/>Ended<br/>September 30,<br/>2015</b> | <b>Three<br/>Months<br/>Ended<br/>September 30,<br/>2014</b> | <b>Nine<br/>Months<br/>Ended<br/>September 30,<br/>2015</b> | <b>Nine<br/>Months<br/>Ended<br/>September 30,<br/>2014</b> |
|---------------------|--|--|---|---|
| Central Banks       | 53%  | 43%  | 56%   | 47%   |
| Verance Corporation |  | 23%  |   | 14%   |

In the third quarter of 2014, the Company extended the patent license agreement with Verance through 2023, in effect waiving any future royalties and license fees, in exchange for a \$1.0 million license fee payment.

**5. Stock-Based Compensation**

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

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

*Determining Fair Value**Stock Options*

*Valuation and Amortization Method.* The Company estimates the fair value of stock options granted using the Black-Scholes option valuation model. The Company amortizes the fair value of all awards on a straight-line basis

over the requisite service periods, which are generally the vesting periods.

*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 by 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.

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There were no stock options granted during the three- and nine-month periods ended September 30, 2015 and 2014.

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

*Restricted Stock*

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, 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.

*Stock-based Compensation*

|   | <b>Three<br/>Months<br/>Ended<br/>September 30,<br/>2015</b> | <b>Three<br/>Months<br/>Ended<br/>September 30,<br/>2014</b> | <b>Nine<br/>Months<br/>Ended<br/>September 30,<br/>2015</b> | <b>Nine<br/>Months<br/>Ended<br/>September 30,<br/>2014</b> |
|---|--|--|---|---|
| <b>Stock-based compensation:</b>              |  |  |   |   |
| Cost of revenue                               | \$ 171   | \$ 131   | \$ 569  | \$ 402  |
| Sales and marketing                           | 251  | 187  | 585   | 504   |
| Research, development and engineering         | 396  | 363  | 1,011   | 1,083   |
| General and administrative                    | 485  | 688  | 1,487   | 1,844   |
| Intellectual property                         | 74   | 85   | 205   | 252   |
| Stock-based compensation expense              | 1,377  | 1,454  | 3,857   | 4,085   |
| Capitalized to patent costs and software      | 46   | 46   | 137   | 133   |
| <b>Total stock-based compensation expense</b> | <b>\$ 1,423</b>  | <b>\$ 1,500</b>  | <b>\$ 3,994</b>   | <b>\$ 4,218</b>   |

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

|  | <b>As of<br/>September 30,<br/>2015</b> | <b>As of<br/>December 31,<br/>2014</b> |
|--|---|--|
| <b>Total unrecognized compensation costs</b> | <b>\$ 10,380</b>                        | <b>\$ 11,206</b>                       |

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, 2015 for stock options and restricted stock over weighted average periods through September 2019 as follows:

|                         | <b>Stock<br/>Options</b> | <b>Restricted<br/>Stock</b> |
|-------------------------|--------------------------|-----------------------------|
| Weighted average period | 0.0 years                | 1.4 years                   |

As of September 30, 2015, under all of the Company's stock-based compensation plans, equity awards to purchase an additional 1,434 shares were authorized for future grants under the plans. The Company issues new shares upon option exercises.

**Table of Contents***Stock Option Activity*

The following table reconciles the outstanding balance of stock options:

|   | Options | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Grant Date<br>Fair Value | Aggregate<br>Intrinsic<br>Value |
|---|---------|--|---|---------------------------------|
| <b>Three-months ended September 30, 2015:</b> |         |  |   |                                 |
| Outstanding at June 30, 2015                  | 530     | \$ 17.12                                 | \$ 8.51   |                                 |
| Options granted                               |         |  |   |                                 |
| Options exercised                             | (20)    | 9.64                                     | 6.30  |                                 |
| Options forfeited or expired                  |         |  |   |                                 |
| Outstanding at September 30, 2015             | 510     | \$ 17.41                                 | \$ 8.59   | \$ 6,699                        |
| <b>Nine-months ended September 30, 2015:</b>  |         |  |   |                                 |
| Outstanding at December 31, 2014              | 601     | \$ 16.97                                 | \$ 8.42   |                                 |
| Options granted                               |         |  |   |                                 |
| Options exercised                             | (91)    | 14.47                                    | 7.46  |                                 |
| Options forfeited or expired                  |         |  |   |                                 |
| Outstanding at September 30, 2015             | 510     | \$ 17.41                                 | \$ 8.59   | \$ 6,699                        |
| Exercisable at September 30, 2015             | 510     | \$ 17.41                                 |   | \$ 6,699                        |

The aggregate intrinsic value is based on the closing price of \$30.55 per share of Digimarc common stock on September 30, 2015, which would have been received by the optionees had all of the options with exercise prices less than \$30.55 per share been exercised on that date.

*Restricted Stock Activity*

The following table reconciles the unvested balance of restricted stock:

|   | Number of<br>Shares | Weighted<br>Average<br>Grant Date<br>Fair Value |
|---|---------------------|---|
| <b>Three-months ended September 30, 2015:</b> |                     |   |
| Unvested balance, June 30, 2015               | 489                 | \$ 23.98  |
| Granted                                       | 13                  | \$ 37.60  |
| Vested  | (52)                | \$ 24.53  |

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|                                      |     |          |
|--------------------------------------|-----|----------|
| Forfeited                            | (1) | \$ 24.43 |
| Unvested balance, September 30, 2015 | 449 | \$ 24.30 |

|  | <b>Number of<br/>Shares</b> | <b>Weighted<br/>Average<br/>Grant Date<br/>Fair Value</b> |
|--|-----------------------------|---|
| <b>Nine-months ended September 30, 2015:</b> |                             |   |
| Unvested balance, December 31, 2014          | 502                         | \$ 23.09  |
| Granted                                      | 132                         | \$ 29.37  |
| Vested                                       | (156)                       | \$ 24.80  |
| Forfeited                                    | (29)                        | \$ 23.68  |
| Unvested balance, September 30, 2015         | 449                         | \$ 24.30  |

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The following table indicates the fair value of all restricted stock awards that vested during the three- and nine-months ended September 30, 2015 and 2014:

|  | <b>Three<br/>Months<br/>Ended<br/>September 30,<br/>2015</b> | <b>Three<br/>Months<br/>Ended<br/>September 30,<br/>2014</b> | <b>Nine<br/>Months<br/>Ended<br/>September 30,<br/>2015</b> | <b>Nine<br/>Months<br/>Ended<br/>September 30,<br/>2014</b> |
|--|--|--|---|---|
| Fair value of restricted stock awards vested | \$ 1,961   | \$ 1,206   | \$ 4,840  | \$ 4,417  |

**6. 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.

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 potentially dilutive effect of stock options. The following table reconciles earnings (loss) per common share for the three- and nine-month periods ended September 30, 2015 and 2014:

|  | <b>Three Months<br/>Ended<br/>September 30,<br/>2015</b> | <b>Three Months<br/>Ended<br/>September 30,<br/>2014</b> | <b>Nine Months<br/>Ended<br/>September 30,<br/>2015</b> | <b>Nine Months<br/>Ended<br/>September 30,<br/>2014</b> |
|--|--|--|---|---|
| <b>Basic Earnings (Loss) per<br/>Common Share:</b>           |  |  |   |   |
| <i>Numerator:</i>  |  |  |   |   |
| Net loss   | \$ (4,469)   | \$ (1,985)   | \$ (12,631)   | \$ (6,651)  |
| Distributed earnings to common shares                        |  |  |   | 1,553   |
| Distributed earnings to participating securities             |  |  |   | 101   |
| Total distributed earnings                                   |  |  |   | 1,654   |
| Undistributed loss allocable to common shares                | (4,469)  | (1,985)  | (12,631)  | (8,305)   |
| Undistributed earnings allocable to participating securities |  |  |   |   |
| Total undistributed loss                                     | (4,469)  | (1,985)  | (12,631)  | (8,305)   |
| Loss to common shares - basic                                | \$ (4,469)   | \$ (1,985)   | \$ (12,631)   | \$ (6,752)  |



| <b>Denominator</b>   |  |  |   |   |
|--|--|--|---|---|
| Weighted average common shares outstanding basic               | 8,309  | 7,176  | 8,101                                       | 7,097                                       |
| Basic earnings (loss) per common share                         | \$ (0.54)                                    | \$ (0.28)                                    | \$ (1.56)                                   | \$ (0.95)                                   |
|  | <b>Three Months Ended September 30, 2015</b> | <b>Three Months Ended September 30, 2014</b> | <b>Nine Months Ended September 30, 2015</b> | <b>Nine Months Ended September 30, 2014</b> |
| <b>Diluted Earnings (Loss) per Common Share:</b>               |  |  |   |   |
| <b>Numerator:</b>  |  |  |   |   |
| Loss to common shares basic                                    | \$ (4,469)                                   | \$ (1,985)                                   | \$ (12,631)                                 | \$ (6,752)                                  |
| Undistributed earnings allocated to participating securities   |  |  |   |   |
| Undistributed earnings reallocated to participating securities |  |  |   |   |
| Loss to common shares diluted                                  | \$ (4,469)                                   | \$ (1,985)                                   | \$ (12,631)                                 | \$ (6,752)                                  |
| <b>Denominator</b>   |  |  |   |   |
| Weighted average common shares outstanding basic               | 8,309  | 7,176  | 8,101                                       | 7,097                                       |
| Dilutive effect of stock options                               |  |  |   |   |
| Weighted average common shares outstanding dilutive            | 8,309  | 7,176  | 8,101                                       | 7,097                                       |
| Diluted earnings (loss) per common share                       | \$ (0.54)                                    | \$ (0.28)                                    | \$ (1.56)                                   | \$ (0.95)                                   |

There were 272 and 234 common stock equivalents related to stock options that were anti-dilutive and excluded from diluted earnings per common share calculations for the three- and nine-month periods ended September 30, 2015, respectively, as the Company incurred a net loss during the periods.

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There were 218 and 226 common stock equivalents related to stock options that were anti-dilutive and excluded from diluted earnings per common share calculations for the three- and nine-month periods ended September 30, 2014, respectively, as the Company incurred a net loss during the periods.

**7. Trade Accounts Receivable***Trade Accounts Receivable*

Trade accounts receivable are recorded at the invoiced amount.

|   | <b>September 30,<br/>2015</b> | <b>December 31,<br/>2014</b> |
|---|-------------------------------|------------------------------|
| Trade accounts receivable                                     | \$ 2,725                      | \$ 4,567                     |
| Allowance for doubtful accounts                               | (38)                          | (22)                         |
| <b>Trade accounts receivable, net</b>                         | <b>\$ 2,687</b>               | <b>\$ 4,545</b>              |
| <br>  |                               |                              |
| Unpaid deferred revenue included in trade accounts receivable | \$ 639                        | \$ 1,974                     |

*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 each reporting period. Account balances are charged against the allowance after all 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 trade accounts receivable nor deferred revenue.

*Major customers*

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

|                       | <b>September 30,<br/>2015</b> | <b>December 31,<br/>2014</b> |
|-----------------------|-------------------------------|------------------------------|
| Central Banks         | 35%                           | 61%                          |
| Intellectual Ventures | 18%                           | *                            |
| Civolution            | *                             | 13%                          |

\* Less than 10%

## 8. Property and Equipment

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

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

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

|  | September 30,<br>2015 | December 31,<br>2014 |
|--|-----------------------|----------------------|
| Office furniture and fixtures                  | \$ 927                | \$ 845               |
| Software                                       | 1,640                 | 1,312                |
| Equipment                                      | 3,275                 | 3,072                |
| Leasehold improvements                         | 1,237                 | 1,198                |
| Gross property and equipment                   | 7,079                 | 6,427                |
| Less accumulated depreciation and amortization | (4,227)               | (3,451)              |
| Property and equipment, net                    | \$ 2,852              | \$ 2,976             |

**Table of Contents****9. 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.

Amortization of intangible assets acquired is calculated using the straight-line method over the estimated useful lives of the assets, generally ranging from one to seven years.

|   | <b>September 30,<br/>2015</b> | <b>December 31,<br/>2014</b> |
|---|-------------------------------|------------------------------|
| Capitalized patent costs                    | \$ 6,722                      | \$ 6,183                     |
| 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                          |
| <br>  |                               |                              |
| Gross intangible assets                     | 9,992                         | 9,453                        |
| Accumulated amortization                    | (3,269)                       | (2,733)                      |
| <br>  |                               |                              |
| Intangibles, net                            | \$ 6,723                      | \$ 6,720                     |

**10. Shareholders Equity**

In August 2014, the Company entered into an Equity Distribution Agreement, whereby the Company may sell from time to time through Wells Fargo Securities, LLC, as sales agent, the Company's common stock having an aggregate offering price of up to \$30 million. For the three- and nine-month periods ended September 30, 2015, the Company sold 342 common shares at a weighted average price of \$38.83 per share under this Equity Distribution Agreement totaling \$12,978 of cash proceeds, net of sales commissions of \$299, and paid \$82 in stock issuance costs.

As of September 30, 2015, the Company has sold 1,026 shares under the Equity Distribution Agreement at an average price of \$29.24 resulting in \$29,300 of cash proceeds, net of sales commissions of \$700, and paid \$415 in stock issuance costs. There are no shares remaining to be sold under the Equity Distribution Agreement.

**11. Joint Ventures and Related Party Transactions**

On July 1, 2009, Digimarc and Nielsen commenced operation of two joint ventures with Nielsen, TVaura LLC (in which Digimarc holds a 51% ownership interest) and TVaura Mobile LLC (in which Digimarc holds a 49% ownership interest). In March 2012, Digimarc and Nielsen decided to reduce the investments in both two joint

ventures to minimal levels while assessing alternative approaches to achieving each of their goals in media asset management and the emerging market opportunity of synchronized second screen television. Payment of all expenses incurred after the suspension of operations of each joint venture was unconditionally the responsibility of the majority owner, which expenses for TVaura LLC, if any, will be paid by Digimarc. In October 2015, Digimarc and Nielsen reactivated the TVaura Mobile LLC joint venture to allow it to provide solutions to programmers and advertisers for engaging with consumers on second screens and otherwise provide enhanced flexibility to brand strategies targeting modern consumers. The enhanced cooperation represents another building block in developing the market for Digimarc Discover and Digimarc Barcode. Initially, neither Digimarc nor Nielsen will be contributing any capital to the joint venture upon reactivation.

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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 were suspended through September 30, 2015. The joint ventures had no revenue or expenses for the three- and nine-month periods ended September 30, 2015 and 2014. The Company's investment in each joint venture was \$0 as of September 30, 2015 and December 31, 2014.

**12. Income Taxes**

The (provision) benefit for income taxes reflects current taxes, deferred taxes, and withholding taxes in certain foreign jurisdictions. The effective tax rate for the nine-months ended September 30, 2015 and 2014 was 0% and 40%, respectively. The valuation allowance against net deferred tax assets as of September 30, 2015 was \$12,092, an increase of \$4,804 from \$7,288 as of December 31, 2014.

**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.

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

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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 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 in the audited consolidated financial statements and related notes included in our Annual Report on Form 10-K for the year ended December 31, 2014 filed on February 20, 2015 (our 2014 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 except per share amounts or unless otherwise noted. Percentages within the following tables may not foot due to rounding.*

*Digimarc, Digimarc Discover, Digimarc Barcode and Guardian are trademarks 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. We have developed the Digimarc Discover® and Digimarc Barcode Intuitive Computing Platform that are designed to optimize the identification of all consumer brand impressions, wherever and whenever they may appear, facilitating modern mobile-centric shopping. The platform includes means to embed Digimarc Barcodes, invisible and inaudible barcode-like information that is recognizable by smartphones, industrial scanners, and other computer interfaces into virtually all forms of media content, including consumer products packaging. Digimarc Barcodes have many applications, including facilitating remarkably faster scanning of products at retail checkout as well as improved engagement with smartphone-equipped consumers. The Digimarc Barcode is robust yet imperceptible by people in ordinary use, allowing for reliable, efficient, economical, globally scalable automatic identification of media without visible computer codes like traditional barcodes.

Our media identification and discovery innovations enable our business partners to create numerous applications across a wide range of media content, including solutions that:

Improve the speed of retail checkout;

Provide simple and intuitive mobile customer engagement experiences in stores;

Quickly and reliably identify and effectively manage music, movies, television programming, digital images, e-books, documents and other printed materials, especially in light of 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

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 many 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, smartphones and other digital devices.



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Our inventions allow our business partners and customers to provide persistent digital identities for 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 enabling software and business processes, and associated intellectual property portfolio, have grown to encompass many related technologies.

We provide solutions directly and through business partners. 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 ( Central Banks ), and many leading companies in the information technology industry. We and our business partners have successfully propagated the use of our technology in music, movies, television broadcasts, digital images, e-books and printed materials. Digimarc Barcodes 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.

Digimarc Barcodes are easily embedded into all forms of media and are imperceptible to human senses, but quickly detected by computers, networks or other digital devices like smartphones. Unlike traditional barcodes and tags, our solution does not require publishers to give up valuable visual space in magazines and newspapers; nor does it impact the overall layout or aesthetics of the publication. Our Digimarc Discover platform delivers a range of rich media experiences to its readers on their smartphones across multiple media including print, audio, video and packaging. Unique to the Digimarc Discover platform is its ability to use various content identification technologies as needed, including our patented technology.

We introduced Digimarc Barcodes for use in consumer product packaging in 2014. Digimarc Barcodes can contain the same information found in traditional universal product codes ( UPC ). The UPC information is invisibly repeated multiple times over the entire package surface. We partnered with Datalogic, a global leader in Automatic Data Capture and Industrial Automation markets and producer of barcode readers, in bringing the Digimarc Barcode to the consumer product packaging market. The first retail scanner enabled was Datalogic's Magellan<sup>™</sup> 9800i multi-plane imaging scanner. Digimarc Barcodes can also connect mobile-enabled consumers directly from packaging to engaging mobile experiences such as additional product information, special offers, recommendations, reviews, social networks and more.

Our patent portfolio contains many innovations in digital watermarking, pattern recognition (sometimes referred to as fingerprinting ), digital rights management and related fields. To protect our inventions, we have implemented an extensive intellectual property protection program that relies on a combination of patent, copyright, trademark and trade secret laws, and nondisclosure agreements and other contracts. As a result, we believe we have one of the world's most extensive patent portfolios in digital watermarking and related fields, with approximately 1,200 U.S. and foreign patents and pending patent applications as of September 30, 2015. We continue to develop and broaden our portfolio 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. The patents in our portfolio have a life of approximately 20 years from the effective filing date, and up to 17 years after the patent has been granted.

Our primary objective is to foster adoption of our inventions by building long-term relationships with potential customers and business partners and to:

make progress toward the realization of our vision to enrich everyday living via pervasive, intuitive computing;

expand the scope of use of our inventions;

improve our financial performance; and

lay a foundation for continuing innovation.

For a discussion of activities and costs related to our research and development, see **Results of Operations - Summary Research, development and engineering.**

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

Detailed information on our critical accounting policies and estimates are set forth in our 2014 Annual Report in Part II, Item 7 thereof ( **Management's Discussion and Analysis of Financial Condition and Results of Operations** ), under the caption **Critical Accounting Policies and Estimates**, which is incorporated by reference into this Quarterly Report on Form 10-Q.

**Table of Contents****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, 2015 and all changes discussed with respect to such periods reflect changes compared to the three- and nine-month periods ended September 30, 2014.

|   | <b>Three<br/>Months<br/>Ended<br/>September 30,<br/>2015</b> | <b>Three<br/>Months<br/>Ended<br/>September 30,<br/>2014</b> | <b>Nine<br/>Months<br/>Ended<br/>September 30,<br/>2015</b> | <b>Nine<br/>Months<br/>Ended<br/>September 30,<br/>2014</b> |
|---|--|--|---|---|
| <b>Revenue:</b>                             |  |  |   |   |
| Service                                     | 57%  | 46%  | 57%   | 45%   |
| Subscription                                | 29   | 21   | 29  | 22  |
| License                                     | 14   | 33   | 14  | 33  |
| <b>Total revenue</b>                        | <b>100</b>   | <b>100</b>   | <b>100</b>  | <b>100</b>  |
| <b>Cost of revenue:</b>                     |  |  |   |   |
| Service                                     | 22   | 18   | 25  | 19  |
| Subscription                                | 15   | 12   | 14  | 11  |
| License                                     | 2  | 1  | 1   | 1   |
| <b>Total cost of revenue</b>                | <b>39</b>  | <b>31</b>  | <b>41</b>   | <b>31</b>   |
| <b>Gross profit</b>                         | <b>61</b>  | <b>69</b>  | <b>59</b>   | <b>69</b>   |
| <b>Operating expenses:</b>                  |  |  |   |   |
| Sales and marketing                         | 43   | 29   | 38  | 30  |
| Research, development and engineering       | 60   | 51   | 54  | 53  |
| General and administrative                  | 34   | 32   | 35  | 35  |
| Intellectual property                       | 7  | 5  | 6   | 7   |
| <b>Total operating expenses</b>             | <b>144</b>   | <b>116</b>   | <b>133</b>  | <b>124</b>  |
| <b>Operating loss</b>                       | <b>(83)</b>  | <b>(47)</b>  | <b>(74)</b>   | <b>(56)</b>   |
| <b>Other income, net</b>                    | <b>1</b>   | <b>0</b>   | <b>0</b>  | <b>0</b>  |
| <b>Loss before income taxes</b>             | <b>(82)</b>  | <b>(47)</b>  | <b>(73)</b>   | <b>(55)</b>   |
| <b>(Provision) benefit for income taxes</b> | <b>(1)</b>   | <b>18</b>  | <b>0</b>  | <b>22</b>   |
| <b>Net loss</b>                             | <b>(83)%</b>   | <b>(29)%</b>   | <b>(74)%</b>  | <b>(34)%</b>  |

**Summary**

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Total revenue for the three-month period ended September 30, 2015, compared to the corresponding three-month period ended September 30, 2014, decreased \$1.5 million or 22% to \$5.4 million, reflecting lower license revenue of \$1.6 million primarily due to the end of payments from Verance Corporation ( Verance ) in the fourth quarter of 2014, partially offset by growth in subscription revenue.

Total revenue for the nine-month period ended September 30, 2015, compared to the corresponding nine-month period ended September 30, 2014, decreased \$2.6 million or 13% to \$17.2 million, reflecting lower license revenue of \$4.2 million primarily due to the end of payments from The Nielsen Company ( Nielsen ) in the first quarter of 2014 and Verance in the fourth quarter of 2014, partially offset by growth in service and subscription revenue.

Total operating expenses for the three- and nine-month periods ended September 30, 2015, compared to the corresponding three- and nine-month periods ended September 30, 2014, decreased 4% to \$7.8 million and 7% to \$22.9 million, respectively, reflecting lower spending in research, development and engineering, partially offset by higher investment in sales and marketing as we focus on market development and delivery for Digimarc Discover and Barcode. General and administrative costs were also lower for the three- and nine-month periods ended September 30, 2015.

**Table of Contents***Revenue*

|                 | <b>Three<br/>Months<br/>Ended<br/>September 30,<br/>2015</b> | <b>Three<br/>Months<br/>Ended<br/>September 30,<br/>2014</b> | <b>Dollar<br/>Increase<br/>(Decrease)</b> | <b>Percent<br/>Increase<br/>(Decrease)</b> | <b>Nine<br/>Months<br/>Ended<br/>September 30,<br/>2015</b> | <b>Nine<br/>Months<br/>Ended<br/>September 30,<br/>2014</b> | <b>Dollar<br/>Increase<br/>(Decrease)</b> | <b>Percent<br/>Increase<br/>(Decrease)</b> |
|-----------------|--|--|---|--|---|---|---|--|
| <b>Revenue:</b> |  |  |   |  |   |   |   |  |
| Service         | \$ 3,072   | \$ 3,155   | \$ (83)                                   | (3)%                                       | \$ 9,808  | \$ 8,859  | \$ 949                                    | 11%  |
| Subscription    | 1,561  | 1,452  | 109                                       | 8%   | 4,947   | 4,360   | 587                                       | 13%  |
| License         | 753  | 2,320  | (1,567)                                   | (68)%                                      | 2,418   | 6,576   | (4,158)                                   | (63)%                                      |
| <b>Total</b>    | <b>\$ 5,386</b>  | <b>\$ 6,927</b>  | <b>\$ (1,541)</b>                         | <b>(22)%</b>                               | <b>\$ 17,173</b>  | <b>\$ 19,795</b>  | <b>\$ (2,622)</b>                         | <b>(13)%</b>                               |

Revenue (as %  
of total revenue):

|              |             |             |  |  |             |             |  |  |
|--------------|-------------|-------------|--|--|-------------|-------------|--|--|
| Service      | 57%         | 46%         |  |  | 57%         | 45%         |  |  |
| Subscription | 29%         | 21%         |  |  | 29%         | 22%         |  |  |
| License      | 14%         | 33%         |  |  | 14%         | 33%         |  |  |
| <b>Total</b> | <b>100%</b> | <b>100%</b> |  |  | <b>100%</b> | <b>100%</b> |  |  |

*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. Most of our service revenue is derived from contracts with the Central Banks 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 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 decrease in service revenue for the three-month period ended September 30, 2015, compared to the corresponding three-month period ended September 30, 2014, was primarily due to the timing of program work with the Central Banks.

The increase in service revenue for the nine-month period ended September 30, 2015, compared to the corresponding nine-month period ended September 30, 2014, was primarily due to timing of program work and higher billable rates under our agreement with the Central Banks and increased program work with a government agency contractor.

*Subscription.* Subscription revenue includes Digimarc Discover, Barcode and Guardian products and services, and is generally recurring in nature, 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, 2015, compared to the corresponding three- and nine-month periods ended September 30, 2014, was primarily from software license fees, recognized over the associated 12-month support period, and growth in Digimarc Barcode revenue, partially offset by lower Digimarc Guardian revenue.

*License.* License revenue originates primarily from licensing our intellectual property where we receive license fees and/or royalties as our income stream.

The decrease in license revenue for the three-month period ended September 30, 2015, compared to the corresponding three-month period ended September 30, 2014, was primarily due to the end of payments from Verance in the fourth quarter of 2014.

The decrease in license revenue for the nine-month period ended September 30, 2015, compared to the corresponding nine-month period ended September 30, 2014, was primarily due to the end of payments from Nielsen in the first quarter of 2014 and Verance in the fourth quarter of 2014.

**Table of Contents***Revenue by Geography*

|   | <b>Three<br/>Months<br/>Ended<br/>September 30,<br/>2015</b> | <b>Three<br/>Months<br/>Ended<br/>September 30,<br/>2014</b> | <b>Dollar<br/>Percent<br/>(Decrease)<br/>(Decrease)</b> | <b>Dollar<br/>Percent<br/>(Decrease)<br/>(Decrease)</b> | <b>Nine<br/>Months<br/>Ended<br/>September 30,<br/>2015</b> | <b>Nine<br/>Months<br/>Ended<br/>September 30,<br/>2014</b> | <b>Dollar<br/>Percent<br/>Increase<br/>Increase<br/>(Decrease)<br/>(Decrease)</b> | <b>Dollar<br/>Percent<br/>Increase<br/>Increase<br/>(Decrease)<br/>(Decrease)</b> |
|---|--|--|---|---|---|---|---|---|
| <b>Revenue by geography:</b>            |  |  |   |   |   |   |   |   |
| Domestic                                | \$ 1,733   | \$ 3,046   | \$ (1,313)  | (43)%   | \$ 5,178  | \$ 7,946  | \$ (2,768)  | (35)%   |
| International                           | 3,653  | 3,881  | (228)   | (6)%  | 11,995  | 11,849  | 146   | 1%  |
| <b>Total</b>                            | <b>\$ 5,386</b>  | <b>\$ 6,927</b>  | <b>\$ (1,541)</b>                                       | <b>(22)%</b>  | <b>\$ 17,173</b>  | <b>\$ 19,795</b>  | <b>\$ (2,622)</b>   | <b>(13)%</b>  |
| <b>Revenue (as % of total revenue):</b> |  |  |   |   |   |   |   |   |
| Domestic                                | 32%  | 44%  |   |   | 30%   | 40%   |   |   |
| International                           | 68%  | 56%  |   |   | 70%   | 60%   |   |   |
| <b>Total</b>                            | <b>100%</b>  | <b>100%</b>  |   |   | <b>100%</b>   | <b>100%</b>   |   |   |

The decrease in domestic revenue for the three-month period ended September 30, 2015, compared to the corresponding three-month period ended September 30, 2014, was primarily due to the end of payments from Verance in the fourth quarter of 2014, partially offset by higher domestic subscription revenue.

The decrease in domestic revenue for the nine-month period ended September 30, 2015, compared to the corresponding nine-month period ended September 30, 2014, was primarily due to the end of payments from Nielsen in the first quarter of 2014 and Verance in the fourth quarter of 2014, partially offset by higher domestic service and subscription revenue.

The decrease in international revenue for the three-month period ended September 30, 2015, compared to the corresponding three-month period ended September 30, 2014, was primarily due to the timing of program work from the Central Banks and lower international subscription revenue.

The increase in international revenue for the nine-month period ended September 30, 2015, compared to the corresponding nine-month period ended September 30, 2014, was primarily due to higher service revenue from the Central Banks, partially offset by lower international license revenue.

We anticipate revenue in 2015 will be lower when compared with 2014, reflecting the end of payments from Nielsen and Verance, partially offset by growth in service and subscription revenue.

*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 direct costs of program delivery for both personnel and operating expenses. 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;

cost of outside contractors to support our Digimarc Guardian anti-piracy service;



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amortization of existing technology acquired in the acquisition of Contributor Corporation ( Contributor );

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:

amortization of capitalized patent costs and patent maintenance fees;

license costs from third parties; and

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

*Gross Profit*

|                      | <b>Three<br/>Months<br/>Ended<br/>September 30,<br/>2015</b> | <b>Three<br/>Months<br/>Ended<br/>September 30,<br/>2014</b> | <b>Dollar<br/>Increase<br/>(Decrease)</b> | <b>Percent<br/>Increase<br/>(Decrease)</b> | <b>Nine<br/>Months<br/>Ended<br/>September 30,<br/>2015</b> | <b>Nine<br/>Months<br/>Ended<br/>September 30,<br/>2014</b> | <b>Dollar<br/>Increase<br/>(Decrease)</b> | <b>Percent<br/>Increase<br/>(Decrease)</b> |
|----------------------|--|--|---|--|---|---|---|--|
| <b>Gross Profit:</b> |  |  |   |  |   |   |   |  |
| Service              | \$ 1,868   | \$ 1,931   | \$ (63)                                   | (3)%                                       | \$ 5,529  | \$ 5,052  | \$ 477                                    | 9%   |
| Subscription         | 753  | 640  | 113                                       | 18%  | 2,519   | 2,200   | 319                                       | 15%  |
| License              | 667  | 2,236  | (1,569)                                   | (70)%                                      | 2,162   | 6,326   | (4,164)                                   | (66)%                                      |
| <b>Total</b>         | <b>\$ 3,288</b>  | <b>\$ 4,807</b>  | <b>\$ (1,519)</b>                         | <b>(32)%</b>                               | <b>\$ 10,210</b>  | <b>\$ 13,578</b>  | <b>\$ (3,368)</b>                         | <b>(25)%</b>                               |

Gross Profit (as %  
of related revenue  
components):

|              |     |     |  |     |     |
|--------------|-----|-----|--|-----|-----|
| Service      | 61% | 61% |  | 56% | 57% |
| Subscription | 48% | 44% |  | 51% | 50% |
| License      | 89% | 96% |  | 89% | 96% |
| Total        | 61% | 69% |  | 59% | 69% |

The decrease in total gross profit and total gross profit as a percentage of total revenue for the three- and nine-month periods ended September 30, 2015, compared to the corresponding three- and nine-month periods ended September 30, 2014, was due primarily to lower license revenue, partially offset by higher service and subscription revenue.

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The decrease in service gross profit for the three-month period ended September 30, 2015, compared to the corresponding three-month period ended September 30, 2014, was due primarily to lower service revenue.

The increase in service gross profit for the nine-month period ended September 30, 2015, compared to the corresponding nine-month period ended September 30, 2014, was due primarily to higher service revenue, partially offset by higher stock compensation expense.

The increase in subscription gross profit and subscription gross profit as a percentage of subscription revenue for the three- and nine-month periods ended September 30, 2015, compared to the corresponding three- and nine-month periods ended September 30, 2014, was due primarily to higher subscription revenue.

The decrease in license gross profit and license gross profit as a percentage of license revenue for the three- and nine-month periods ended September 30, 2015, compared to the corresponding three- and nine-month periods ended September 30, 2014, was due primarily to lower license revenue.

We anticipate total gross profit and total gross profit as a percentage of total revenue to be lower in 2015 than in 2014, reflecting lower projected license revenue partially offset by higher projected service and subscription revenue.

**Table of Contents***Operating Expenses*

We allocate certain costs of research, development and engineering, sales and marketing, and intellectual property to cost of revenue when they relate directly to our customer contracts. We record all remaining, or residual, costs as sales and marketing, research, development and engineering, general and administrative, and intellectual property expenses.

*Sales and marketing*

|  | <b>Three<br/>Months<br/>Ended<br/>September 30,<br/>2015</b> | <b>Three<br/>Months<br/>Ended<br/>September 30,<br/>2014</b> | <b>Dollar<br/>Increase</b> | <b>Percent<br/>Increase</b> | <b>Nine<br/>Months<br/>Ended<br/>September 30,<br/>2015</b> | <b>Nine<br/>Months<br/>Ended<br/>September 30,<br/>2014</b> | <b>Dollar<br/>Increase</b> | <b>Percent<br/>Increase</b> |
|--|--|--|----------------------------|-----------------------------|---|---|----------------------------|-----------------------------|
| Sales and marketing                            | \$ 2,309   | \$ 1,999   | \$ 310                     | 16%                         | \$ 6,497  | \$ 5,930  | \$ 567                     | 10%                         |
| Sales and marketing (as<br>% of total revenue) | 43%  | 29%  |                            |                             | 38%   | 30%   |                            |                             |

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

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

The increase in sales and marketing expenses for the three-month period ended September 30, 2015, compared to the corresponding three-month period ended September 30, 2014, was due primarily to:

increased headcount and compensation-related expenses of \$0.3 million; partially offset by

decreased amortization expense of \$0.1 million related to the intangibles acquired in the acquisition of Contributor.

The increase in sales and marketing expenses for the nine-month period ended September 30, 2015, compared to the corresponding nine-month period ended September 30, 2014, was due primarily to:

increased headcount and compensation-related expenses of \$0.7 million; partially offset by

decreased amortization expense of \$0.3 million related to the intangibles acquired in the acquisition of  
Attributor.

We anticipate sales and marketing expenses in 2015 will be higher than in 2014 as a result of the expansion of our sales and marketing organization to accelerate market development and delivery for Digimarc Discover and Barcode.

**Table of Contents***Research, development and engineering*

|   | <b>Three<br/>Months<br/>Ended<br/>September 30,<br/>2015</b> | <b>Three<br/>Months<br/>Ended<br/>September 30,<br/>2014</b> | <b>Dollar<br/>(Decrease)</b> | <b>Percent<br/>(Decrease)</b> | <b>Nine<br/>Months<br/>Ended<br/>September 30,<br/>2015</b> | <b>Nine<br/>Months<br/>Ended<br/>September 30,<br/>2014</b> | <b>Dollar<br/>(Decrease)</b> | <b>Percent<br/>(Decrease)</b> |
|---|--|--|------------------------------|-------------------------------|---|---|------------------------------|-------------------------------|
| Research, development and engineering                         | \$ 3,236   | \$ 3,499   | \$ (263)                     | (8)%                          | \$ 9,345  | \$ 10,449   | \$ (1,104)                   | (11)%                         |
| Research, development and engineering (as % of total revenue) | 60%  | 51%  |                              |                               | 54%   | 53%   |                              |                               |

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;

the purchase of materials and services for product development; and

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

The decrease in research, development and engineering expenses for the three-month period ended September 30, 2015, compared to the corresponding three-month period ended September 30, 2014, was due primarily to:

decreased headcount and compensation-related expenses of \$0.1 million; and

decreased use of outside contractors and consultants of \$0.1 million.

The decrease in research, development and engineering expenses for the nine-month period ended September 30, 2015, compared to the corresponding nine-month period ended September 30, 2014, was due primarily to:

decreased headcount and compensation-related expenses of \$0.8 million; and

decreased use of outside contractors and consultants of \$0.3 million.

We anticipate research, development and engineering expenses in 2015 will be lower than in 2014 as we continue the transition from research and product development to market development and delivery for Digimarc Discover and Barcode.

*General and administrative*

|  | <b>Three<br/>Months<br/>Ended<br/>September 30,<br/>2015</b> | <b>Three<br/>Months<br/>Ended<br/>September 30,<br/>2014</b> | <b>Dollar<br/>(Decrease)</b> | <b>Percent<br/>(Decrease)</b> | <b>Nine<br/>Months<br/>Ended<br/>September 30,<br/>2015</b> | <b>Nine<br/>Months<br/>Ended<br/>September 30,<br/>2014</b> | <b>Dollar<br/>(Decrease)</b> | <b>Percent<br/>(Decrease)</b> |
|--|--|--|------------------------------|-------------------------------|---|---|------------------------------|-------------------------------|
| General and administrative                         | \$ 1,847   | \$ 2,183   | \$ (336)                     | (15)%                         | \$ 6,033  | \$ 6,929  | \$ (896)                     | (13)%                         |
| General and administrative (as % of total revenue) | 34%  | 32%  |                              |                               | 35%   | 35%   |                              |                               |

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 to this area as well as each of the areas in cost of revenue, 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 and human resources;

costs associated with being a public company; and

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

The decrease in general and administrative expenses for the three-month period ended September 30, 2015, compared to the corresponding three-month period ended September 30, 2014, was due primarily to decreased stock compensation expense of \$0.2 million.

The decrease in general and administrative expenses for the nine-month period ended September 30, 2015, compared to the corresponding nine-month period ended September 30, 2014, was due primarily to:

decreased legal costs of \$0.4 million; and

decreased stock compensation expense of \$0.4 million.

We anticipate general and administrative expenses will be lower in 2015 than in 2014, primarily reflecting lower legal costs and stock compensation expense. We will continue to examine means to reduce general and administrative expenses in the longer term.

*Intellectual property*

|   | <b>Three<br/>Months<br/>Ended<br/>September 30,<br/>2015</b> | <b>Three<br/>Months<br/>Ended<br/>September 30,<br/>2014</b> | <b>Dollar<br/>Increase</b> | <b>Percent<br/>Increase</b> | <b>Nine<br/>Months<br/>Ended<br/>September 30,<br/>2015</b> | <b>Nine<br/>Months<br/>Ended<br/>September 30,<br/>2014</b> | <b>Dollar<br/>(Decrease)</b> | <b>Percent<br/>(Decrease)</b> |
|---|--|--|----------------------------|-----------------------------|---|---|------------------------------|-------------------------------|
| Intellectual property                               | \$ 367   | \$ 366   | \$ 1                       | 0%                          | \$ 1,025  | \$ 1,287  | \$ (262)                     | (20)%                         |
| Intellectual property<br>(as % of total<br>revenue) | 7%   | 5%   |                            |                             | 6%  | 7%  |                              |                               |

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;

consulting costs related to marketing our intellectual property portfolio;

charges to write-off previously capitalized patent costs for patent assets we abandon; 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

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

The decrease in intellectual property expenses for the nine-month period ended September 30, 2015, compared to the corresponding nine-month period ended September 30, 2014, was due primarily to:

decreased consulting fees of \$0.2 million for a third party intellectual property marketing study performed in 2014; and

decreased headcount and compensation-related expenses of \$0.2 million; partially offset by

increased write-off of abandoned patent costs of \$0.1 million.

We anticipate intellectual property expenses will be lower in 2015 than in 2014, primarily as a result of the third party intellectual property marketing study performed in 2014 that is not planned to reoccur in 2015 and lower headcount.



**Table of Contents***Stock-based compensation*

|  | <b>Three<br/>Months<br/>Ended<br/>September<br/>30<br/>2015</b> | <b>Three<br/>Months<br/>Ended<br/>September 30<br/>2014</b> | <b>Dollar<br/>Increase<br/>(Decrease)</b> | <b>Percent<br/>Increase<br/>(Decrease)</b> | <b>Nine<br/>Months<br/>Ended<br/>September 30<br/>2015</b> | <b>Nine<br/>Months<br/>Ended<br/>September 30<br/>2014</b> | <b>Dollar<br/>Increase<br/>(Decrease)</b> | <b>Percent<br/>Increase<br/>(Decrease)</b> |
|--|---|---|---|--|--|--|---|--|
| Cost of revenue                          | \$ 171  | \$ 131  | \$ 40                                     | 31%  | \$ 569   | \$ 402   | \$ 167                                    | 42%  |
| Sales and marketing                      | 251   | 187   | 64  | 34%  | 585  | 504  | 81  | 16%  |
| Research, development<br>and engineering | 396   | 363   | 33  | 9%   | 1,011  | 1,083  | (72)                                      | (7)%                                       |
| General and<br>administrative            | 485   | 688   | (203)                                     | (30)%                                      | 1,487  | 1,844  | (357)                                     | (19)%                                      |
| Intellectual property                    | 74  | 85  | (11)                                      | (13)%                                      | 205  | 252  | (47)                                      | (19)%                                      |
| <b>Total</b>                             | <b>\$ 1,377</b>   | <b>\$ 1,454</b>   | <b>\$ (77)</b>                            | <b>(5)%</b>                                | <b>\$ 3,857</b>  | <b>\$ 4,085</b>  | <b>\$ (228)</b>                           | <b>(6)%</b>                                |

Stock-based compensation expense decreased for the three- and nine-month periods ended September 30, 2015, compared to the corresponding three- and nine-month periods ended September 30, 2014, as all outstanding stock options were fully vested by January 2015. We anticipate incurring an additional \$10,380 in stock-based compensation expense through September 2019 for unvested restricted stock awards as of September 30, 2015.

*Other income, net*

|  | <b>Three<br/>Months<br/>Ended<br/>September 30<br/>2015</b> | <b>Three<br/>Months<br/>Ended<br/>September 30<br/>2014</b> | <b>Dollar<br/>Increase<br/>Increase</b> | <b>Percent<br/>Increase<br/>Increase</b> | <b>Nine<br/>Months<br/>Ended<br/>September 30<br/>2015</b> | <b>Nine<br/>Months<br/>Ended<br/>September 30<br/>2014</b> | <b>Dollar<br/>Increase<br/>Increase</b> | <b>Percent<br/>Increase<br/>Increase</b> |
|--|---|---|---|--|--|--|---|--|
| Other income, net                            | \$ 29   | \$ 3  | 26                                      | 867%                                     | \$ 84  | \$ 50  | 34                                      | 68%                                      |
| Other income, net (as %<br>of total revenue) | 1%  | 0%  |   |  | 0%   | 0%   |   |  |

The increase in other income, net for the three- and nine-month periods ended September 30, 2015, compared to the corresponding three- and nine-month periods ended September 30, 2014, was primarily due to higher interest income as a result of higher cash balances.

*Income Taxes*

The (provision) benefit for income taxes reflects current taxes, deferred taxes, and withholding taxes in certain foreign jurisdictions. The effective tax rate for the nine-months ended September 30, 2015 and 2014 was 0% and 40%, respectively. The effective tax rate was 0% for the nine-months ended September 30, 2015 because we have a full valuation allowance recorded against our deferred tax assets. The valuation allowance against deferred tax assets as of September 30, 2015 was \$12,092, an increase of \$4,804 from \$7,288 as of December 31, 2014.

We continually assess the applicability of valuation allowance against our deferred tax assets. Based upon the positive and negative evidence available as of September 30, 2015, and largely due to the cumulative loss incurred by us over the last three years, which is considered a significant piece of negative evidence when assessing the realizability of deferred tax assets, a full valuation allowance is recorded against our deferred tax assets.

**Table of Contents****Liquidity and Capital Resources**

|   | <b>September 30,<br/>2015</b> | <b>December 31,<br/>2014</b> |
|---|-------------------------------|------------------------------|
| Working capital   | \$ 45,130                     | \$ 40,440                    |
| Current ratio (1)   | 14.1:1                        | 9.0:1                        |
| Cash, cash equivalents and short-term marketable securities | \$ 43,037                     | \$ 38,323                    |
| Long-term marketable securities                             | \$                            | \$ 749                       |
| Total cash, cash equivalents and all marketable securities  | \$ 43,037                     | \$ 39,072                    |

(1) The current ratio is calculated by dividing total current assets by total current liabilities. The \$4.0 million increase in cash, cash equivalents and marketable securities resulted primarily from:

proceeds from the issuance of common stock;

cash flows provided by the net maturity of marketable securities; and

proceeds from stock option exercises; partially offset by

cash used in operations;

purchases of common stock related to the vesting of restricted stock; and

purchases of property and equipment and capitalized patent costs.

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. Marketable securities primarily include corporate notes, federal agency notes, commercial paper and pre-refunded municipal bonds. 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 by us.

*Operating Cash Flow.*

The components of operating cash flows were:

|   | <b>Nine<br/>Months<br/>Ended<br/>September 30,<br/>2015</b> | <b>Nine<br/>Months<br/>Ended<br/>September 30,<br/>2014</b> | <b>Dollar<br/>Increase<br/>(Decrease)</b> | <b>Percent<br/>Increase<br/>(Decrease)</b> |
|---|---|---|---|--|
| Net loss                                    | \$ (12,631)   | \$ (6,651)  | \$ (5,980)                                | (90)%                                      |
| Non-cash items                              | 5,597   | 2,822   | 2,775                                     | 98%  |
| Changes in operating assets and liabilities | 8   | (2,077)   | 2,085                                     | 100%                                       |
| Net cash used in operating activities       | \$ (7,026)  | \$ (5,906)  | \$ (1,120)                                | (19)%                                      |

Cash flows used in operating activities for the nine-month period ended September 30, 2015, compared to the corresponding nine-month period ended September 30, 2014, increased by \$1.1 million, primarily as the result of a higher net loss, partially offset by higher non-cash items and changes in operating assets and liabilities. The increase from non-cash items primarily reflects no income tax benefits recorded during the nine-months ended September 30, 2015 due to the full valuation allowance recorded on deferred tax assets. The impact from changes in operating assets and liabilities for the nine-month period was primarily due to changes in other current assets.

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Cash flows from investing activities for the nine-month period ended September 30, 2015, compared to the corresponding nine-month period ended September 30, 2014, decreased by \$7.2 million from \$7.2 million to \$0.0 million, as a result of lower net maturities of marketable securities partially offset by lower purchases of property and equipment and capitalized patent costs.

Cash flows from financing activities for the nine-month period ended September 30, 2015, compared to the corresponding nine-month period ended September 30, 2014, increased by \$14.8 million from \$2.4 million used to \$12.4 million provided, primarily as a result of cash proceeds from the issuance of common stock, net of issuance costs and no cash dividends paid in 2015.

***Future Cash Expectations***

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 have a \$100 million shelf registration statement in place, of which \$30 million was allocated for sale under the Equity Distribution Agreement entered into with Wells Fargo Securities, LLC in August 2014. As of September 30, 2015, we had sold 1,026,164 shares under the Equity Distribution Agreement at an average price of \$29.24 resulting in \$29.3 million of cash proceeds, net of sales commissions of \$0.7 million, and we paid \$0.4 million in stock issuance costs. There are no shares remaining to be sold under the Equity Distribution Agreement.

We may also raise capital in the future to fund acquisitions and/or investments in complementary businesses, technologies or product lines. If it becomes necessary to obtain additional financing, we may not be able to do so, or if these funds are available, they may not be available on satisfactory terms.

***Contractual Obligations***

In July 2015, we entered into an amendment with the landlord of our corporate offices in Beaverton, Oregon to extend the lease term through March 2024 for rent payments totaling \$5.5 million, payable in monthly installments.

In February 2015, we entered into a new facilities lease agreement in San Mateo, California with a lease term through March 2020 for rent payments totaling \$1.0 million, payable in monthly installments.

The following table presents our contractual obligations as of September 30, 2015:

|                                   | Total    | Payment Due by Period |           |           | More than<br>5 years |
|-----------------------------------|----------|-----------------------|-----------|-----------|----------------------|
|                                   |          | Less than<br>1 year   | 1-3 years | 3-5 years |                      |
| Total operating lease obligations | \$ 7,361 | \$ 1,070              | \$ 1,524  | \$ 1,864  | \$ 2,903             |

***Off-Balance Sheet Arrangements***

Other than the contractual obligations disclosed above and in our 2014 Annual Report, we do not have any off-balance sheet arrangements that have or are reasonably likely to have a current or future material effect on our financial condition, changes in financial condition, revenue or expenses, results of operations, liquidity, capital expenditures or capital resources.

**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, should, could, expect, anticipate, believe, project, 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;

revenue trends and expectations;

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our future level of investment in our business, including investment in research, development and engineering of products and technology, development and protection of our intellectual property, sales growth initiatives 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;

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

variability of contracted arrangements;

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, 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 of Attributor Corporation;

the success of Digimarc Discover and Barcode;

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 2014 Annual Report.



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We believe that the risk factors specified above and the risk factors identified in Part I, Item 1A of our 2014 Annual Report, among others, 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 2014 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 Quarterly Report on 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 officer, 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 Quarterly Report on 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) that occurred during the three-months ended September 30, 2015 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.

**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 2014 Annual Report. The risks and uncertainties described in our 2014 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, 2015, there have been no material changes to the risk factors set forth in our 2014 Annual Report.

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

We withhold (repurchase) shares of common stock in connection with the vesting of restricted shares from time to time.

The following table sets forth information regarding purchases of our equity securities during the three-month period ended September 30, 2015:

| <b>Period</b>                           | <b>(a)<br/>Total number of<br/>shares<br/>purchased<sup>(1)</sup></b> | <b>(b)<br/>Average price<br/>paid per<br/>share<sup>(1)</sup></b> | <b>(c)<br/>Total number of<br/>shares<br/>purchased<br/>as<br/>part of<br/>publicly<br/>announced plans<br/>or<br/>programs</b> | <b>(d)<br/>Approximate<br/>dollar<br/>value<br/>of shares<br/>that<br/>may yet<br/>be<br/>purchased<br/>under the plans<br/>or<br/>programs</b> |
|---|---|---|---|---|
| <b>Month 1</b>                          |   |   |   |   |
| July 1, 2015 to July 31, 2015           | 503   | \$ 43.24  |   | \$  |
| <b>Month 2</b>                          |   |   |   |   |
| August 1, 2015 to August 31, 2015       | 20,348  | \$ 37.60  |   | \$  |
| <b>Month 3</b>                          |   |   |   |   |
| September 1, 2015 to September 30, 2015 | 336   | \$ 35.12  |   | \$  |

|       |        |    |       |
|-------|--------|----|-------|
| Total | 21,187 | \$ | 37.69 |
|-------|--------|----|-------|

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

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**Item 6. Exhibits.**

| <b>Exhibit Number</b> | <b>Exhibit Description</b>   |
|-----------------------|--|
| 10.1                  | Second Amendment to Lease, dated as of July 31, 2015, by and between PD Office Owner 9, L.P. and Digimarc Corporation. |
| 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, 2015

DIGIMARC CORPORATION

By:

*/s/ CHARLES BECK  
CHARLES BECK  
Chief Financial Officer  
(Duly Authorized Officer and Principal Financial  
and Accounting Officer)*