

Digimarc CORP  
Form 10-Q  
October 24, 2014  
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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, 2014**

**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

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 20, 2014, there were 7,693,663 shares of the registrant's common stock, par value \$0.001 per share, outstanding.

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

|   | <b>September 30,<br/>2014</b> | <b>December 31,<br/>2013</b> |
|---|-------------------------------|------------------------------|
| <b>ASSETS</b>   |                               |                              |
| Current assets:   |                               |                              |
| Cash and cash equivalents   | \$ 2,704                      | \$ 3,811                     |
| Marketable securities   | 19,081                        | 25,851                       |
| Trade accounts receivable, net  | 3,851                         | 5,838                        |
| Other current assets  | 3,541                         | 1,658                        |
| <b>Total current assets</b>   | <b>29,177</b>                 | <b>37,158</b>                |
| Marketable securities   | 2,951                         | 5,302                        |
| Property and equipment, net   | 2,904                         | 2,395                        |
| Intangibles, net  | 6,836                         | 6,709                        |
| Goodwill  | 1,114                         | 1,114                        |
| Deferred tax assets, net  | 5,447                         | 3,949                        |
| Other assets  | 410                           | 570                          |
| <b>Total assets</b>   | <b>\$ 48,839</b>              | <b>\$ 57,197</b>             |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>  |                               |                              |
| Current liabilities:  |                               |                              |
| Accounts payable and other accrued liabilities  | \$ 1,868                      | \$ 1,560                     |
| Deferred revenue  | 1,853                         | 4,218                        |
| <b>Total current liabilities</b>  | <b>3,721</b>                  | <b>5,778</b>                 |
| Deferred rent and other long-term liabilities   | 241                           | 496                          |
| <b>Total liabilities</b>  | <b>3,962</b>                  | <b>6,274</b>                 |
| Commitments and contingencies (Note 14)   |                               |                              |
| Shareholders' equity:   |                               |                              |
| Preferred stock (par value \$0.001 per share, 2,500,000 authorized, 10,000 shares issued and outstanding at September 30, 2014 and December 31, 2013) | 50                            | 50                           |
|   | 8                             | 7                            |

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|  |           |           |
|--|-----------|-----------|
| Common stock (par value \$0.001 per share, 50,000,000 authorized, 7,689,471 and 7,401,072 shares issued and outstanding at September 30, 2014 and December 31, 2013, respectively) |           |           |
| Additional paid-in capital   | 43,756    | 41,498    |
| Retained earnings  | 1,063     | 9,368     |
| Total shareholders' equity   | 44,877    | 50,923    |
| Total liabilities and shareholders' equity   | \$ 48,839 | \$ 57,197 |

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>2014 | Three<br>Months<br>Ended<br>September 30,<br>2013 | Nine<br>Months<br>Ended<br>September 30,<br>2014 | Nine<br>Months<br>Ended<br>September 30,<br>2013 |
|---|---|---|--|--|
| Revenue:                                    |   |   |  |  |
| Service                                     | \$ 3,155  | \$ 3,030  | \$ 8,859   | \$ 8,981   |
| Subscription                                | 1,452   | 1,424   | 4,360  | 4,241  |
| License                                     | 2,320   | 2,971   | 6,576  | 14,916   |
| <b>Total revenue</b>                        | <b>6,927</b>                                      | <b>7,425</b>                                      | <b>19,795</b>                                    | <b>28,138</b>                                    |
| Cost of revenue:                            |   |   |  |  |
| Service                                     | 1,224   | 1,232   | 3,807  | 4,067  |
| Subscription                                | 812   | 625   | 2,160  | 1,848  |
| License                                     | 84  | 98  | 250  | 294  |
| <b>Total cost of revenue</b>                | <b>2,120</b>                                      | <b>1,955</b>                                      | <b>6,217</b>                                     | <b>6,209</b>                                     |
| <b>Gross profit</b>                         | <b>4,807</b>                                      | <b>5,470</b>                                      | <b>13,578</b>                                    | <b>21,929</b>                                    |
| Operating expenses:                         |   |   |  |  |
| Sales and marketing                         | 1,999   | 1,482   | 5,930  | 4,322  |
| Research, development and engineering       | 3,499   | 3,277   | 10,449   | 8,824  |
| General and administrative                  | 2,183   | 2,456   | 6,929  | 6,990  |
| Intellectual property                       | 366   | 278   | 1,287  | 816  |
| <b>Total operating expenses</b>             | <b>8,047</b>                                      | <b>7,493</b>                                      | <b>24,595</b>                                    | <b>20,952</b>                                    |
| <b>Operating income (loss)</b>              | <b>(3,240)</b>                                    | <b>(2,023)</b>                                    | <b>(11,017)</b>                                  | <b>977</b>                                       |
| <b>Other income, net</b>                    | <b>3</b>  | <b>33</b>   | <b>50</b>  | <b>81</b>  |
| <b>Income (loss) before income taxes</b>    | <b>(3,237)</b>                                    | <b>(1,990)</b>                                    | <b>(10,967)</b>                                  | <b>1,058</b>                                     |
| <b>(Provision) benefit for income taxes</b> | <b>1,252</b>                                      | <b>1,195</b>                                      | <b>4,316</b>                                     | <b>(280)</b>                                     |
| <b>Net income (loss)</b>                    | <b>\$ (1,985)</b>                                 | <b>\$ (795)</b>                                   | <b>\$ (6,651)</b>                                | <b>\$ 778</b>                                    |
| Earnings (loss) per common share:           |   |   |  |  |
| Earnings (loss) per common share basic      | \$ (0.28)   | \$ (0.12)   | \$ (0.95)  | \$ 0.09  |
| Earnings (loss) per common share diluted    | \$ (0.28)   | \$ (0.12)   | \$ (0.95)  | \$ 0.09  |
|   | 7,176   | 6,860   | 7,097  | 6,850  |

Weighted average common shares  
outstanding basic

|   |       |       |       |       |
|---|-------|-------|-------|-------|
| Weighted average common shares<br>outstanding diluted | 7,176 | 6,860 | 7,097 | 7,080 |
|---|-------|-------|-------|-------|

|  |    |         |         |         |
|--|----|---------|---------|---------|
| Cash dividends declared per common share | \$ | \$ 0.11 | \$ 0.22 | \$ 0.33 |
|--|----|---------|---------|---------|

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

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**DIGIMARC CORPORATION**  
**CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY**

(In thousands, except share data)

(UNAUDITED)

|  | Preferred Stock |        | Common Stock |        | Additional<br>Paid-in<br>Capital | Retained<br>Earnings | Total<br>Shareholders<br>Equity |
|--|-----------------|--------|--------------|--------|----------------------------------|----------------------|---------------------------------|
|  | Shares          | Amount | Shares       | Amount |                                  |                      |                                 |
| <b>BALANCE AT<br/>DECEMBER 31, 2012</b>    | 10,000          | \$ 50  | 7,168,359    | \$ 7   | \$ 39,869                        | \$ 13,077            | \$ 53,003                       |
| Exercise of stock options                  |                 |        | 18,300       |        |                                  |                      |                                 |
| Issuance of restricted common<br>stock     |                 |        | 217,090      |        |                                  |                      |                                 |
| Forfeiture of restricted common<br>stock   |                 |        | (67,360)     |        |                                  |                      |                                 |
| Purchase and retirement of<br>common stock |                 |        | (47,101)     |        | (854)                            |                      | (854)                           |
| Stock-based compensation                   |                 |        |              |        | 3,305                            |                      | 3,305                           |
| Net income                                 |                 |        |              |        |                                  | 778                  | 778                             |
| Cash dividends declared                    |                 |        |              |        |                                  | (2,400)              | (2,400)                         |
| <b>BALANCE AT SEPTEMBER 30,<br/>2013</b>   | 10,000          | \$ 50  | 7,289,288    | \$ 7   | \$ 42,320                        | \$ 11,455            | \$ 53,832                       |
| <b>BALANCE AT<br/>DECEMBER 31, 2013</b>    | 10,000          | \$ 50  | 7,401,072    | \$ 7   | \$ 41,498                        | \$ 9,368             | \$ 50,923                       |
| Exercise of stock options                  |                 |        | 184,784      | 1      | 1,318                            |                      | 1,319                           |
| Issuance of restricted common<br>stock     |                 |        | 204,720      |        |                                  |                      |                                 |
| Forfeiture of restricted common<br>stock   |                 |        | (12,995)     |        |                                  |                      |                                 |
| Purchase and retirement of<br>common stock |                 |        | (88,110)     |        | (1,931)                          |                      | (1,931)                         |
| Stock-based compensation                   |                 |        |              |        | 4,218                            |                      | 4,218                           |
| Tax impact of 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>   | 10,000          | \$ 50  | 7,689,471    | \$ 8   | \$ 43,756                        | \$ 1,063             | \$ 44,877                       |

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)

|  | Nine<br>Months<br>Ended<br>September 30,<br>2014 | Nine<br>Months<br>Ended<br>September 30,<br>2013 |
|--|--|--|
| Cash flows from operating activities:  |  |  |
| Net income (loss)  | \$ (6,651)                                       | \$ 778   |
| Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities: |  |  |
| Depreciation and amortization of property and equipment  | 708  | 513  |
| Amortization and write-off of intangibles  | 916  | 931  |
| Change in allowance for doubtful accounts  | (13)   | 22   |
| Gain on reversal of contingent merger consideration  |  | (190)  |
| Stock-based compensation   | 4,085  | 3,219  |
| Deferred income taxes  | (2,874)  | 354  |
| Changes in operating assets and liabilities:   |  |  |
| Trade accounts receivable, net   | 2,000  | (923)  |
| Other current assets   | (1,559)  | (577)  |
| Other assets   | 160  | (99)   |
| Accounts payable and other accrued liabilities   | (171)  | 286  |
| Income taxes payable   | (169)  | 88   |
| Deferred revenue   | (2,338)  | 263  |
| Net cash provided by (used in) operating activities  | (5,906)  | 4,665  |
| Cash flows from investing activities:  |  |  |
| Purchase of property and equipment   | (1,010)  | (1,532)  |
| Capitalized patent costs   | (922)  | (824)  |
| Maturity of marketable securities  | 47,961   | 47,344   |
| Purchase of marketable securities  | (38,840)   | (48,186)   |
| Net cash provided by (used in) investing activities  | 7,189  | (3,198)  |
| Cash flows from financing activities:  |  |  |
| Issuance of common stock   | 1,319  |  |
| Purchase of common stock   | (1,931)  | (854)  |
| Cash dividends paid  | (1,654)  | (2,400)  |
| Common stock issuance costs  | (124)  |  |
| Net cash used in financing activities  | (2,390)  | (3,254)  |

|   |          |          |
|---|----------|----------|
| Net decrease in cash and cash equivalents                             | (1,107)  | (1,787)  |
| Cash and cash equivalents at beginning of period                      | 3,811    | 6,866    |
| Cash and cash equivalents at end of period                            | \$ 2,704 | \$ 5,079 |
| <b>Supplemental disclosure of cash flow information:</b>              |          |          |
| Cash paid (received) for income taxes, net                            | \$ (12)  | \$ 46    |
| <b>Supplemental schedule of non-cash investing activities:</b>        |          |          |
| Stock-based compensation capitalized to fixed assets and patent costs | \$ 133   | \$ 86    |

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

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**DIGIMARC CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**(UNAUDITED)**

**1. Description of Business and Significant Accounting Policies**

*Description of Business*

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

*Interim Consolidated Financial Statements*

The Company has adhered to the accounting policies set forth in its Annual Report on Form 10-K for the year ended December 31, 2013 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, 2013, which was filed with the SEC on February 21, 2014. 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 estimates 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, 2014 and 2013, it was concluded that there was no impairment as the estimated fair value of the Company's reporting unit substantially exceeded the carrying value.

#### *Recent Accounting Pronouncements*

In May 2014, the Financial Accounting Standards Board 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. The amendments in this update are effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. Early application is not permitted. 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 impact of this standard on the financial condition or results of operations of the Company.

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

The estimated fair values of the Company's financial instruments, which include cash equivalents, accounts receivable, and 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, 2014 and December 31, 2013, respectively, was as follows:

| <b>September 30, 2014</b>        | <b>Level 1</b>  | <b>Level 2</b>   | <b>Level 3</b> | <b>Total</b>     |
|----------------------------------|-----------------|------------------|----------------|------------------|
| Money market securities          | \$ 1,201        | \$               | \$             | \$ 1,201         |
| Pre-refunded municipal bonds (1) |                 | 12,831           |                | 12,831           |
| Corporate notes                  |                 | 8,047            |                | 8,047            |
| Certificates of deposit          |                 | 958              |                | 958              |
| U.S. federal agency notes        |                 | 196              |                | 196              |
| <b>Total</b>                     | <b>\$ 1,201</b> | <b>\$ 22,032</b> | <b>\$</b>      | <b>\$ 23,233</b> |
| <br>                             |                 |                  |                |                  |
| <b>December 31, 2013</b>         | <b>Level 1</b>  | <b>Level 2</b>   | <b>Level 3</b> | <b>Total</b>     |
| Money market securities          | \$ 2,343        | \$               | \$             | \$ 2,343         |
| Pre-refunded municipal bonds (1) |                 | 29,268           |                | 29,268           |
| Corporate notes                  |                 | 1,180            |                | 1,180            |
| U.S. federal agency notes        |                 | 331              |                | 331              |
| Certificates of deposit          |                 | 321              |                | 321              |
| Other municipals                 |                 | 153              |                | 153              |
| <b>Total</b>                     | <b>\$ 2,343</b> | <b>\$ 31,253</b> | <b>\$</b>      | <b>\$ 33,596</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, 2014 are as follows:

|  | <b>Total</b> | <b>Maturities by Period</b> |                  |                                      |
|--|--------------|-----------------------------|------------------|--------------------------------------|
|  |              | <b>Less than 1 year</b>     | <b>1-5 years</b> | <b>More than 5-10 years 10 years</b> |
| Cash equivalents and marketable securities | \$ 23,233    | \$ 20,282                   | \$ 2,951         | \$                                   |

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 \$1,201 and \$2,443 at September 30, 2014 and December 31, 2013, respectively. Cash equivalents are carried at cost or amortized cost, which approximates fair value.

### **3. Acquisition of Contributor Corporation ( Contributor )**

The Company accounted for the acquisition of Contributor in December 2012 using the acquisition method of accounting. Under the acquisition method of accounting, the total purchase price was allocated to the tangible and identifiable intangible assets acquired and liabilities assumed based on their estimated fair values.

The Company recorded a \$190 liability in the preliminary purchase price allocation reflecting the estimated fair value of the contingent merger consideration on the acquisition date. At March 31, 2013, the Company determined that the estimated fair value of the contingent merger consideration was \$0 based on the Company's most recent projections and therefore reversed the liability. The reversal of the \$190 liability was reflected as a reduction in general and administrative expense within the consolidated statements of operations for the nine-month period ended September 30, 2013. The contingency period ended on December 31, 2013 with \$0 contingent merger consideration being earned.

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**4. Revenue Recognition**

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

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

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

License revenue, including royalty revenue, originates primarily from licensing the Company's technology and patents where the Company receives 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 subscriptions, and maintenance fees. For arrangements that include multiple deliverables, the Company identifies separate units of accounting at inception based on the consensus reached under ASC 605-25 *Multiple-Element Arrangements*, which provides that revenue arrangements with multiple deliverables 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 professional services is recognized as the services are performed. Billing for services rendered generally occurs within one month after the services are provided.

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

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 professional services, licenses and subscriptions for which revenue has not been earned.

**Table of Contents****5. Segment Information***Geographic Information*

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

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

|                   | <b>Three<br/>Months<br/>Ended<br/>September 30,<br/>2014</b> | <b>Three<br/>Months<br/>Ended<br/>September 30,<br/>2013</b> | <b>Nine<br/>Months<br/>Ended<br/>September 30,<br/>2014</b> | <b>Nine<br/>Months<br/>Ended<br/>September 30,<br/>2013</b> |
|-------------------|--|--|---|---|
| Domestic          | \$ 3,046   | \$ 3,536   | \$ 7,946  | \$ 15,902   |
| International (1) | 3,881  | 3,889  | 11,849  | 12,236  |
| <b>Total</b>      | <b>\$ 6,927</b>  | <b>\$ 7,425</b>  | <b>\$ 19,795</b>  | <b>\$ 28,138</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/>2014</b> | <b>Three<br/>Months<br/>Ended<br/>September 30,<br/>2013</b> | <b>Nine<br/>Months<br/>Ended<br/>September 30,<br/>2014</b> | <b>Nine<br/>Months<br/>Ended<br/>September 30,<br/>2013</b> |
|-------------------------------|--|--|---|---|
| Central Banks                 | 43%  | 37%  | 47%   | 31%   |
| Verance Corporation           | 23%  | 12%  | 14%   | *   |
| The Nielsen Company (Nielsen) | *  | 13%  | *   | 11%   |
| Intellectual Ventures         | *  | *  | *   | 27%   |

\* Less than 10%

**6. 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 patents and fixed assets based on direct labor hours charged to capitalized patent costs and fixed assets.

### ***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.

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*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.

There were no stock options granted during the three- and nine-month periods ended September 30, 2014 and 2013.

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 (measurement date), and is recognized over the vesting period using the straight-line method.

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

*Stock-based Compensation Expense*

|   | <b>Three<br/>Months<br/>Ended<br/>September 30,<br/>2014</b> | <b>Three<br/>Months<br/>Ended<br/>September 30,<br/>2013</b> | <b>Nine<br/>Months<br/>Ended<br/>September 30,<br/>2014</b> | <b>Nine<br/>Months<br/>Ended<br/>September 30,<br/>2013</b> |
|---|--|--|---|---|
| <b>Stock-based compensation:</b>              |  |  |   |   |
| Cost of revenue                               | \$ 131   | \$ 78  | \$ 402  | \$ 374  |
| Sales and marketing                           | 187  | 103  | 504   | 298   |
| Research, development and engineering         | 363  | 278  | 1,083   | 766   |
| General and administrative                    | 688  | 529  | 1,844   | 1,595   |
| Intellectual property                         | 85   | 62   | 252   | 186   |
| Stock-based compensation expense              | 1,454  | 1,050  | 4,085   | 3,219   |
| Capitalized to fixed assets and patent costs  | 46   | 22   | 133   | 86  |
| <b>Total stock-based compensation expense</b> | <b>\$ 1,500</b>  | <b>\$ 1,072</b>  | <b>\$ 4,218</b>   | <b>\$ 3,305</b>   |

The following table sets forth total unrecognized compensation costs 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/>2014</b> | <b>As of<br/>December 31,<br/>2013</b> |
|---------------------------------------|---|--|
| Total unrecognized compensation costs | \$ 11,007                               | \$ 9,711                               |

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

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The Company expects to recognize the total unrecognized compensation costs as of September 30, 2014 for stock options and restricted stock over weighted average periods through September 2018 as follows:

|                         | <b>Stock<br/>Options</b> | <b>Restricted<br/>Stock</b> |
|-------------------------|--------------------------|-----------------------------|
| Weighted average period | 0.5 years                | 1.3 years                   |

*Stock Option Activity*

As of September 30, 2014, under all of the Company's stock-based compensation plans, an additional 1,505,553 shares were authorized for future grants under the plans. The Company issues new shares upon option exercises.

The following table reconciles the outstanding balance of stock options:

|   | <b>Options</b> | <b>Weighted<br/>Average<br/>Exercise<br/>Price Per<br/>Share</b> | <b>Weighted<br/>Average<br/>Grant Date<br/>Fair Value Per<br/>Share</b> | <b>Aggregate<br/>Intrinsic<br/>Value</b> |
|---|----------------|--|---|--|
| <b>Three-months ended September 30, 2014:</b> |                |  |   |  |
| Outstanding at June 30, 2014                  | 643,738        | \$ 16.71   | \$ 8.34   |  |
| Options granted                               |                |  |   |  |
| Options exercised                             | (15,000)       | 9.64   | 6.30  |  |
| Options canceled or expired                   |                |  |   |  |
| Outstanding at September 30, 2014             | 628,738        | \$ 16.88   | \$ 8.35   | \$ 3,942                                 |

|  | <b>Options</b> | <b>Weighted<br/>Average<br/>Exercise<br/>Price Per<br/>Share</b> | <b>Weighted<br/>Average<br/>Grant Date<br/>Fair Value Per<br/>Share</b> | <b>Aggregate<br/>Intrinsic<br/>Value</b> |
|--|----------------|--|---|--|
| <b>Nine-months ended September 30, 2014:</b> |                |  |   |  |
| Outstanding at December 31, 2013             | 813,522        | \$ 15.44   | \$ 7.96   |  |
| Options granted                              |                |  |   |  |
| Options exercised                            | (184,784)      | 10.56  | 6.50  |  |
| Options canceled or expired                  |                |  |   |  |
| Outstanding at September 30, 2014            | 628,738        | \$ 16.88   | \$ 8.35   | \$ 3,942                                 |
| Exercisable at September 30, 2014            | 604,433        | \$ 16.49   | \$ 8.25   | \$ 3,942                                 |
| Unvested at September 30, 2014               | 24,305         | \$ 26.55   | \$ 10.88  | \$                                       |

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The aggregate intrinsic value is based on the closing price of \$20.71 per share of Digimarc common stock on September 30, 2014, which would have been received by the optionees had all of the options with exercise prices less than \$20.71 per share been exercised on that date.

**Table of Contents***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<br>Value<br>Per<br>Share |
|---|---------------------|--|
| <b>Three-months ended September 30, 2014:</b> |                     |  |
| Unvested balance, June 30, 2014               | 420,697             | \$ 21.10   |
| Granted                                       | 122,400             | \$ 25.26   |
| Vested  | (49,492)            | \$ 24.18   |
| Canceled                                      |                     | \$   |
| Unvested balance, September 30, 2014          | 493,605             | \$ 22.27   |

|  | Number of<br>Shares | Weighted<br>Average<br>Grant Date<br>Fair<br>Value<br>Per<br>Share |
|--|---------------------|--|
| <b>Nine-months ended September 30, 2014:</b> |                     |  |
| Unvested balance, December 31, 2013          | 448,126             | \$ 19.89   |
| Granted                                      | 204,720             | \$ 28.30   |
| Vested                                       | (146,246)           | \$ 23.51   |
| Canceled                                     | (12,995)            | \$ 21.54   |
| Unvested balance, September 30, 2014         | 493,605             | \$ 22.27   |

**7. Shareholder s 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-month period ended September 30, 2014, there were no shares sold under the Equity Distribution Agreement and the Company has paid \$124 in stock issuance costs.

**8. Earnings 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-months ended September 30, 2014 and 2013:

|   | Three Months<br>Ended<br>September 30, 2014 | Three Months<br>Ended<br>September 30, 2013 | Nine Months<br>Ended<br>September 30, 2014 | Nine Months<br>Ended<br>September 30, 2013 |
|---|---|---|--|--|
| <b>Basic Earnings (Loss) per<br/>Common Share:</b>              |   |   |  |  |
| <i>Numerator:</i>   |   |   |  |  |
| Net income (loss)   | \$ (1,985)                                  | \$ (795)                                    | \$ (6,651)                                 | \$ 778                                     |
| Distributed earnings to common<br>shares                        |   | 754   | 1,553                                      | 2,260                                      |
| Distributed earnings to<br>participating securities             |   | 46  | 101  | 142  |
| Total distributed earnings                                      |   | 800   | 1,654                                      | 2,402                                      |
| Undistributed loss allocable to<br>common shares                | (1,985)                                     | (1,595)                                     | (8,305)                                    | (1,624)                                    |
| Undistributed earnings allocable<br>to participating securities |   |   |  |  |
| Total undistributed loss  | (1,985)                                     | (1,595)                                     | (8,305)                                    | (1,624)                                    |
| Earnings (loss) to common<br>shares basic                       | \$ (1,985)                                  | \$ (841)                                    | \$ (6,752)                                 | \$ 636                                     |
| <i>Denominator (shares in<br/>thousands):</i>                   |   |   |  |  |
| Weighted average common<br>shares outstanding basic             | 7,176                                       | 6,860                                       | 7,097                                      | 6,850                                      |
| Basic earnings (loss) per<br>common share                       | \$ (0.28)                                   | \$ (0.12)                                   | \$ (0.95)                                  | \$ 0.09                                    |

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|   | Three Months<br>Ended<br>September 30, 2014 | Three Months<br>Ended<br>September 30, 2013 | Nine Months<br>Ended<br>September 30, 2014 | Nine Months<br>Ended<br>September 30, 2013 |
|---|---|---|--|--|
| <b>Diluted Earnings (Loss) per<br/>Common Share:</b>              |   |   |  |  |
| <i>Numerator:</i>   |   |   |  |  |
| Earnings (loss) to common shares<br>basic                         | \$ (1,985)                                  | \$ (841)                                    | \$ (6,752)                                 | \$ 636                                     |
| Undistributed earnings allocated to<br>participating securities   |   |   |  |  |
| Undistributed earnings reallocated<br>to participating securities |   |   |  |  |
| Earnings (loss) to common<br>shares diluted                       | \$ (1,985)                                  | \$ (841)                                    | \$ (6,752)                                 | \$ 636                                     |
| <i>Denominator (shares in<br/>thousands):</i>                     |   |   |  |  |
| Weighted average common shares<br>outstanding basic               | 7,176                                       | 6,860                                       | 7,097                                      | 6,850                                      |
| Dilutive effect of stock options                                  |   |   |  | 230  |
| Weighted average common shares<br>outstanding dilutive            | 7,176                                       | 6,860                                       | 7,097                                      | 7,080                                      |
| Diluted earnings (loss) per<br>common share                       | \$ (0.28)                                   | \$ (0.12)                                   | \$ (0.95)                                  | \$ 0.09                                    |

There were 218,404 and 226,165 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.

There were 175,000 and 75,000 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 their exercise prices were higher than the average market price of the underlying common stock for the periods.

There were 228,158 common stock equivalents related to stock options that were anti-dilutive and excluded from diluted earnings per common share calculations for the three-month period ended September 30, 2013 as the Company incurred a net loss during the period.

There were 215,000 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, 2013 as their exercise prices were higher than the average market price of the underlying common stock for the periods.

**9. Trade Accounts Receivable***Trade Accounts Receivable*

Trade accounts receivable are recorded at the invoiced amount.

|   | <b>September 30,<br/>2014</b> | <b>December 31,<br/>2013</b> |
|---|-------------------------------|------------------------------|
| Trade accounts receivable                                     | \$ 3,883                      | \$ 5,883                     |
| Allowance for doubtful accounts                               | (32)                          | (45)                         |
| <b>Trade accounts receivable, net</b>                         | <b>\$ 3,851</b>               | <b>\$ 5,838</b>              |
| <br>  |                               |                              |
| Unpaid deferred revenue included in trade accounts receivable | \$ 639                        | \$ 3,319                     |

*Allowance for doubtful accounts*

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

**Table of Contents***Unpaid deferred revenue*

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

*Major customers*

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

|               | <b>September 30,<br/>2014</b> | <b>December 31,<br/>2013</b> |
|---------------|-------------------------------|------------------------------|
| Central Banks | 45%                           | 47%                          |
| Civolution    | 21%                           | 10%                          |
| Nielsen       | *                             | 20%                          |

\* Less than 10%

**10. Property and Equipment**

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

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

|  | <b>September 30,<br/>2014</b> | <b>December 31,<br/>2013</b> |
|--|-------------------------------|------------------------------|
| Office furniture fixtures                      | \$ 843                        | \$ 762                       |
| Software                                       | 1,046                         | 311                          |
| Equipment                                      | 3,078                         | 2,816                        |
| Leasehold improvements                         | 1,198                         | 1,137                        |
| <b>Gross property and equipment</b>            | <b>6,165</b>                  | <b>5,026</b>                 |
| Less accumulated depreciation and amortization | (3,261)                       | (2,631)                      |
| <b>Property and equipment, net</b>             | <b>\$ 2,904</b>               | <b>\$ 2,395</b>              |

**11. 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 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.

|   | <b>September 30,<br/>2014</b> | <b>December 31,<br/>2013</b> |
|---|-------------------------------|------------------------------|
| Capitalized patent costs                    | \$ 6,059                      | \$ 5,157                     |
| Intangible assets acquired:                 |                               |                              |
| Purchased patents and intellectual property | 250                           | 250                          |
| Existing technology                         | 1,560                         | 1,560                        |
| Customer relationships                      | 290                           | 290                          |
| Backlog                                     | 760                           | 760                          |
| Tradenames                                  | 290                           | 290                          |
| Non-solicitation agreements                 | 120                           | 120                          |
| Gross intangible assets                     | 9,329                         | 8,427                        |
| Accumulated amortization                    | (2,493)                       | (1,718)                      |
| Intangibles, net                            | \$ 6,836                      | \$ 6,709                     |

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

In March 2012, Digimarc and Nielsen decided to reduce the investments in their two joint ventures, TVaura LLC (in which Digimarc holds a 51% ownership interest) and TVaura Mobile LLC (in which Digimarc holds a 49% ownership interest), to minimal levels while assessing alternative approaches to achieving each of their goals in the emerging market opportunity of synchronized second screen television. Payment of all expenses incurred after the suspension of operations of each joint venture is unconditionally the responsibility of the majority owner, which expenses for TVaura LLC, if any, will be paid by Digimarc. As of September 30, 2014, both Digimarc and Nielsen continued to assess the market opportunities of each of the joint ventures.

Summarized financial information for the joint ventures has not been provided as the disclosures are immaterial to the Company's filing given the operations of the joint ventures continue to be suspended. The joint ventures had no revenue or expenses for the three- and nine-months ended September 30, 2014 and 2013. The Company's investment in each joint venture was \$0 as of September 30, 2014 and December 31, 2013.

**13. Income Taxes**

The provision (benefit) for income taxes for the nine-months ended September 30, 2014 and 2013 reflects current taxes, deferred taxes, and withholding taxes in certain foreign jurisdictions. The effective tax rate for the nine-months ended September 30, 2014 and 2013 was 39% and 26%, respectively. The valuation allowance against net deferred tax assets as of September 30, 2014 was \$527, an increase of \$156 from \$371 as of December 31, 2013.

**14. 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's wholly owned subsidiary, Attributor, is a defendant in a patent infringement lawsuit brought by Blue Spike, LLC (Blue Spike) (E.D. Texas, Civil Action No: 6:12-cv-540). The case was brought against Attributor in August 2012.

Blue Spike asserted infringement by Attributor of four patents. Attributor filed an answer denying that it has infringed any valid claim of the patents in suit, and asserting specified defenses, including non-infringement and invalidity. The court has consolidated the cases that Blue Spike has brought against over ninety defendants into one case, Civil Action No. 6:12-cv-00499. The Company settled the lawsuit with Blue Spike in October 2014. The total settlement amount is immaterial.

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, 2013 filed with the Securities and Exchange Commission (SEC) on February 21, 2014 (the 2013 Annual Report), and other reports and filings made with the 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 Discover and Guardian are registered 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. Our technology provides the means to infuse persistent digital information, Digimarc IDs, perceptible only to computers and digital devices, into all forms of media content. The unique digital identifier placed in media generally persists with it regardless of the distribution path and whether it is copied, manipulated or converted to a different format, and does not affect the quality of the content or the enjoyment or other traditional uses of it. Our technology permits computers and digital devices to quickly identify relevant data from vast amounts of media content.

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

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 some physical objects, including photographs, movies, music, television, personal identification documents, financial instruments, industrial parts and product packages. The digital information can be detected and read by a wide range of computers, mobile phones and other digital devices.



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Our technology allows our 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 technology and intellectual property portfolios have grown to encompass many related technologies.

We provide solutions directly and through our licensees. Our proprietary technology has proven to be a powerful element of document security, giving rise to our long-term relationship with a consortium of central banks, which we refer to as the Central Banks, and many leading companies in the information technology industry. We and our licensees have successfully propagated the use of our technology in music, movies, television broadcasts, images and printed materials. Digimarc IDs 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 IDs 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 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.

As part of the Digimarc Discover platform, we recently introduced Digimarc Barcodes, which contain the same type of information found in traditional product UPC codes, but is invisibly repeated multiple times over the entire packaging. We have partnered with Datalogic, a global leader in Automatic Data Capture and Industrial Automation markets and producer of barcode readers, who has enabled its new Magellan™ 9800i multi-plane imaging scanner to detect and process Digimarc Barcodes. Digimarc Barcodes can also connect mobile-enabled consumers to engaging mobile experiences such as additional product information, special offers, recommendations, reviews, social networks and more directly from a product's packaging.

Our patent portfolio contains a number of innovations in digital watermarking, pattern recognition (sometimes referred to as fingerprinting), digital rights management and related fields. To protect our significant efforts in creating our technology, we have implemented an extensive intellectual property protection program that relies on a combination of patent, copyright, trademark and trade secret laws, and nondisclosure agreements and other contracts. As a result, we believe we have one of the world's most extensive patent portfolios in digital watermarking and related fields, with more than 1,250 U.S. and foreign patents and pending patent applications as of September 30, 2014. We continue to develop and broaden our portfolio of patented technology in the fields of media identification and management technology and related applications and systems. We devote significant resources to developing and protecting our inventions and continuously seek to identify and evaluate potential licensees for our patents. The patents in our portfolio have a life of approximately 20 years from invention date, and up to 17 years after the patent has been granted.

As part of our intellectual property marketing and patent monetization efforts, our key objectives in building relationships with potential customers and partners are to:

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

expand the scope of our license program;

more effectively monetize our patent assets;

encourage large scale adoption of our technologies by industry leaders;

improve our financial performance;

increase the scale and rate of growth of our products and services business; 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.

**Table of Contents****Critical Accounting Policies and Estimates**

Detailed information on our critical accounting policies and estimates are set forth in our 2013 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.

**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, 2014 and all changes discussed with respect to such period reflect changes compared to the three- and nine-month periods ended September 30, 2013.

|  | <b>Three<br/>Months<br/>Ended<br/>September 30,<br/>2014</b> | <b>Three<br/>Months<br/>Ended<br/>September 30,<br/>2013</b> | <b>Nine<br/>Months<br/>Ended<br/>September 30,<br/>2014</b> | <b>Nine<br/>Months<br/>Ended<br/>September 30,<br/>2013</b> |
|--|--|--|---|---|
| <b>Revenue:</b>                          |  |  |   |   |
| Service                                  | 46%  | 41%  | 45%   | 32%   |
| Subscription                             | 21   | 19   | 22  | 15  |
| License                                  | 33   | 40   | 33  | 53  |
| <b>Total revenue</b>                     | <b>100</b>   | <b>100</b>   | <b>100</b>  | <b>100</b>  |
| <b>Cost of revenue:</b>                  |  |  |   |   |
| Service                                  | 18   | 17   | 19  | 14  |
| Subscription                             | 12   | 8  | 11  | 7   |
| License                                  | 1  | 1  | 1   | 1   |
| <b>Total cost of revenue</b>             | <b>31</b>  | <b>26</b>  | <b>31</b>   | <b>22</b>   |
| <b>Gross profit</b>                      | <b>69</b>  | <b>74</b>  | <b>69</b>   | <b>78</b>   |
| <b>Operating expenses:</b>               |  |  |   |   |
| Sales and marketing                      | 29   | 20   | 30  | 15  |
| Research, development and engineering    | 51   | 44   | 53  | 31  |
| General and administrative               | 32   | 33   | 35  | 25  |
| Intellectual property                    | 5  | 4  | 7   | 3   |
| <b>Total operating expenses</b>          | <b>116</b>   | <b>101</b>   | <b>124</b>  | <b>74</b>   |
| <b>Operating income (loss)</b>           | <b>(47)</b>  | <b>(27)</b>  | <b>(56)</b>   | <b>3</b>  |
| <b>Other income, net</b>                 |  |  |   |   |
| <b>Income (loss) before income taxes</b> | <b>(47)</b>  | <b>(27)</b>  | <b>(55)</b>   | <b>4</b>  |

|                                      |       |       |       |     |
|--------------------------------------|-------|-------|-------|-----|
| (Provision) benefit for income taxes | 18    | 16    | 22    | (1) |
| Net income (loss)                    | (29)% | (11)% | (34)% | 3%  |

### *Summary*

During 2013, we increased the level of investment in our product development and sales growth initiatives, primarily through hiring additional engineering and sales personnel. These initiatives include developing and marketing Digimarc Discover, the Digimarc Barcode and other aspects of our Intuitive Computing Platform as well as further developing our retained patent assets and exploring strategic opportunities in the mobile payments market. We expect this level of investing to continue through the remainder of 2014 in support of these initiatives.

Total revenue for the three-month period ended September 30, 2014, compared to the corresponding three-month period ended September 30, 2013, decreased 7% to \$6.9 million primarily due to the scheduled completion of the quarterly license fee payments from The Nielsen Company ( Nielsen ) in the first quarter of 2014 and lower reported quarterly royalties from Verance Corporation ( Verance ) and another licensee, partially offset by a \$1.0 million license fee from Verance in the third quarter of 2014 to extend an existing license through 2023 without additional royalties or fees.

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Total revenue for the nine-month period ended September 30, 2014, compared to the corresponding nine-month period ended September 30, 2013, decreased 30% to \$19.8 million primarily due to the scheduled completion of the quarterly license fee payments from Intellectual Ventures ( IV ) in the second quarter of 2013 and Nielsen in the first quarter of 2014, partially offset by the \$1.0 million license fee payment from Verance in the third quarter of 2014.

Total operating expenses for the three- and nine-month periods ended September 30, 2014, compared to the corresponding three- and nine-month periods ended September 30, 2013, increased 7% to \$8.0 million and 17% to \$24.6 million, respectively, reflecting the full-year impact of the continued investment in our product development and sales growth initiatives.

*Revenue*

|                 | <b>Three<br/>Months<br/>Ended<br/>September 30,<br/>2014</b> | <b>Three<br/>Months<br/>Ended<br/>September 30,<br/>2013</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/>2014</b> | <b>Nine<br/>Months<br/>Ended<br/>September 30,<br/>2013</b> | <b>Dollar<br/>Increase<br/>(Decrease)</b> | <b>Percent<br/>Increase<br/>(Decrease)</b> |
|-----------------|--|--|---|--|---|---|---|--|
| <b>Revenue:</b> |  |  |   |  |   |   |   |  |
| Service         | \$ 3,155   | \$ 3,030   | \$ 125                                    | 4%   | \$ 8,859  | \$ 8,981  | \$ (122)                                  | (1)%                                       |
| Subscription    | 1,452  | 1,424  | 28  | 2%   | 4,360   | 4,241   | 119                                       | 3%   |
| License         | 2,320  | 2,971  | (651)                                     | (22)%                                      | 6,576   | 14,916  | (8,340)                                   | (56)%                                      |
| <b>Total</b>    | <b>\$ 6,927</b>  | <b>\$ 7,425</b>  | <b>\$ (498)</b>                           | <b>(7)%</b>                                | <b>\$ 19,795</b>  | <b>\$ 28,138</b>  | <b>\$ (8,343)</b>                         | <b>(30)%</b>                               |

Revenue (as %  
of total  
revenue):

|              |             |             |  |  |             |             |  |  |
|--------------|-------------|-------------|--|--|-------------|-------------|--|--|
| Service      | 46%         | 41%         |  |  | 45%         | 32%         |  |  |
| Subscription | 21%         | 19%         |  |  | 22%         | 15%         |  |  |
| License      | 33%         | 40%         |  |  | 33%         | 53%         |  |  |
| <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, IV and government agency contractors. The agreements range from several months to several years in length, and our longer term contracts are subject to work plans that are reviewed and agreed upon at 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.

Service revenue was essentially flat for the three- and nine-month periods ended September 30, 2014, compared to the corresponding three- and nine-month periods ended September 30, 2013.

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

Subscription revenue was essentially flat for the three- and nine-month periods ended September 30, 2014, compared to the corresponding three- and nine-month periods ended September 30, 2013.

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

The decrease in license revenue for the three-month period ended September 30, 2014, compared to the corresponding three-month period ended September 30, 2013, was primarily due to the scheduled completion of the quarterly license fee payments from Nielsen in the first quarter of 2014 and lower reported quarterly royalties from Verance and another licensee, partially offset by the \$1.0 million license fee payment from Verance in the third quarter of 2014.

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The decrease in license revenue for the nine-month period ended September 30, 2014, compared to the corresponding nine-month period ended September 30, 2013, was primarily due to the scheduled completion of the quarterly license fee payments from IV in the second quarter of 2013 and from Nielsen in the first quarter of 2014 and lower reported royalties from Verance and another licensee, partially offset by the \$1.0 million license fee payment from Verance in the third quarter of 2014.

*Revenue by Geography*

|   | <b>Three<br/>Months<br/>Ended<br/>September 30,<br/>2014</b> | <b>Three<br/>Months<br/>Ended<br/>September 30,<br/>2013</b> | <b>Dollar<br/>(Decrease)</b> | <b>Percent<br/>(Decrease)</b> | <b>Nine<br/>Months<br/>Ended<br/>September 30,<br/>2014</b> | <b>Nine<br/>Months<br/>Ended<br/>September 30,<br/>2013</b> | <b>Dollar<br/>(Decrease)</b> | <b>Percent<br/>(Decrease)</b> |
|---|--|--|------------------------------|-------------------------------|---|---|------------------------------|-------------------------------|
| <b>Revenue by geography:</b>            |  |  |                              |                               |   |   |                              |                               |
| Domestic                                | \$ 3,046   | \$ 3,536   | \$ (490)                     | (14)%                         | \$ 7,946  | \$ 15,902   | \$ (7,956)                   | (50)%                         |
| International                           | 3,881  | 3,889  | (8)                          | 0%                            | 11,849  | 12,236  | (387)                        | (3)%                          |
| <b>Total</b>                            | <b>\$ 6,927</b>  | <b>\$ 7,425</b>  | <b>\$ (498)</b>              | <b>(7)%</b>                   | <b>\$ 19,795</b>  | <b>\$ 28,138</b>  | <b>\$ (8,343)</b>            | <b>(30)%</b>                  |
| <b>Revenue (as % of total revenue):</b> |  |  |                              |                               |   |   |                              |                               |
| Domestic                                | 44%  | 48%  |                              |                               | 40%   | 57%   |                              |                               |
| International                           | 56%  | 52%  |                              |                               | 60%   | 43%   |                              |                               |
| <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, 2014, compared to the corresponding three-month period ended September 30, 2013, was primarily the result of the scheduled completion of the quarterly license fee payments Nielsen and lower reported quarterly royalties from Verance, partially offset by the \$1.0 million license fee payment from Verance in the third quarter of 2014.

The decrease in domestic revenue for the nine-month period ended September 30, 2014, compared to the corresponding nine-month period ended September 30, 2013, was primarily the result of the scheduled completion of the quarterly license fee payments from IV and Nielsen, partially offset by the \$1.0 million license fee payment from Verance in the third quarter of 2014.

The decrease in international revenue for the nine-month period ended September 30, 2014, compared to the corresponding nine-month period ended September 30, 2013, was primarily due to lower reported quarterly royalties from an international licensee.

We anticipate a decrease in revenue for 2014 compared to 2013 primarily as a result of the scheduled completion of quarterly license fee payments from IV and Nielsen. These declines are expected to be partially offset by increased revenue from existing customers and new customers as we continue to expand the marketing of our Digimarc Discover, Barcode and Guardian products and our intellectual property portfolio.

*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.



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*Subscription.* Cost of subscription revenue primarily includes:

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

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

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

*License.* Cost of license revenue primarily includes:

amortization of capitalized patent costs and patent maintenance fees;

license costs for any software and/or patents licensed 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/>2014</b> | <b>Three<br/>Months<br/>Ended<br/>September 30,<br/>2013</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/>2014</b> | <b>Nine<br/>Months<br/>Ended<br/>September 30,<br/>2013</b> | <b>Dollar<br/>Increase<br/>(Decrease)</b> | <b>Percent<br/>Increase<br/>(Decrease)</b> |
|----------------------|--|--|---|--|---|---|---|--|
| <b>Gross Profit:</b> |  |  |   |  |   |   |   |  |
| Service              | \$ 1,931   | \$ 1,798   | \$ 133                                    | 7%   | \$ 5,052  | \$ 4,914  | \$ 138                                    | 3%   |
| Subscription         | 640  | 799  | (159)                                     | (20)%                                      | 2,200   | 2,393   | (193)                                     | (8)%                                       |
| License              | 2,236  | 2,873  | (637)                                     | (22)%                                      | 6,326   | 14,622  | (8,296)                                   | (57)%                                      |
| <b>Total</b>         | <b>\$ 4,807</b>  | <b>\$ 5,470</b>  | <b>\$ (663)</b>                           | <b>(12)%</b>                               | <b>\$ 13,578</b>  | <b>\$ 21,929</b>  | <b>\$ (8,351)</b>                         | <b>(38)%</b>                               |

Gross Profit (as  
% of related  
revenue  
components):

|              |            |            |  |  |            |            |  |  |
|--------------|------------|------------|--|--|------------|------------|--|--|
| Service      | 61%        | 59%        |  |  | 57%        | 55%        |  |  |
| Subscription | 44%        | 56%        |  |  | 50%        | 56%        |  |  |
| License      | 96%        | 97%        |  |  | 96%        | 98%        |  |  |
| <b>Total</b> | <b>69%</b> | <b>74%</b> |  |  | <b>69%</b> | <b>78%</b> |  |  |

The increase in service gross profit as a percentage of revenue for the three- and nine-month periods ended September 30, 2014, compared to the corresponding three- and nine-month periods ended September 30, 2013, was due primarily to higher billable rates under our agreement with the Central Banks.

The decrease in subscription gross profit as a percentage of revenue for the three- and nine-month periods ended September 30, 2014, compared to the corresponding three- and nine-month periods ended September 30, 2013, was due primarily to higher contractor costs to support new Digimarc Guardian customers.

The decrease in license gross profit for the three- and nine-month periods ended September 30, 2014, compared to the corresponding three- and nine-month periods ended September 30, 2013, was due primarily to the scheduled completion of the quarterly license fee payments from IV in the second quarter of 2013 and from Nielsen in the first quarter of 2014, partially offset by the \$1.0 million license fee payment from Verance in the third quarter of 2014.

#### *Operating Expenses*

We allocate certain costs of research, development and engineering, sales and marketing, and intellectual property to cost of service 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.

We anticipate operating expenses will be higher in 2014 than 2013, reflecting the full-year impact of the continued investment in our product development and sales growth initiatives, partially offset by lower legal costs due to the completion of licensing audits in 2013 and the arbitration with IV in January 2014.

**Table of Contents***Sales and marketing*

|   | <b>Three<br/>Months<br/>Ended<br/>September 30,<br/>2014</b> | <b>Three<br/>Months<br/>Ended<br/>September 30,<br/>2013</b> | <b>Dollar<br/>Increase</b> | <b>Percent<br/>Increase</b> | <b>Nine<br/>Months<br/>Ended<br/>September 30,<br/>2014</b> | <b>Nine<br/>Months<br/>Ended<br/>September 30,<br/>2013</b> | <b>Dollar<br/>Increase</b> | <b>Percent<br/>Increase</b> |
|---|--|--|----------------------------|-----------------------------|---|---|----------------------------|-----------------------------|
| Sales and marketing                         | \$ 1,999   | \$ 1,482   | \$ 517                     | 35%                         | \$ 5,930  | \$ 4,322  | \$ 1,608                   | 37%                         |
| Sales and marketing (as % of total revenue) | 29%  | 20%  |                            |                             | 30%   | 15%   |                            |                             |

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- and nine-month periods ended September 30, 2014, compared to the corresponding three- and nine-month periods ended September 30, 2013, reflects the full-year impact of the continued investment in our sales growth initiatives.

We anticipate sales and marketing expenses will be higher in 2014 than 2013 as we continue to invest in our sales growth initiatives.

*Research, development and engineering*

|                           | <b>Three<br/>Months<br/>Ended<br/>September 30,<br/>2014</b> | <b>Three<br/>Months<br/>Ended<br/>September 30,<br/>2013</b> | <b>Dollar<br/>Increase</b> | <b>Percent<br/>Increase</b> | <b>Nine<br/>Months<br/>Ended<br/>September 30,<br/>2014</b> | <b>Nine<br/>Months<br/>Ended<br/>September 30,<br/>2013</b> | <b>Dollar<br/>Increase</b> | <b>Percent<br/>Increase</b> |
|---------------------------|--|--|----------------------------|-----------------------------|---|---|----------------------------|-----------------------------|
| Research, development and | \$ 3,499   | \$ 3,277   | \$ 222                     | 7%                          | \$ 10,449   | \$ 8,824  | \$ 1,625                   | 18%                         |

engineering

Research,

development and

engineering (as % of  
total revenue)

51%

44%

53%

31%

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

Fundamental Research:

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

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

industry conference participation and authorship of papers for industry journals;

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

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

research in multi-spectral analyses, machine learning, barcodes, QR codes, fingerprinting, and other content identification technologies;

metadata ranking algorithms for matching Internet file content against reference database; and

investigation of substrates, printing techniques, and printing technology relating to consumer packaged goods.

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Platform Development:

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

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

tuning big data analytics transformation and metrics aggregation engine;

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

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

Product Development:

deliver the Digimarc Barcode;

maintaining the Digimarc Discover ID Manager to provide campaign management and routing services for the Digimarc Discover platform;

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

iterative development and release of the Digimarc Discover application for the iOS and Android platforms;

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

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

Research, development and engineering expenses consist primarily of:

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

payments to outside contractors;

the purchase of materials and services for product development; and

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

The increase in research, development and engineering expenses for the three- and nine-month periods ended September 30, 2014, compared to the corresponding three- and nine-month periods ended September 30, 2013, reflects the full-year impact of the continued investment in our product development initiatives.

We anticipate research, development and engineering expenses will be higher in 2014 than 2013 as we continue to invest in our research and product development initiatives.

*General and administrative*

|  | <b>Three<br/>Months<br/>Ended<br/>September 30,<br/>2014</b> | <b>Three<br/>Months<br/>Ended<br/>September 30,<br/>2013</b> | <b>Dollar<br/>(Decrease)</b> | <b>Percent<br/>(Decrease)</b> | <b>Nine<br/>Months<br/>Ended<br/>September 30,<br/>2014</b> | <b>Nine<br/>Months<br/>Ended<br/>September 30,<br/>2013</b> | <b>Dollar<br/>(Decrease)</b> | <b>Percent<br/>(Decrease)</b> |
|--|--|--|------------------------------|-------------------------------|---|---|------------------------------|-------------------------------|
| General and administrative                         | \$ 2,183   | \$ 2,456   | \$ (273)                     | (11)%                         | \$ 6,929  | \$ 6,990  | \$ (61)                      | (1)%                          |
| General and administrative (as % of total revenue) | 32%  | 33%  |                              |                               | 35%   | 25%   |                              |                               |

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 costs of services, sales and marketing, research, development and engineering and intellectual property.

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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;

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, 2014, compared to the corresponding three-month period ended September 30, 2013, was primarily due to the completion of licensing audits in 2013.

General and administrative expenses were essentially flat for the nine-month period ended September 30, 2014, compared to the corresponding nine-month period ended September 30, 2013.

We anticipate general and administrative expenses will be lower in 2014 than 2013, reflecting lower legal costs due to the completion of licensing audits in 2013 and the arbitration with IV in January 2014. 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/>2014</b> | <b>Three<br/>Months<br/>Ended<br/>September 30,<br/>2013</b> | <b>Dollar<br/>Increase</b> | <b>Percent<br/>Increase</b> | <b>Nine<br/>Months<br/>Ended<br/>September 30,<br/>2014</b> | <b>Nine<br/>Months<br/>Ended<br/>September 30,<br/>2013</b> | <b>Dollar<br/>Increase</b> | <b>Percent<br/>Increase</b> |
|---|--|--|----------------------------|-----------------------------|---|---|----------------------------|-----------------------------|
| Intellectual property                               | \$ 366   | \$ 278   | \$ 88                      | 32%                         | \$ 1,287  | \$ 816  | \$ 471                     | 58%                         |
| Intellectual property<br>(as % of total<br>revenue) | 5%   | 4%   |                            |                             | 7%  | 3%  |                            |                             |

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

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

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

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

consulting costs related to marketing our intellectual property portfolio; and

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

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

the level of capitalized patent activity, and

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

The increase in intellectual property expense for the three- and nine-month periods ended September 30, 2014, compared to the corresponding three- and nine-month periods ended September 30, 2013, reflects full-year impact of the continued investment in our intellectual property development and marketing efforts and a third party intellectual property valuation and marketing study in the first quarter of 2014.

We anticipate intellectual property expenses will be higher in 2014 than 2013 as we continue to invest in our intellectual property development and marketing efforts.



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

|                                       | Three Months Ended |                    | Three Months Ended |                  | Nine Months Ended  |                    | Nine Months Ended |                  |
|---------------------------------------|--------------------|--------------------|--------------------|------------------|--------------------|--------------------|-------------------|------------------|
|                                       | September 30, 2014 | September 30, 2013 | Dollar Increase    | Percent Increase | September 30, 2014 | September 30, 2013 | Dollar Increase   | Percent Increase |
| Cost of revenue                       | \$ 131             | \$ 78              | \$ 53              | 68%              | \$ 402             | \$ 374             | \$ 28             | 7%               |
| Sales and marketing                   | 187                | 103                | 84                 | 82%              | 504                | 298                | 206               | 69%              |
| Research, development and engineering | 363                | 278                | 85                 | 31%              | 1,083              | 766                | 317               | 41%              |
| General and administrative            | 688                | 529                | 159                | 30%              | 1,844              | 1,595              | 249               | 16%              |
| Intellectual property                 | 85                 | 62                 | 23                 | 37%              | 252                | 186                | 66                | 35%              |
| Total                                 | \$ 1,454           | \$ 1,050           | \$ 404             | 38%              | \$ 4,085           | \$ 3,219           | \$ 866            | 27%              |

The increase in total stock-based compensation expense for the three- and nine-month periods ended September 30, 2014, compared to the corresponding three- and nine-month periods ended September 30, 2013, was primarily due to higher headcount and the timing of restricted stock grants. We anticipate incurring an additional \$11.0 million in stock-based compensation expense through September 2018 for awards outstanding as of September 30, 2014.

*Other income, net*

|   | Three Months Ended |                    | Three Months Ended |                    | Nine Months Ended  |                    | Nine Months Ended |                    |
|---|--------------------|--------------------|--------------------|--------------------|--------------------|--------------------|-------------------|--------------------|
|   | September 30, 2014 | September 30, 2013 | Dollar (Decrease)  | Percent (Decrease) | September 30, 2014 | September 30, 2013 | Dollar (Decrease) | Percent (Decrease) |
| Other income, net                         | \$ 3               | \$ 33              | (30)               | (91)%              | \$ 50              | \$ 81              | (31)              | (38)%              |
| Other income, net (as % of total revenue) | *                  | *                  |                    |                    | *                  | *                  |                   |                    |

\* Less than 1%

The decrease in other income, net for the three- and nine-month periods ended September 30, 2014, compared to the corresponding three- and nine-month periods ended September 30, 2013, was primarily due to losses on foreign currency and lower interest income, due to a combination of lower cash balances and interest rates on cash and investments.

*Provision for Income Taxes*

The provision (benefit) for income taxes for the three- and nine-month periods ended September 30, 2014 and 2013 reflects current taxes, deferred taxes, and withholding taxes in certain foreign jurisdictions. The effective tax rate for the nine-months ended September 30, 2014 and 2013 was 39% and 26%, respectively. The valuation allowance against net deferred tax assets as of September 30, 2014 was \$527, an increase of \$156 from \$371 as of December 31, 2013.

We continually assess the applicability of a valuation allowance. Based upon the positive and negative evidence available as of September 30, 2014, and due to Contributor's history of losses and the inability to utilize Contributor losses to offset Digimarc income for state tax purposes, we concluded that it is not more likely than not that the Contributor state deferred tax assets will be realized, and a full valuation allowance has been recorded on the state deferred tax assets of Contributor.

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

|   | <b>September 30,<br/>2014</b> | <b>December 31,<br/>2013</b> |
|---|-------------------------------|------------------------------|
| Working capital   | \$ 25,456                     | \$ 31,380                    |
| Current (liquidity) ratio (1)                               | 7.8:1                         | 6.4:1                        |
| Cash, cash equivalents and short-term marketable securities | \$ 21,785                     | \$ 29,662                    |
| Long-term marketable securities                             | \$ 2,951                      | \$ 5,302                     |
| Total cash, cash equivalents and all marketable securities  | \$ 24,736                     | \$ 34,964                    |

(1) The current (liquidity) ratio is calculated by dividing total current assets by total current liabilities. The \$10.2 million decrease in cash, cash equivalents and marketable securities resulted primarily from:

cash used in operations;

investments in both equipment and patent assets;

purchases of common stock to satisfy required tax withholding obligations on restricted stock vesting; and

payment of dividends; partially offset by

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

proceeds from stock option exercises.

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 include pre-refunded municipal bonds, corporate notes, certificates of deposit, commercial paper and U.S. federal agency notes. 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/>2014</b> | <b>Nine<br/>Months<br/>Ended<br/>September 30,<br/>2013</b> | <b>Dollar<br/>(Decrease)</b> | <b>Percent<br/>(Decrease)</b> |
|--|---|---|------------------------------|-------------------------------|
| Net income (loss)                                      | \$ (6,651)  | \$ 778  | \$ (7,429)                   | (955)%                        |
| Non-cash items   | 2,822   | 4,849   | (2,027)                      | (42)%                         |
| Changes in operating assets and liabilities            | (2,077)   | (962)   | (1,115)                      | (116)%                        |
| Net cash provided by (used in)<br>operating activities | \$ (5,906)  | \$ 4,665  | \$ (10,571)                  | (227)%                        |

Cash flows from operating activities for the nine-month period ended September 30, 2014, compared to the nine-month period ended September 30, 2013, decreased by \$10.6 million, reflecting a net loss versus net income, lower non-cash items and the impact of changes in operating assets and liabilities. The change in operating assets and liabilities was primarily from the generation of income taxes receivable due to net operating losses generated in the nine-month period ended September 30, 2014 that can be carried back for refund to the 2012 tax return.

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Cash flows from investing activities for the nine-month period ended September 30, 2014, compared to the nine-month period ended September 30, 2013, increased by \$10.4 million from (\$3.2) million to \$7.2 million, reflecting higher net maturities of marketable securities and lower purchases of equipment.

Cash flows used in financing activities for the nine-month period ended September 30, 2014, compared to the nine-month period ended September 30, 2013, decreased \$0.9 million from \$3.3 million to \$2.4 million, primarily as a result of cash proceeds from stock option exercises and the suspension of quarterly dividends, partially offset by higher stock repurchases to satisfy required tax withholding obligations on restricted stock vesting.

### ***Future Cash Expectations***

In connection with our license agreement with IV, the quarterly license fee payments ended in the second quarter of 2013. We are not able to estimate the future cash flow impact of any profit sharing we may earn from IV. No profit sharing was earned from 2013 licensing activities.

In connection with our license agreement with Nielsen, the quarterly license fee payments ended in the first quarter of 2014.

We negotiated an extension to the existing license agreement with Verance for a \$1.0 million license fee that was paid during the third quarter of 2014. There are no other royalties or license fees payable under the extended license agreement.

In November 2013, our Board of Directors extended our stock repurchase program, under which we have \$3,998 available to purchase shares of our common stock as of September 30, 2014. Shares of our common stock may be purchased in the open market or through privately negotiated transactions, subject to market conditions. This repurchase program does not obligate us to acquire any specific number of shares or to acquire shares over any specified period of time. This repurchase program expires in December 2014. We did not repurchase any common stock under our stock repurchase program during the three-month period ended September 30, 2014.

In August 2014, we entered into an Equity Distribution Agreement, whereby we may sell from time to time through Wells Fargo Securities, LLC, as our sales agent, our common stock having an aggregate offering price of up to \$30 million. Wells Fargo Securities, LLC will receive from us a commission equal to 2.50% of the gross sales price per share of common stock for shares having an aggregate offering price of up to \$10 million, and a commission of 2.25% of the gross sales price per share of common stock thereafter, for shares sold under the Equity Distribution Agreement. We did not sell any common stock under the Equity Distribution Agreement during the three-month period ended September 30, 2014.

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 in place, of which \$30 million was allocated for At-the-Market offerings under the Equity Distribution Agreement. We may sell shares under the Equity Distribution Agreement and/or use other financing means to raise working capital in the future to support continued investment in our product development and sales growth initiatives. 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.

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

Other than the contractual obligations disclosed in our 2013 Annual Report, we do not have any off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on our financial condition, changes in financial condition, revenue or expenses, results of operations, liquidity, capital expenditures or capital resources that are material to investors.

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

This Quarterly Report on Form 10-Q includes forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934 and Section 27A of the Securities Act of 1933. Words such as may, plan, should, could, expect, anticipate, intend, believe, project, forecast, estimate, continue, variations of such terms and 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,

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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;

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

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

anticipated levels of backlog in future periods;

the success of our arrangements with Intellectual Ventures;

the success of our acquisition of Attributor Corporation;

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

other risks detailed in our filings with the Securities and Exchange Commission, including the risk factors set forth in Part I, Item 1A of our 2013 Annual Report.

We believe that the risk factors specified above and the risk factors identified in Part II, Item 1A of this Quarterly Report on Form 10-Q, 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 2013 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





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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, 2014 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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**PART II. OTHER INFORMATION.**

**Item 1. Legal Proceedings.**

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

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

Blue Spike asserted infringement by Attributor of four patents. Attributor filed an answer denying that it has infringed any valid claim of the patents in suit, and asserting specified defenses, including non-infringement and invalidity. The court has consolidated the cases that Blue Spike has brought against over ninety defendants into one case, Civil Action No. 6:12-cv-00499. We settled the lawsuit with Blue Spike in October 2014. The total settlement amount is immaterial.

**Item 1A. Risk Factors**

The following risk factors include changes to and supersede the risk factors previously disclosed in Part I, Item IA of our 2013 Annual Report, as updated by our quarterly reports on Form 10-Q for the quarters ended March 31, 2014 and June 30, 2014. The risks 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. The risks and uncertainties we have described are not the only ones we face. Additional risks and uncertainties not presently known to us or that we currently deem immaterial may also affect our operations.

**RISKS RELATED TO OUR BUSINESS**

*(1) A small number of customers account for a substantial portion of our revenue, and the loss of any large contract could materially disrupt our business.*

Historically, we have derived a significant portion of our revenue from a limited number of customers. Five customers, the Bank for International Settlements (acting on behalf of the Central Banks), IV, Nielsen, Verance and Civolution represented approximately 81% of our revenue for the year ended December 31, 2013. Most of our revenue comes from long-term contracts generally having terms of at least three to five years, with some licenses for the life of the associated patents, which could be up to 20 years. The agreements with some of these customers provide minimum or fixed payment obligations that have ceased, in the case of IV and Nielsen. Some contracts we enter into contain termination for convenience provisions. If we were to lose such a contract for any reason, or if revenue from variable payment obligations do not replace revenue under the existing fixed payment obligations, our financial results could be adversely affected. For example, in connection with our arrangement with IV, the quarterly license fee payments ended in the second quarter of 2013. We are not able to reasonably estimate the future revenue impact of any profit sharing we may earn from IV.

We expect to continue to depend upon a small number of customers for a significant portion of our revenue for the foreseeable future. The loss of, or decline in, orders or backlog from one or more major customers could reduce our revenue and have a material adverse effect on our financial results.

***(2) Although we achieved profitability in prior years, we were not profitable in 2013 and may not be able to return to or sustain profitability in the future, particularly if we were to lose large contracts. Sustained lack of profitability could cause us to incur asset impairment charges for long-lived assets and could render us unable to realize the benefit of our net deferred tax assets.***

For the year ended December 31, 2012, we generated net income of \$8.3 million. Our profit was primarily due to a past due royalties payment received from Verance in the first quarter of 2012 and quarterly license fee payments from IV, which ended in the second quarter of 2013. For the year ended December 31, 2013, we incurred a net loss largely due to the end of the quarterly license fee payments from IV. We have continued to incur losses in 2014 due to the end of these license fee payments and increased level of investments in our business.

Returning to and maintaining profitability in the future will depend upon a variety of factors, including our ability to maintain and obtain more significant partnerships like we have with the Central Banks and acquiring new customers for Digimarc Discover and Barcode and future licensees. Profitability will also depend on growth in revenue from our efficiency in executing our business strategy and capitalizing on new opportunities. Various adverse developments, including the loss of large contracts or cost overruns on our existing contracts, could adversely affect our revenue, margins and profitability.

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If we continue to incur operating losses, it could result in an impairment to the carrying value of our long-lived assets, including acquired intangible assets, patent assets and property, plant and equipment. We evaluate impairment of our long-lived assets when events or changes in circumstances indicate that the carrying value may not be recoverable. Our methodology for assessing impairment may require management to make judgments and assumptions regarding the fair value of our long-lived assets, which is largely based on projections of future financial performance. Our projections of future financial performance are largely based on historical experience, and these projections may or may not be achieved. Changes to the financial projections used in our impairment analysis could lead to an impairment of a portion or all of our long-lived assets. Any such impairment charge could adversely affect our results of operations and our stock price.

As of September 30, 2014, we had \$5.6 million of deferred tax assets, net of a \$0.5 million valuation allowance. We establish valuation allowances against deferred tax assets when there is insufficient evidence that we will be able to realize the benefit of these deferred tax assets. If we are unable to regain profitability in the future, we may be required to increase the valuation allowance against these deferred tax assets. Adjustments to our deferred tax assets could adversely affect our results of operations and our stock price.

***(3) We may be adversely affected by variability of contracted arrangements.***

We frequently have agreed to modify the terms of contractual arrangements with our customers, partners and licensees in response to changes in circumstances underlying the original contractual arrangements, and it is likely that we will do so in the future. As a result of this practice, the terms of our contractual arrangements with our customers, partners and licensees may vary over time and, depending on the particular modification, could have a material adverse effect on our financial position, results of operations or cash flows.

Some of our customers and licensees report royalties to us based on their revenue and their interpretation and allocation of contracted royalty obligations. For example, one licensee reports profit sharing to us based on income earned, which is subject to their interpretation and allocation of revenue and expenses, which could be less favorable to us than our own interpretation. It is possible that we may not agree with the judgments of our customers on such matters, and such disagreement may lead to potential disputes and reduced revenue to us. These disputes could result in a distraction to our management and may not result in increased revenues to us but may nevertheless result in friction between us and our customers, and potentially the loss of customers, which may ultimately be harmful to our business.

***(4) A significant portion of our current and potential future revenue is subject to commercial and government contracts and development of new markets that may involve unpredictable delays and other unexpected changes. Such volatility and uncertainty might limit our actual revenue in any given quarter or year.***

We derive substantial portions of our revenue from contracts tied to development schedules or development of new markets, which could shift for months, quarters or years as the needs of our customers and the markets in which they participate change. Government agencies and commercial customers also face budget pressures that introduce added uncertainty. Any shift in development schedules, the markets in which we or our licensees participate, or customer procurement processes, which are outside our control and may not be predictable, could result in delays in bookings forecasted for any particular period, could affect the predictability of our quarterly and annual results, and might limit our actual revenue in any given quarter or year, resulting in reduced and less predictable revenue and adversely affecting profitability.

We are also expanding into new markets, which involve inherent risk and unpredictability. In recent years, particularly with the proliferation of smartphones and increased demands for enhanced security options, we have investigated

other technologies that may provide attractive future opportunities, for example in the packaging and publishing markets. These generally include technologies that leverage our strength in signal processing and support our vision for intuitive, pervasive computing. As we seek to expand outside our areas of historical expertise, we lack the history and insight that benefited us in the watermarking field. We also lack the size and scale typical of contractors providing products and services to the federal government. While we were in the vanguard of commercial application of digital watermarking, we are investing in but may not be as uniquely poised in these other disciplines. Accordingly, it may be difficult for us to replicate our watermarking success in other technologies we might pursue.

***(5) The market for our products is highly competitive, and alternative technologies or larger companies that compete with us may be more successful than us in gaining market share, which would decrease our revenue and profits.***

The markets in which we compete for business are intensely competitive and rapidly evolving. We expect competition to continue from both existing competitors and new market entrants. We face competition from other companies and from alternative technologies, including some of our customers and licensees. We also may face competition from unexpected sources.

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Alternative technologies that may directly or indirectly compete with particular applications of our watermarking technologies include:

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

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

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

Image recognition one or several pre-specified or learned objects or object classes that can be recognized, usually together with their two-dimensional positions in the image or three-dimensional poses in the scene, such as Google Goggles, which provides a stand-alone program illustration of this function;

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

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

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

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

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

In the competitive environments in which we operate, product generation, development and marketing processes relating to technology are uncertain and complex, and require accurate prediction of demand as well as successful management of various risks inherent in technology development. In light of these uncertainties, it is possible that our failure to successfully accommodate future changes in technologies related to our technology could have a long-term negative effect on our growth and results of operations.

New developments are expected to continue, and discoveries by others, including current and potential competitors, possibly could render our services and products noncompetitive. Moreover, because of rapid technological changes, we may be required to expend greater amounts of time and money than anticipated to develop new products and services, which in turn may require greater revenue streams from those products and services to cover developmental costs. Many of the companies that compete with us for some of our business, as well as other companies with whom we may compete in the future, are larger and may have stronger brand recognition and greater technical, financial, marketing and political resources than we do. These attributes could enable these companies to have more success in the market than we have, either by providing better products or better pricing than we can provide. We may be unable to compete successfully against current or future participants in our market or against alternative technologies, and the competitive pressures we face could decrease our revenue and profits in the future.

***(6) We may not receive any profit-sharing from our patent licensing arrangement with Intellectual Ventures.***

In connection with our patent licensing arrangement with IV, we granted an exclusive license to sublicense our patent assets existing at that time to IV in exchange for various strategic and financial benefits, including profit participation. We have received all the minimum guaranteed license fees and most of the minimum consulting fees. We may not realize any profit participation revenue from our patent licensing arrangement with IV. We have given IV control over both prosecution and enforcement of these assets. While IV can seek our assistance and has committed to pay for it, we cannot guarantee that IV will seek our assistance in prosecution, nor enforce the patents to the extent we would.

***(7) We may acquire or invest in other companies or technologies in the future, which could divert management's attention, result in additional dilution to our stockholders, increase expenses, disrupt our operations and harm our operating results.***

We acquired Contributor Corporation in December 2012, and we may in the future acquire or invest in businesses, products or technologies that we believe could complement or expand our current product and service offerings, enhance our technical capabilities, expand our operations into new markets or otherwise offer growth opportunities. We cannot assure you that we will realize the anticipated benefits of our recent or any future acquisition. The pursuit of potential acquisitions may divert the attention of management and cause us to incur various expenses related to identifying, investigating and pursuing suitable acquisitions, whether or not they are consummated.



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There are inherent risks in integrating and managing acquisitions. We may not be able to assimilate or integrate the acquired personnel, operations and technologies successfully or effectively manage the combined business following an acquisition. We also may not achieve the anticipated benefits from an acquired business due to a number of factors, including:

unanticipated costs or liabilities associated with the acquisition;

incurrence of acquisition-related costs, which would be recognized as a current period expense;

inability to generate sufficient revenue to offset acquisition or investment costs;

the inability to maintain relationships with customers and partners of the acquired business;

the need to implement additional controls, procedures and policies;

entry into geographic markets in which we have little or no prior experience, and challenges caused by distance, language and cultural differences;

differences in foreign labor and employment laws, including classification of employees and contractors;

disruption of our ongoing business;

the potential loss of key employees; and

use of substantial portions of our available cash to consummate the acquisition.

Acquisitions could also result in dilutive issuances of equity securities or the incurrence of debt, which could adversely affect our operating results. In addition, if an acquired business fails to meet our expectations, our operating results, business and financial condition may suffer.

***(8) An increase in our operations outside of the U.S. subjects us to risks additional to those to which we are exposed in our domestic operations.***

We believe that revenue from sales of products and services to commercial, governmental and other customers outside the U.S. could represent a growing percentage of our total revenue in the future. In addition, as a result of our acquisition of Attributor Corporation, we perform certain functions in various jurisdictions outside of the U.S. International operations are subject to a number of risks that can adversely affect our sales of products and services to customers outside of the U.S., or expose us to additional expense or liabilities, including the following:

difficulties and costs of staffing, developing and managing foreign operations as a result of distance, language and cultural differences;

the effect of laws governing employee and contractor relationships, and the existence of workers' councils and labor unions in some jurisdictions;

changes in foreign government regulations and security requirements;

export license requirements, tariffs and taxes;

trade barriers;

difficulty in protecting intellectual property;

difficulty in collecting accounts receivable;

currency fluctuations;

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

political and economic instability.

We do not have an extensive operational infrastructure for international business. We generally depend on local or international business partners and subcontractors for performance of substantial portions of our business. These factors may result in greater risk of performance problems or of reduced profitability with respect to our international programs in these markets. In addition, if foreign customers, in particular foreign government authorities, terminate or delay the implementation of our products and services, it may be difficult for us, or we may not be able, to recover our potential losses.

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***(9) Our future growth will depend to some extent on our successful implementation of our technology in solutions provided by third parties.***

Our business and strategy rely substantially on deployment of our technology by our licensees and other third-party software developers and original equipment manufacturers. For example, one form of our technology is commonly deployed in image editing applications to permit users of these products to read data embedded in imagery, and thereby identify ownership and discern the identities of image owners. Another form of our technology is used in our anti-counterfeiting products. Our patented inventions are also being deployed as part of Digital Cinema systems to theatres around the world by companies that integrate technologies and subsystems. Most recently, our software has been integrated into Point of Sale scanners from Datalogic. In addition, we rely on the ability of IV to license a portion of our patented inventions to third party licensees pursuant to the patent licensing arrangement we entered into with IV in October 2010. If third parties who include our technology in their products or otherwise license our intellectual property for use in their products cease to do so, or we fail to obtain other partners who will incorporate, embed, integrate or bundle our technology, or these partners are unsuccessful in their efforts, our efforts to expand deployment of our technology and increase licensing revenue would be adversely affected. Consequently, our ability to increase revenue would be adversely affected and we may suffer other adverse effects to our business. In addition, if our technology does not perform according to market expectations, our future sales would suffer as customers seek other alternatives.

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

Our success depends to a significant extent on the performance and continued service of our management and our intellectual property team. The loss of the services of any of these employees could limit our growth or undermine customer relationships.

Due to the high level of technical expertise that our industry requires, our ability to successfully develop, market, sell, license and support our products, services, and intellectual property depends to a significant degree upon the continued contributions of our key personnel in engineering, sales, marketing, operations, legal and licensing, many of whom would be difficult to replace. We believe our future success will depend in large part upon our ability to retain our current key employees and our ability to attract, integrate and retain new personnel in the future. It may not be practical for us to match the compensation some of our employees could garner at other employment. In addition, we may encounter difficulties in hiring and retaining employees because of concerns related to our financial performance or operating results. These circumstances may have a negative effect on the market price of our common stock, and employees and prospective employees may factor in the uncertainties relating to our stability and the value of any equity-based incentives in their decisions regarding employment opportunities and decide to leave our employ. Moreover, our business is based in large part on patented technology, which is a unique and sophisticated signal processing technology. New employees require substantial training, involving significant resources and management attention. Competition for experienced personnel in our business can be intense. If we do not succeed in attracting new, qualified personnel or in integrating, retaining and motivating our current personnel, our growth and ability to deliver products and services that our customers require may be hampered. Although our employees generally have executed agreements containing non-competition clauses, we do not assure you that a court would enforce all of the terms of these clauses or the agreements generally. If these clauses were not fully enforced, our employees could be able to freely join our competitors. Although we generally attempt to control access to and distribution of our proprietary information by our employees, we do not assure you that the confidential nature of our proprietary information will be maintained in the course of such future employment. Any of these events could have a material adverse effect on our financial and business prospects.

***(11) If leading companies in the retail and consumer products industries or standard-setting bodies or institutions downplay, minimize or reject the use of our technology, deployment may be slowed and we may be unable to achieve revenue growth.***

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

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

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

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

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

we may be unable to develop and maintain new technologies upon which our existing and new products and services are dependent which may cause our products and services to be less sustainable and competitive or which could make it harder for us to expand our revenue and business; and

our licensees may not be able to successfully enter new markets or grow their businesses, limiting the royalties payable to us and our associated revenue and profits.

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

***(13) (a) We may not be able to adequately secure patent or other protection for our technologies.***

Our business depends in part on securing protection for our proprietary technology and successfully licensing our technology to third parties. To protect our intellectual property portfolio, we rely on a combination of patent, copyright, trademark and trade secret rights, confidentiality procedures and licensing arrangements. Although we regularly apply for patents, copyrights and trademarks to protect our intellectual property, there is no guarantee that we will secure protection for any particular technology we develop. In particular, the process of securing a patent is complex and may take several years in the United States. To secure patent protection, among other things, our invention must be novel and useful, we must be the first to file a patent application, we must secure the cooperation of the inventor of the invention that is the subject of the patent and we must prepare and file the patent application with the relevant U.S. or foreign patent offices. During the process, third parties, including our competitors, can challenge and seek to limit any patent claims we seek. Even if we are successful in obtaining a patent, the scope of the patent may not be as broad as our claims in our patent application. Furthermore, patent protection throughout the world is generally established on a country-by-country basis and we may not have as much success in securing patents in foreign jurisdictions as we have experienced in the United States. We cannot assure you that pending patents will be issued or that issued patents will be valid or enforceable. Failure to secure the issuance of patents for which we have filed applications or failure to enforce patents that are issued may result in less future revenue to us.

Changes in the U.S. and foreign patent laws, or in the interpretation of existing laws, may adversely affect our ability to secure patents as well. An example includes the passage of the America Invents Act of 2011, which codifies several significant changes to the U.S. patent laws, including changing from a first to invent to a first inventor to file system, limiting where a patentee may file a patent suit, replacing interference proceedings with derivation actions, and creating a post-grant opposition process to challenge patents after they have issued.

Even if we are successful in securing patent protection for any particular technology, patents have finite lives, and our ability to continue to commercially exploit our patents is limited to the term of the patents. Our earliest patents began

expiring in July 2012. The size and strength of our portfolio depends on the number of patents that have been granted, offset by the number of patents that expire, in any given year. We continue to grow our patent portfolio, but we do not assure you that we will be able to exploit newer patents to the extent that we have our earlier patents.

Third parties may petition the U.S. Patent and Trademark Office or comparable government authorities in other jurisdictions to review and reconsider the patentability of any of our inventions claimed in our issued patents. Any such re-examination may result in one or more of our patents becoming subject to reissuance with more limited claims, or even become invalidated altogether. Such reexaminations, associated government or judicial hearings, and potentially adverse decisions may cause us increased expense and distraction, and may negatively impede any licensing discussions we are then engaged in with respect to such patents, and may adversely affect any existing licenses we have granted with respect to such patents, thus impacting adversely our revenues.

As part of our confidentiality procedures, we generally enter into non-disclosure agreements with our employees, directors, consultants and corporate partners, and attempt to control access to and distribution of our technology, solutions, documentation and other proprietary information. Despite these procedures, third parties could copy or otherwise obtain and make unauthorized use of our technology, solutions or other proprietary information or independently develop similar technologies, solutions or information. The steps that we have taken to prevent misappropriation of our solutions, technology or other proprietary information may not succeed.

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We do not assure you that the protection of our proprietary rights will be adequate or that our competitors will not independently develop similar technologies, duplicate our services or design around any of our patents or other intellectual property rights.

***(b) We may not be successful in enforcing our intellectual property rights against third parties.***

Unlicensed copying and use of our intellectual property or infringement of our intellectual property rights may result in the loss of revenue to us and cause us other harm. We seek diligently to enforce our intellectual property rights. Although we devote significant resources to developing and protecting our technologies, and evaluating potential competitors of our technologies for infringement of our intellectual property rights, these infringements may nonetheless go undetected or may arise in the future. In the ordinary course of business, we encounter companies that we believe are infringing on our intellectual property rights. When we encounter a company that we believe is infringing our intellectual property rights, we may try to negotiate a license arrangement with such party. If we try and are unable to negotiate a license or secure the agreement of such alleged infringing party to cease its activities, we must make decisions as to how best to enforce our intellectual property rights.

The process of negotiating a license with a third party can be lengthy, and may take months or even years in some circumstances. Even if we are successful in securing a license agreement, there can be no assurance that our technologies will be used in a product that is ultimately brought to market, achieves commercial acceptance or results in significant royalties to us. We generally incur expense prior to entering into our license agreements, generating a license fee and establishing a royalty stream from each customer. We may incur costs in any particular period before any associated revenue stream begins, if at all. Further, it is possible that third parties who we believe are infringing our intellectual property rights are unwilling to license our intellectual property from us on terms we can accept, or at all.

If we cannot persuade a third party who we believe is infringing our technology to enter into a license with us, we may be required to consider other alternatives to enforce our rights, including commencing litigation. The decision to commence litigation over infringement of a patent is complex and may lead to several risks to us, including the following, among others:

the time, significant expense and distraction to management of managing such litigation;

the uncertainty of litigation and its potential outcomes;

the possibility that in the course of such litigation, the defendant may challenge the validity of our patents, which could result in a re-examination of our patents and the possibility that our patents may be limited in scope or invalidated altogether;

the potential that the defendant may successfully persuade a court that their technology or products do not infringe our intellectual property rights;

the impact of such litigation on other licensing relationships we have or seek to establish, including the timing of renewing or entering into such relationships, as applicable, as well as the terms of such relationships; and

adverse publicity to us or harm to relationships we have with customers or others.

Further, we are the exclusive licensee under some third-party patents, and may need the assistance of these parties if we choose to enforce any of these patent rights. The cooperation of these third parties cannot be assured.

Also, enforcement of patent protection throughout the world is generally established on a country-by-country basis and we may not have as much success enforcing our patents in foreign jurisdictions as we have experienced in the United States. Further, in some instances, certain foreign governmental entities that might infringe our intellectual property rights may enjoy sovereign immunity from such claims. Consequently, effective protection of our intellectual property rights may be unavailable or limited.

Defendants in any litigation we consider commencing may have substantially greater financial and management resources necessary to manage litigation than we have. Further, such potential defendants may also have their own substantial patent portfolio. Patent litigation can endure for years and result in millions of dollars of expenses. If our counterparties in such litigation have substantially greater resources than we have, we may not be able to withstand the time, expense or distraction of the litigation, even though we may have a better litigation position than such counterparties. In such instances we may not recover the expenses of litigation, and we may be required to enter into settlement agreements that would be adverse to us or our intellectual property portfolio. From time to time, we contemplate, and are currently contemplating, litigation against companies that we believe to be infringing upon our intellectual property. Some of these companies we know to have extremely significant cash and legal resources focused on the development and enforcement of their intellectual property portfolios. Should we commence litigation against one or more of those parties, we expect that we will be required to devote substantial resources and funds to such litigation and we may not be successful in recouping such resources.



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The foregoing and other factors may cause us not to file or continue litigation against alleged infringers of our intellectual property rights, or may cause us not to file for, or pursue, patent protection for our inventive technology, in certain jurisdictions. Our failure to seek to enforce our intellectual property rights may weaken our ability to enforce our intellectual property in the future or make our efforts to license our intellectual property rights more difficult.

If we fail to protect our intellectual property rights adequately, if there are adverse changes in applicable laws, or if we become involved in litigation relating to our intellectual property rights or the intellectual property rights of others, our business could be seriously harmed. In such case, the value ascribed to our intellectual property could diminish, we may incur significant legal expenses that could harm our results of operations and our patents or other intellectual property rights may be limited or invalidated. Any of the foregoing could have a negative effect on the value of our common stock.

***(c) We may be subject to infringement claims and other litigation, which could adversely affect our business.***

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

Some of our contracts include indemnity and similar provisions regarding our non-infringement of third-party intellectual property rights. As deployment of our technology increases, and more companies enter our markets, the likelihood of a third party lawsuit resulting from these provisions increases. If an infringement arose in a context governed by such a contract, we may have to refund to our customer amounts already paid to us or pay significant damages, or we may be sued by the party whose intellectual property has allegedly been infringed upon.

***(d) Governmental regulation of non-practicing patent holders may adversely affect our business.***

Governmental policymakers and commercial participants have proposed reforming U.S. patent laws and regulations in a manner that may limit a patent-holder's ability to enforce its patents against others to the extent that the holder is not practicing the subject matter of the patent at issue. The U.S. International Trade Commission has also recently taken certain actions that have been viewed as unfavorable to patentees seeking recourse in this forum. While we cannot predict what form any new patent reform laws or regulations may ultimately take, or what impact they may have on our business, any laws or regulations that restrict our ability to enforce our patent rights against third parties could have a material adverse effect on our business.

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

Some of our business involves embedding digital watermarks in traditional and digital media, including consumer product packaging and related marketing materials, secure documents, audio, video and imagery, and licensing our intellectual property. Our revenues result from a combination of development, consulting, subscription and license fees from a variety of media identification and management applications. We launched our Digimarc Discover initiative during 2011 and the Digimarc Barcode in 2014, both of which incorporates new business and pricing models

for licensing access to our online services portal and value added service providers. We have not fully developed revenue models for some applications and licensing endeavors. Because some of our products and services are not yet well-established in the marketplace, and because some of these products and services will not directly displace existing solutions, we cannot be certain that the pricing structure for these products and services will gain market acceptance or be sustainable over time or that the marketing for these products and services will be effective.

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

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

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remain competitive will depend in part on our ability to influence and respond to emerging industry and governmental standards in a timely and cost-effective manner. If we are unable to influence these or other standards or respond to these standards effectively, our growth and the development of various products and services could be delayed or limited.

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

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

continue to develop our technical expertise; and

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

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

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

We have staffed our company with the intent of accelerating our product development and sales growth initiatives while also focusing on achieving and sustaining profitability. Our current staffing levels could affect our ability to respond to increased demand for our services. In addition, to meet any increased demand and take advantage of new business opportunities in the future, we may need to increase our workforce through additional employees or contract labor. Although we believe that increasing our workforce would potentially support anticipated growth and profitability, it would increase our costs. If we experience such an increase in costs, we may not succeed in achieving or sustaining profitability in the short term.

***(17) The terms and conditions of our contracts could subject us to damages, losses and other expenses if we fail to meet delivery and other performance requirements.***

Our service contracts typically include provisions imposing:

development, delivery and installation schedules and milestones;

customer acceptance and testing requirements; and

other performance requirements.

To the extent these provisions involve performance over extended periods of time, risks of noncompliance may increase. From time to time we have experienced delays in system implementation, timely acceptance of programs, concerns regarding program performance and other contractual disputes. If we fail to meet contractual milestones or other performance requirements as promised, or to successfully resolve customer disputes, we could incur liability for damages, as well as increased costs, lower margins, or compensatory obligations in addition to other losses, such as harm to our reputation. Any unexpected increases in costs to meet our contractual obligations or any other requirements necessary to address claims and damages with regard to our customer contracts could have a material adverse effect on our business and financial results.

***(18) Products deploying our technology could have unknown defects or errors, which may give rise to claims against us, divert application of our resources from other purposes or increase our project implementation and support costs.***

Products and services as complex as those we offer or develop may contain undetected defects or errors. Furthermore, we often provide complex implementation, integration, customization, consulting and other technical services in connection with the implementation and ongoing maintenance of our products. Despite testing, defects or errors in our products and services may occur, which could result in delays in the development and implementation of products and systems, inability to meet customer requirements or expectations in a timely manner, loss of revenue or market share, increased implementation and support costs, failure to achieve market acceptance, diversion of development resources, injury to our reputation, increased insurance costs, increased service and warranty costs and warranty or breach of contract claims. Although we attempt to reduce the risk of losses resulting from warranty or breach of contract claims through warranty disclaimers and liability limitation clauses in our sales agreements when we can, these

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contractual provisions are sometimes not included and may not be enforceable in every instance. If a court refuses to enforce the liability limiting provisions of our contracts for any reason, or if liabilities arise that were not contractually limited or adequately covered by insurance, the expense associated with defending these actions or paying the resultant claims could be significant.

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

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

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

***(20) We are periodically involved in the ordinary course of business in litigation, and an adverse resolution of such litigation may adversely affect our business, financial condition, results of operations, and cash flows.***

From time to time, in our normal course of business, we are a party to various legal claims, actions and complaints. As part of our patent licensing program, we bring claims or counterclaims of patent infringement to enforce our patent rights. Given the uncertain nature of litigation, we are not able to estimate the amount or range of gain or loss that could result from an outcome of litigation. Litigation can be expensive, lengthy, and disruptive to normal business operations. The results of complex legal proceedings are often uncertain and difficult to predict. We could incur costs in excess of any currently established accruals and, to the extent available, excess liability insurance. An unfavorable outcome in any legal proceedings could have a material adverse effect on our business, financial condition, results of operations, and cash flows.

**RISKS RELATED TO OUR CAPITAL STOCK**

***(21) Our common stock price may be volatile, and you could lose all or part of your investment in shares of our common stock.***

The price of shares of our common stock may fluctuate as a result of changes in our operating performance or prospects and other factors. Some specific factors that may have a significant effect on the price of shares of our common stock include:

the public's reaction to our public disclosures;

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actual or anticipated changes in our operating results or future prospects;

potential unfavorable changes from originally reported royalties by customers resulting from an audit performed by us or a third party, or self-corrected by the customer;

strategic actions by us or our competitors, such as acquisitions or restructurings;

impact of acquisitions on our liquidity and financial performance;

new laws or regulations or new interpretations of existing laws or regulations applicable to our business;

changes in accounting standards, policies, guidance, interpretations or principles applicable to us;

conditions of the industry as a result of changes in financial markets or general economic or political conditions;

the failure of securities analysts to cover our common stock in the future, or changes in financial estimates by analysts;

changes in analyst recommendations or earnings estimates regarding us, other comparable companies or the industry generally, and our ability to meet those estimates;

changes in the amount of dividends paid;

future issuances of our common stock or the perception that future sales could occur; and

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volatility in the equity securities market.

**(22) Our common stock price may increase or decrease on material news or developments.**

As a thinly-traded microcap company, volatility in the equity securities market may disproportionately affect swings in our stock price, upward and downward, on positive and negative developments. We suspect that the effects of computerized trading also exacerbate fluctuations in our stock price.

**(23) Our corporate governance documents, our rights agreement and Oregon law may delay or prevent an acquisition of us that shareholders may consider favorable, which could decrease the value of your shares.**

Our articles of incorporation and bylaws and Oregon law contain provisions that could make it more difficult for a third party to acquire us without the consent of our board of directors. These provisions include supermajority voting requirements for shareholders to amend our organizational documents and limitations on actions by our shareholders by written consent. In addition, our board of directors has the right to issue preferred stock without shareholder approval, which could be used to dilute the stock ownership of a potential hostile acquirer. In July 2008, our Board of Directors adopted a rights agreement pursuant to which one one-hundredth (1/100) of a preferred stock purchase right will be issued for each outstanding share of our common stock. In general terms, our rights agreement works by imposing a significant penalty upon any person or group that acquires 15% or more of our outstanding common stock without the approval of our Board of Directors. Oregon law also restricts the ability to vote shares of stock acquired in a transaction that causes the acquiring person to control at least one-fifth, one-third or one-half of the votes entitled to be cast in the election of directors. Shares acquired in a control share acquisition have no voting rights except as authorized by a vote of the shareholders. Although we believe these provisions protect our shareholders from coercive or otherwise unfair takeover tactics and thereby provide for an opportunity to receive a higher bid by requiring potential acquirers to negotiate with our board of directors, these provisions apply even if the offer may be considered beneficial by some shareholders.

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

In November 2011, our Board of Directors approved a stock repurchase programs authorizing the purchase, at the discretion of management, of up to \$5.0 million of our common stock for a one year period through periodic open-market or private transactions at then-prevailing market prices. In November 2013, the program was extended through December 31, 2014. As of September 30, 2014, we had repurchased 43,293 shares under this program at an aggregate purchase price of \$1.0 million. No shares were repurchased under the program for the three-month period ended September 30, 2014.

In addition to the stock repurchase program described above, we withhold (repurchase) shares of common stock in connection with the vesting of restricted shares to satisfy required tax withholding obligations.

The following table sets forth information regarding purchases of our equity securities during the three-month period ended September 30, 2014:

| <b>Period</b> | <b>(a)</b><br><b>Total number of</b><br><b>shares</b><br><b>purchased<sup>(1)</sup></b> | <b>(b)</b><br><b>Average price</b><br><b>paid per</b><br><b>share<sup>(1)</sup></b> | <b>(c)</b><br><b>Total number of</b><br><b>shares</b><br><b>purchased</b> | <b>(d)</b><br><b>Approximate</b><br><b>dollar value</b><br><b>of shares that</b> |
|---------------|---|---|---|--|
|---------------|---|---|---|--|

|   |               | <b>as<br/>part of<br/>publicly<br/>announced plans<br/>or<br/>programs</b> | <b>may yet be<br/>purchased<br/>under the plans<br/>or programs</b> |
|---|---------------|--|---|
| <b>Month 1</b>                          |               |  |   |
| July 1, 2014 to July 31, 2014           |               | \$   | \$ 4.0 million  |
| <b>Month 2</b>                          |               |  |   |
| August 1, 2014 to August 31, 2014       | 20,159        | \$ 24.37   | \$ 4.0 million  |
| <b>Month 3</b>                          |               |  |   |
| September 1, 2014 to September 30, 2014 |               | \$   | \$ 4.0 million  |
| <b>Total</b>                            | <b>20,159</b> | <b>\$ 24.37</b>  |   |

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



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| <b>Exhibit Number</b> | <b>Exhibit Description</b>  |
|-----------------------|---|
| 10.1                  | Employment Agreement, dated effective as of November 1, 2014, between Digimarc Corporation and Bruce Davis (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K, filed with the Commission on August 5, 2014 (File No. 001-34108)). |
| 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 24, 2014

DIGIMARC CORPORATION

By:

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