DIGIMARC CORP
Form 10-Q
August 01, 2008

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2008

OR

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

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

DIGIMARC CORPORATION

(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	**94-3342784** (I.R.S. Employer Identification No.)

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

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

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 ý No o

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

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

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

As of July 29, 2008, there were 24,566,078 shares of the registrant's common stock, par value $0.001 per share, outstanding.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements.

DIGIMARC CORPORATION

CONSOLIDATED BALANCE SHEETS

(In thousands, except share data)

(UNAUDITED)

	June 30, 2008	December 31, 2007(1)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 24,492	$ 19,582
Restricted cash		205
Short-term investments	3,849	3,568
Trade accounts receivable, net	17,481	18,498
Inventory, net	5,035	7,316
Other current assets	3,587	2,628
Total current assets	54,444	51,797
Restricted cash	8,573	9,358
Property and equipment, net	68,929	66,277
Intangibles, net	12,578	13,462
Other assets, net	1,240	1,129
Total assets	$ 145,764	$ 142,023
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 7,471	$ 6,092
Accrued payroll and related costs	4,140	1,952
Deferred revenue	5,078	6,239
Other current liabilities	2,131	1,955
Total current liabilities	18,820	16,238
Long-term deferred revenue, net of current portion	7,138	7,007
Other long-term liabilities	1,141	1,455
Total liabilities	27,099	24,700
Commitments and contingencies (Note 11)		
Stockholders' equity:		
Common stock (22,508,533 and 21,838,375 shares issued and outstanding at June 30, 2008 and December 31, 2007, respectively)	23	22
Additional paid-in capital	221,998	217,341
Accumulated deficit	(103,356)	(100,040)
Total stockholders' equity	118,665	117,323
Total liabilities and stockholders' equity	$ 145,764	$ 142,023

(1)

Derived from the Company's December 31, 2007 audited consolidated financial statements

See Notes to Unaudited Consolidated Financial Statements.

DIGIMARC CORPORATION

CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share data)

(UNAUDITED)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	**2007**	**2008**	**2007**
Revenue:				
Service	$25,920	$22,538	$50,594	$43,837
Product and subscription	4,825	4,826	10,721	10,373
Total revenue	30,745	27,364	61,315	54,210
Cost of revenue:				
Service	17,432	15,089	33,635	29,804
Product and subscription	1,907	1,988	4,327	4,088
Total cost of revenue	19,339	17,077	37,962	33,892
Gross profit	11,406	10,287	23,353	20,318
Operating expenses:				
Sales and marketing	4,473	4,365	9,096	8,642
Research, development and engineering	2,488	1,883	4,766	3,925
General and administrative	4,136	3,809	8,720	7,907
Amortization of intangibles	463	509	883	1,009
Intellectual property	513	476	1,058	975
Acquisition related costs	1,448		2,537	
Total operating expenses	13,521	11,042	27,060	22,458
Operating income (loss)	(2,115)	(755)	(3,707)	(2,140)
Other income (expense), net	362	402	715	784
Income (loss) before provision for income taxes	(1,753)	(353)	(2,992)	(1,356)
(Provision) benefit for income taxes	(202)	(142)	(324)	(161)
Net income (loss)	$ (1,955)	$ (495)	$ (3,316)	$ (1,517)
Net income (loss) per share basic	$ (0.09)	$ (0.02)	$ (0.15)	$ (0.07)
Net income (loss) per share diluted	$ (0.09)	$ (0.02)	$ (0.15)	$ (0.07)
Weighted average shares outstanding basic	21,502	20,898	21,422	20,847
Weighted average shares outstanding diluted	21,502	20,898	21,422	20,847

See Notes to Unaudited Consolidated Financial Statements.

DIGIMARC CORPORATION

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

(In thousands, except share data)

(UNAUDITED)

	Common stock		Additional paid-in capital	Accumulated deficit	Total stockholders' equity
	Shares	Amount			
BALANCE AT DECEMBER 31, 2006	21,191,918	$ 22	$ 211,209	$ (99,740)	$ 111,491
Initial adjustment to adopt FIN 48				145	145
Exercise of stock options	325,709		1,624		1,624
Issuance of employee stock purchase plan shares	119,143		920		920
Issuance of restricted common stock	309,490				
Purchase and retirement of common stock	(107,885)		(357)		(357)
Stock-based compensation expense			3,945		3,945
Net loss				(445)	(445)
BALANCE AT DECEMBER 31, 2007	21,838,375	22	217,341	(100,040)	117,323
Exercise of stock options	294,426	1	2,121		2,122
Issuance of employee stock purchase plan shares	67,558		509		509
Issuance of restricted common stock	347,280				
Purchase and retirement of common stock	(39,106)		(295)		(295)
Stock-based compensation expense			2,322		2,322
Net loss				(3,316)	(3,316)
BALANCE AT JUNE 30, 2008	22,508,533	$ 23	$ 221,998	$ (103,356)	$ 118,665

See Notes to Unaudited Consolidated Financial Statements.

DIGIMARC CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(UNAUDITED)

	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007
Cash flows from operating activities:		
Net loss	$ (3,316)	$ (1,517)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	9,117	7,801
Stock-based compensation expense	2,322	2,012
Other non-cash charges		(49)
Changes in operating assets and liabilities:		
Restricted cash	990	378
Trade and unbilled accounts receivable	1,017	(1,996)
Inventory, net	2,281	(430)
Other current assets	(959)	(332)
Other assets, net	(111)	54
Accounts payable	1,379	142
Accrued payroll and related costs	2,188	(1,887)
Deferred revenue	(1,030)	2,651
Other liabilities	102	(116)
Net cash provided by (used in) operating activities	13,980	6,711
Cash flows from investing activities:		
Purchase of property and equipment and capitalized labor costs	(10,834)	(11,109)
Sale or maturity of short-term investments	103,395	76,807
Purchase of short-term investments	(103,676)	(78,522)
Net cash provided by (used in) investing activities	(11,115)	(12,824)
Cash flows from financing activities:		
Issuance of common stock	2,631	1,011
Purchase of common stock	(295)	(140)
Principal payments under capital lease obligations	(291)	(312)
Net cash provided by (used in) financing activities	2,045	559
Net increase (decrease) in cash and cash equivalents	4,910	(5,554)
Cash and cash equivalents at beginning of period	19,582	23,135
Cash and cash equivalents at end of period	$ 24,492	$ 17,581
Supplemental disclosure of cash flow information:		
Cash paid for interest	$ 92	$ 38
Cash paid for income taxes	$ 304	$ 323
Summary of non-cash investing and financing activities:		
Equipment acquired or exchanged under capital lease obligations	$ 51	$ 244

See Notes to Unaudited Consolidated Financial Statements.

DIGIMARC CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except share and per share data)

(UNAUDITED)

1. Description of Business and Summary of Significant Accounting Policies

Description of Business

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

Pending Acquisition of Digimarc and Spin-Off of Digital Watermarking Business

On March 23, 2008, the Company entered into a definitive agreement (the "Original Merger Agreement") with L-1 Identity Solutions, Inc. ("L-1") pursuant to which a subsidiary of L-1 would be merged with and into the Company, with the Company continuing after the merger as a wholly-owned subsidiary of L-1. Immediately prior to the merger, the Company would contribute all of the assets and liabilities related to the Company's digital watermarking business, together with all of the Company's cash, to a wholly-owned subsidiary of the Company, the shares of which will be distributed to the Company's stockholders in a taxable spin-off transaction. The Original Merger Agreement provided for a combination of cash and L-1 common stock to be paid to the Company's stockholders upon effectiveness of the merger, with an aggregate transaction value of approximately $250 million based on the market value of L-1 common stock on the date of the Original Merger Agreement.

On June 29, 2008, the Company and L-1 entered into an Amended and Restated Agreement and Plan of Merger, which provides for cash consideration to the Company's stockholders in an aggregate amount of $310 million following the spin-off of the Company's digital watermarking business and cash on hand. The proposed transaction will be effected through a tender offer by L-1 for the Company's common stock, followed by a second-step merger of a wholly-owned subsidiary of L-1 with and into the Company, with the Company continuing after the merger. In addition, all outstanding options to purchase shares of the Company's common stock will vest and become fully exercisable prior to the record date for the spin-off (the "spin-off record date"). Holders of Digimarc stock options will be given the opportunity to exercise their stock options on or prior to the spin-off record date and, to the extent the stock options are exercised, the holders of shares of the Company's common stock issued upon exercise can participate in the tender offer or receive cash consideration for their shares in the merger. All outstanding shares of Digimarc restricted stock will become fully vested on or prior to the spin-off record date, and holders of shares of Digimarc restricted stock will be stockholders for purposes of the spin-off and can participate in the tender offer or receive cash consideration for their shares in the merger.

L-1 commenced a tender offer for the Company's common stock on July 3, 2008 pursuant to an Offer to Purchase, which was filed as an exhibit to L-1's Schedule TO ("tender offer") filed with the SEC on July 3, 2008 (as amended, the "Offer to Purchase"). The amended offer price is $12.25 per share of the Company's common stock (including associated preferred stock purchase rights). Completion of the tender offer is subject to a minimum number of shares of the Company's common stock being tendered, completion of the spin-off and certain other customary conditions, as described in

DIGIMARC CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(UNAUDITED)

1. Description of Business and Summary of Significant Accounting Policies (Continued)

the Offer to Purchase. If the Registration Statement on Form 10 filed by DMRC Corporation, an indirect wholly owned subsidiary of the Company that will be the surviving entity of the spin-off, has not been declared effective by the SEC prior to the spin-off, the equity interests of the spin-off entity will be transferred to a newly-created trust for the benefit of the Company's stockholders as of the spin-off record date, and the trust will distribute the equity interests to Company's stockholders as of the spin-off record date upon effectiveness of the Registration Statement on Form 10.

The completion of the merger is subject to payment by L-1 for the shares of the Company's common stock tendered in the tender offer, approval of the merger agreement by the Company's stockholders, if required by law, and completion of the spin-off prior to the expiration of the tender offer and other customary closing conditions. On June 12, 2008 the Federal Trade Commission granted early termination of the antitrust review process under the Hart-Scott-Rodino Act. The transaction is not subject to any financing condition. There is no assurance that the tender offer, the merger and spin-off will be consummated in a timely manner, if at all.

The tender offer statement (including the offer to purchase, letter of transmittal and related tender offer documents) filed by L-1 with the SEC and the solicitation/recommendation statement filed by Digimarc with the SEC contain important information which we encourage investors and securityholders to read.

Principles of Consolidation

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

Interim Financial Statements

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

These consolidated financial statements should be read in conjunction with the audited consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2007, which was filed with the SEC on February 29, 2008. The results of operations for the interim periods presented in these consolidated financial statements are not necessarily indicative of the results for the full year.

Use of Estimates

The preparation of consolidated financial statements in accordance with accounting principles generally accepted in the U.S. requires Digimarc to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses, and related disclosure of contingent assets

DIGIMARC CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(UNAUDITED)

1. Description of Business and Summary of Significant Accounting Policies (Continued)

and liabilities. Certain of the Company's accounting policies require higher degrees of judgment than others in their application. These include revenue recognition on long-term service contracts, impairments and estimation of useful lives of long-lived assets, inventory valuation, reserves for uncollectible accounts receivable, valuation allowance for deferred tax assets, contingencies and litigation and stock-based compensation. Digimarc bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

Investments

The Company considers all investments with original maturities over 90 days that mature in less than one year to be short-term investments. Investments with maturities beyond one year may be classified as short-term based on their highly liquid nature and because such marketable securities represent the investment of cash that is available for current operations. Short-term investments include federal agency notes, company notes, and commercial paper. The Company's marketable securities are generally classified as held-to-maturity as of the balance sheet date and are reported at amortized cost, which approximates market. The book value of these investments approximates fair market value and, accordingly, no amounts have been recorded to other comprehensive income.

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. The impairment is charged to earnings and a new cost basis for the security is established. To determine whether an impairment is other-than-temporary, the Company considers whether it has the ability and intent to hold the investment until a market price recovery and considers whether evidence indicating the cost of the investment is recoverable outweighs evidence to the contrary. There have been no other-than-temporary impairments identified or recorded by the Company.

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

Fair Value of Financial Instruments

The carrying amounts of cash and cash equivalents, short-term investments, trade accounts receivable, accounts payable and accrued payroll approximate fair value due to the short-term nature of these instruments. The carrying amounts of capital leases approximate fair value as the stated interest rates approximate current market rates. Fair value estimates are made at a specific point in time, based on relevant market information about the financial instrument when available. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and, therefore, cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

DIGIMARC CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(UNAUDITED)

1. Description of Business and Summary of Significant Accounting Policies (Continued)

Impairment of Long-Lived Assets

The Company accounts for long-lived assets in accordance with the provisions of Statement of Financial Accounting Standards ("SFAS") No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. This statement requires that long-lived assets and certain identifiable intangibles be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future net undiscounted cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Fair value is determined based on discounted cash flows or appraised values, depending on the nature of the asset. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell.

Software Development Costs

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

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

2. Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board ("FASB") issued SFAS No. 157, *Fair Value Measurements,* which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value. This statement does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. SFAS No. 157 is effective the first fiscal year beginning after November 15, 2007. The Company has applied the provisions of this standard regarding the framework of measuring fair value and noted no material effect on the current financial statements.

In February 2007, the FASB issued SFAS No. 159, *The Fair Option for the Financial Assets and Financial Liabilities,* which permits entities to choose to measure certain financial assets and liabilities

DIGIMARC CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(UNAUDITED)

2. Recent Accounting Pronouncements (Continued)

at fair value. SFAS No. 159 is effective the first fiscal year beginning after November 15, 2007. The Company has elected not to measure certain financial assets and liabilities at fair value as permitted by SFAS No. 159.

In April 2008, FASB issued Staff Position No. FAS 142-3 *Determination of the Useful Life of Intangible Assets* (FSP 142-3). FSP 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142, *Goodwill and Other Intangible Assets*. The intent of this Staff Position is to improve the consistency between the useful life of a recognized intangible asset under SFAS No. 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS No. 141 (revised 2007), *Business Combinations*, and other U.S. generally accepted accounting principles. FSP 142-3 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Early adoption is prohibited. The Company is currently reviewing the effect, if any, the proposed guidance will have on its consolidated financial statements.

In May 2008, the FASB issued SFAS NO. 162, *The Hierarchy of Generally Accepted Accounting Principles*, which identifies the sources of accounting principles and the framework for selecting principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles in the United States. This statement shall be effective 60 days following the SEC's approval of the Public Company Accounting Oversight Board's amendments to AU section 411, The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles. The Company is currently evaluating the impact of SFAS 162, but does not expect the adoption of this pronouncement will have a material impact on the Company's financial statements.

3. Revenue Recognition

Certain customer arrangements encompass multiple deliverables, such as software, hardware sales, consumables sales, maintenance fees, and software development fees. The Company accounts for these arrangements in accordance with EITF Issue No. 00-21. If the deliverables meet the criteria in EITF Issue No. 00-21, the deliverables are divided into separate units of accounting and revenue is allocated to the deliverables based on their relative fair values. The criteria specified in EITF Issue No. 00-21 are as follows (i) the delivered item has value to the customer on a stand-alone basis, (ii) there is objective and reliable evidence of the fair value of the undelivered item, and (iii) if the arrangement includes a general right of return relative to the delivered item, delivery or performance of the undelivered item is considered probable and substantially in the control of the vendor. For our purposes, fair value is generally defined as the price at which a customer could purchase each of the elements independently from other vendors or as the price that the Company has sold the element separately to another customer. Management applies judgment to ensure appropriate application of EITF Issue No. 00-21, including value allocation among multiple deliverables, determination of whether undelivered elements are essential to the functionality of delivered elements and timing of revenue recognition, among others. Revenue is recognized in accordance with SAB 104 when the following four criteria are met (i) persuasive evidence of an arrangement exists, (ii) delivery has occurred, (iii) the fee is fixed or determinable, and (iv) collection is probable.

DIGIMARC CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(UNAUDITED)

3. Revenue Recognition (Continued)

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

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

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

Revenue related to an enhancement of, or upgrade to, an existing system is deferred and recognized over the remaining life of the contract, unless VSOE can be established for the delivered items, title passes to those items and all obligations are completed in which case we recognize revenue at acceptance.

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

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

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

Royalty revenue is recognized when the royalty amounts owed to the Company have been earned, are determinable, and collection is probable. Subscriptions are paid in advance and revenue is recognized ratably over the term of the subscription. These revenues include the licensing of digital watermarking products and services for use in authenticating documents,

DIGIMARC CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(UNAUDITED)

3. Revenue Recognition (Continued)

detecting fraudulent documents and deterring unauthorized duplication or alteration of high-value documents, for use in communicating copyright, asset management and business-to-business image commerce solutions, and for use in connecting analog media to a digital environment.

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

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

Revenue earned which has not been invoiced is classified as unbilled trade receivables, which is included in the balance of trade accounts receivable, net in the consolidated balance sheets.

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

4. Segment Information

Geographic Information

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

Revenue by geographic areas is as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	**2007**	**2008**	**2007**
United States	$25,388	$21,219	$49,810	$41,739
International	5,357	6,145	11,505	12,471
Total	$30,745	$27,364	$61,315	$54,210

DIGIMARC CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(UNAUDITED)

4. Segment Information (Continued)

Major Customers

No single customer accounted for more than 10% of the Company's revenues for the three- and six-month periods ended June 30, 2008 and June 30, 2007, respectively.

5. Stock-Based Compensation

Stock-based compensation includes expense charges for all stock-based awards to employees and directors. Such awards include option grants, restricted stock awards, and shares expected to be purchased under an employee stock purchase plan.

Stock-based compensation recognized in the Company's consolidated financial statements in the three-and six-month periods ended June 30, 2008 and 2007 is based on the value of the portion of the stock-based award that vested during the period, adjusted for expected forfeitures for stock-based awards granted prior to, but not fully vested as of, December 31, 2005 and stock-based awards granted subsequent to December 31, 2005. The compensation cost for awards granted prior to January 1, 2006 is based on the grant date fair value estimated in accordance with the pro forma provisions of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, while awards granted on or after January 1, 2006 follow the provisions of SFAS 123(R) to determine the grant date fair value and compensation cost. Compensation cost for all stock-based awards is recognized using the straight-line method.

Determining Fair Value Under SFAS 123(R)

Stock Options

Valuation and Amortization Method. The Company estimates the fair value of stock-based awards granted using the Black-Scholes option pricing 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. The fair value of each option grant is estimated on the date of grant.

Expected Life. The expected life of awards granted represents the period of time that they are expected to be outstanding. The Company determines the expected life based on historical experience with similar awards, giving consideration to the contractual terms, vesting schedules and pre-vesting and post-vesting forfeitures. Stock options granted during the three- and six-month periods ended June 30, 2008 and 2007 generally vest over four years and have contractual terms of ten years.

Expected Volatility. The Company estimates the volatility of its common stock at the date of grant based on the historical volatility of its common stock using the Black-Scholes option pricing model based on historical stock prices over the most recent period commensurate with the estimated expected life of the award. This historical period excludes portions of time when unusual transactions occurred, such as a significant acquisition.

Risk-Free Interest Rate. The Company bases the risk-free interest rate used in the Black-Scholes option pricing model on the implied yield currently available on U.S. Treasury zero-coupon issues with an equivalent remaining term approximately equal to the expected life of the award.

DIGIMARC CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(UNAUDITED)

5. Stock-Based Compensation (Continued)

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

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

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	**2007**	**2008**	**2007**
Expected life (in years)	5.7	5.8	5.7	5.8
Expected volatility	44%	44%	44%	44%
Risk-free interest rate	2.5%	4.7%	2.5%	4.7%
Expected dividend yield	0%	0%	0%	0%
Expected forfeiture rate	15%	16%	15%	16%
Fair value	$4.97	$4.76	$3.88	$4.36

Employee Stock Purchase Plans

The Company also recognizes stock-based compensation in connection with its 1999 Employee Stock Purchase Plan. The plan, as amended on November 2, 2006, allows employees to purchase shares of Digimarc common stock through payroll deductions of up to 15% of their base compensation during each three-month plan period, up to a maximum deduction of $5.3 for each plan period, not to exceed $21 per year. The three-month plan periods begin December 1, March 1, June 1 and September 1. The price an employee pays for the shares is 85% of the lower of (i) the fair market value of Digimarc common stock at the beginning of the plan period or (ii) the fair market value at the end of the plan period. There were 33,644 and 67,558 shares purchased under the Company's stock purchase plan during the three- and six-month periods ended June 30, 2008, respectively. There were 28,742 and 54,119 shares purchased under the Company's stock purchase plan during the three- and six-month periods ended June 30, 2007, respectively.

The current offer period under the plan was terminated as of July 25, 2008 in connection with the anticipated close of the tender offer from L-1 and all payroll deductions have been refunded.

Restricted Stock and Market or Performance Based Vesting Shares

The Compensation Committee of the Board of Directors (the "Board") awarded restricted stock shares under the Company's 1999 Stock Incentive Plan, as amended, to certain officers, employees and directors. The shares subject to the restricted stock awards vest over a certain period, usually one to four years, following the date of the grant.

DIGIMARC CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(UNAUDITED)

5. Stock-Based Compensation (Continued)

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

In addition to restricted stock shares that vest over time, the Compensation Committee awarded restricted stock that vests upon satisfaction of either market based or employee performance based conditions under the 1999 Stock Incentive Plan, as amended.

The fair value of restricted stock awards that vest upon the satisfaction of market based conditions is calculated using a Monte Carlo valuation model that results in a discount factor applied to the fair market value of the Company's common stock on the date of the grant (measurement date). Compensation cost is recognized over the derived service period, which is shorter than the performance period, using the straight-line method. If the market condition is met prior to completion of the derived service period, all remaining expense is immediately recognized in the period the awards vest. Expense for market based awards is recognized if the employee completes the derived service period, regardless of whether the market condition is met. If the market condition is not met, the shares will be forfeited.

The fair value of restricted stock awards that vest upon the satisfaction of employee performance conditions is based on the fair market value of the Company's common stock on the date of grant (measurement date). Management has determined it is probable that all performance conditions can be achieved; therefore, compensation cost is recognized on a straight line basis over the explicit service period. If the performance condition is satisfied early, all remaining compensation cost will be recognized in the period the condition is satisfied. If the performance vesting condition is not met by the end of the explicit service condition, all previously recognized compensation cost will be reversed and the shares will be forfeited.

Specific terms of the restricted stock awards (including market or performance based vesting share awards) are governed by restricted stock agreements between the Company and the award recipients.

Stock-based Compensation Under FAS 123(R)

The following table summarizes stock-based compensation expense related to stock-based awards under SFAS 123(R) for the three- and six-month periods ended June 30, 2008 and 2007, which was incurred as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	**2007**	**2008**	**2007**
Stock-based compensation:				
Cost of revenue	$ 121	$ 109	$ 235	$ 215
Sales and marketing	191	185	359	392
Research, development and engineering	119	101	232	173
General and administrative	760	599	1,462	1,207
Intellectual property	17	13	34	25
Total stock-based compensation	$ 1,208	$ 1,007	$ 2,322	$ 2,012

DIGIMARC CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(UNAUDITED)

5. Stock-Based Compensation (Continued)

At June 30, 2008, the Company had 1.3 million non-vested stock options that had a weighted average grant date price of $7.83. As of June 30, 2008, the Company had $9,530 of total unrecognized compensation cost related to non-vested stock-based awards granted under all equity compensation plans, including options, restricted stock, and employee stock purchase plan. Total unrecognized compensation cost will be adjusted for any future changes in estimated forfeitures. The Company expects to recognize this cost over a weighted average period of 1.34 years.

Stock Option Activity

As of June 30, 2008, under all of the Company's stock-based compensation plans, options to purchase an aggregate of 6.7 million shares were outstanding, and options to purchase an additional 6.9 million shares were authorized for future grants under the plans. The Company issues new shares upon option exercises.

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

Three-months ended June 30, 2008:	**Options**	**Weighted Average Exercise Price**	**Weighted Average Remaining Contractual Life**
Outstanding at March 31, 2008	6,932,342	$ 13,40	
Options granted	74,350	$ 11.20	
Options exercised	(273,257)	$ 7.27	
Options canceled	(32,753)	$ 10.72	
Options expired			
Outstanding at June 30, 2008	6,700,682	$ 13.64	5.40 years
Exercisable at June 30, 2008	5,402,548	$ 15.04	4.65 years

Six-months ended June 30, 2008:	**Options**	**Weighted Average Exercise Price**	**Weighted Average Remaining Contractual Life**
Outstanding at December 31, 2007	6,691,725	$ 13.61	
Options granted	420,100	$ 8.75	
Options exercised	(294,426)	$ 7.21	
Options canceled	(116,717)	$ 10.80	
Options expired			
Outstanding at June 30, 2008	6,700,682	$ 13.64	5.40 years
Exercisable at June 30, 2008	5,402,548	$ 15.04	4.65 years

DIGIMARC CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(UNAUDITED)

5. Stock-Based Compensation (Continued)

The following table summarizes information about stock options outstanding at June 30, 2008:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number Outstanding	Remaining Contractual Life (Years)	Weighted Average Price	Number Exercisable	Weighted Average Price
$ 1.50 - $ 5.96	641,595	7.13	$ 5.59	455,067	$ 5.47
$ 6.00 - $ 6.46	507,990	7.19	$ 6.09	307,759	$ 6.06
$ 6.52 - $ 8.29	636,553	8.60	$ 7.61	197,593	$ 7.20
$ 8.46 - $ 9.49	726,608	7.67	$ 8.83	367,862	$ 8.79
$ 9.50 - $11.98	779,424	6.31	$ 11.15	674,255	$ 11.23
$12.07 - $12.55	221,550	3.40	$ 12.54	221,550	$ 12.54
$13.00 - $13.87	363,900	5.31	$ 13.17	355,400	$ 13.17
$14.02 - $14.11	124,300	2.86	$ 14.02	124,300	$ 14.02
$14.13	521,500	2.48	$ 14.13	521,500	$ 14.13
$14.40 - $14.95	105,400	4.54	$ 14.52	105,400	$ 14.52
$15.06 - $15.25	429,000	4.42	$ 15.24	429,000	$ 15.24
$15.34 - $15.71	311,228	5.03	$ 15.69	311,228	$ 15.69
$16.00 - $16.91	83,784	4.85	$ 16.56	83,784	$ 16.56
$17.00 - $17.88	222,500	3.49	$ 17.03	222,500	$ 17.03
$18.13 - $18.61	291,100	3.45	$ 18.18	291,100	$ 18.18
$19.35 - $19.93	130,500	3.52	$ 19.86	130,500	$ 19.86
$20.00 - $53.94	603,750	1.81	$ 36.57	603,750	$ 36.57
$0.50 - $53.94	6,700,682	5.40	$ 13.64	5,402,548	$ 15.04

At December 31, 2007, 5,454,008 options were exercisable at a weighted average price of $15.04.

At June 30, 2008, the aggregate intrinsic value of outstanding and exercisable stock options was $20,739 and $12,525, respectively. The aggregate intrinsic value is based on our closing price of $14.16 per share on June 30, 2008, which would have been received by the optionees had all of the options with exercise prices less than $14.16 per share been exercised on that date.

Restricted Stock and Market or Performance Based Vesting Shares Activity

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

Three-months ended June 30, 2008:	Number of Shares
Unvested balance, March 31, 2008	788,659
Granted	24,000
Vested	(27,555)
Canceled	(3,010)
Unvested balance, June 30, 2008	782,094

DIGIMARC CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(UNAUDITED)

5. Stock-Based Compensation (Continued)

Six-months ended June 30, 2008:	Number of Shares
Unvested balance, December 31, 2007	554,953
Granted	347,280
Vested	(115,424)
Canceled	(4,715)
Unvested balance, June 30, 2008	782,094

6. Net Income (Loss) Per Share Computation

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

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
	Shares (in 000's)			
Basic EPS				
Weighted average shares outstanding	21,502	20,898	21,422	20,847
Effect of Dilutive Securities				
Options				
Restricted stock and performance vesting shares				
Diluted EPS				
Weighted average shares outstanding	21,502	20,898	21,422	20,847

Common stock equivalents related to stock options of 3,948 and 4,077 were excluded from diluted net loss per share calculations for the three- and six-month periods ended June 30, 2008, respectively, as their exercise price was higher than the average market price of the underlying common stock for the period and therefore their impact would be anti-dilutive. In addition, common stock equivalents related to stock options and restricted stock of 759 and 467 for the three-and six-month periods ended June 30, 2008, respectively, were excluded from diluted net loss per share as the Company was in a loss position and the inclusion would be anti-dilutive.

Common stock equivalents related to stock options of 4,429 and 4,366 were excluded from diluted net loss per share calculations for the three- and six-month periods ended June 30, 2007, respectively, as their exercise price was higher than the average market price of the underlying common stock for the period and therefore their impact would be anti-dilutive. In addition, common stock equivalents

DIGIMARC CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(UNAUDITED)

6. Net Income (Loss) Per Share Computation (Continued)

related to stock options and restricted stock of 729 and 891 for the three- and six-month periods ended June 30, 2007, respectively, were excluded from diluted net loss per share as the Company was in a loss position and the inclusion would be anti-dilutive.

7. Trade Accounts Receivable

Trade Accounts Receivable

Trade accounts receivable are recorded at the invoiced amount and do not bear interest. Revenue earned which has not been invoiced as of the balance sheet date, and generally billed the following month, is classified as unbilled trade receivables in the consolidated balance sheets.

	June 30, 2008	December 31, 2007
Billed trade receivables, net	$ 10,184	$ 12,396
Unbilled trade receivables	7,297	6,102
Trade accounts receivable, net	$ 17,481	$ 18,498

Trade accounts receivable, net includes $2,035 and $3,060 at June 30, 2008 and at December 31, 2007, respectively, of deferred revenue, billed in accordance with the provisions of the contracts with the Company's customers.

Allowance for doubtful accounts

The allowance for doubtful accounts was $95 and $187 at June 30, 2008 and at December 31, 2007, respectively, and is the Company's best estimate of the amount of probable credit losses in the Company's existing accounts receivable. The Company determines the allowance based on historical write-off experience and current information. The Company reviews its allowance for doubtful accounts monthly. Account balances are charged off against the allowance after all means of collection have been exhausted and the potential for recovery is considered remote.

Major Customers

There was one customer that accounted for more than 10% of the Company's trade and unbilled accounts receivable, net at June 30, 2008. No single customer accounted for more than 10% of the Company's trade and unbilled accounts receivable, net at December 31, 2007.

8. Inventory

Inventory

Inventory consists primarily of the consumable materials used to manufacture identification cards, such as inks, laminates, and adhesives (considered raw material), equipment held for sale (considered

DIGIMARC CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(UNAUDITED)

8. Inventory (Continued)

finished goods) and deferred contract costs (considered either finished goods or in-process). Inventories are valued on a first-in, first-out basis at the lower of cost or market value (net realizable value).

	June 30, 2008	December 31, 2007
Equipment and deferred contract costs	$ 502	$ 1,213
Consumable materials, net	4,533	6,103
Inventory, net	$ 5,035	$ 7,316

Reserve for slow moving and obsolete inventory

The Company records a provision for excess and obsolete inventory based on changes in market conditions, sales orders, expected sales volumes, and technology advances. The provision was recorded in the period the circumstances occurred or were identified.

The reserve for slow moving and obsolete consumable materials was $94 and $138 at June 30, 2008 and at December 31, 2007, respectively. While the Company does not currently expect to be able to sell or otherwise use the reserved inventory it has on hand based upon its forecast and backlog, it is possible that one or more customers will decide in the future to purchase a portion of the reserved inventory.

9. Other Income (Expense), Net

Other income (expense), net consists primarily of interest received and paid and foreign currency translation gain or loss.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
Other income (expense):				
Interest income	$235	$362	$553	$774
Interest expense	(44)	4	(92)	(15)
Foreign currency and other	171	36	254	25
Total other income (expense), net	$362	$402	$715	$784

10. Income Taxes

Provision for Income Taxes. The provision for income taxes reflects expected tax expense in certain foreign jurisdictions. The Company has recorded a full valuation allowance against the Company's net deferred tax assets at June 30, 2008 due to the uncertainty of realization of the Company's net operating losses. The Company will continue to evaluate the realizability of the Company's domestic and other foreign net deferred tax assets and may record additional benefits in future earnings if the Company determines the realization of these assets is more likely than not.

DIGIMARC CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(UNAUDITED)

11. Commitments and Contingencies

Litigation

In 2004, three purported class action lawsuits were filed in the U.S. District Court for the District of Oregon against the Company and certain of its current and former directors and officers on behalf of purchasers of the Company's securities during the period April 17, 2002 to July 28, 2004. These lawsuits were later consolidated into one action for all purposes. The amended complaint, which sought unspecified damages, asserted claims under the federal securities laws relating to the Company's restatement of its financial statements for 2003 and the first two quarters of 2004 and alleged that the Company issued false and misleading financial statements and issued misleading public statements about the Company's operations and prospects. On August 4, 2006, the court granted the Company's motion to dismiss the lawsuit with prejudice and entered judgment in the Company's favor. Plaintiffs appealed to the Ninth Circuit Court of Appeals. The appeal has been fully briefed but not yet scheduled for oral argument. Due to the inherent uncertainties of litigation, the Company cannot accurately predict the ultimate timing of a decision in or the outcome of this matter.

On or about October 19, 2004, two purported shareholder derivative lawsuits were filed against certain of the Company's officers and directors, naming the Company as a nominal defendant, in the Superior Court of the State of California for the County of San Luis Obispo. These lawsuits were consolidated into one action for all purposes on March 14, 2005. This suit claims that certain of these officers and directors breached their fiduciary duties to the Company's stockholders and to the Company. The complaint is derivative in nature and does not seek relief from the Company. The Board appointed an independent committee to investigate the claims asserted in this derivative lawsuit. On July 19, 2005, the court granted the Company's motion to dismiss these consolidated actions in favor of a shareholder derivative action to be filed by plaintiffs in the Circuit Court of the State of Oregon for the County of Washington. On August 25, 2005, the California plaintiffs filed two new derivative lawsuits in the United States District Court for the District of Oregon. On October 17, 2005, the defendants filed a motion to dismiss these complaints for lack of subject matter jurisdiction and failure to state a claim. In May of 2006, the Board committee, after completing its investigation, concluded that pursuit of the allegations would not be in the best interests of the Company or its stockholders. On August 24, 2006, the court granted the defendants' motion and dismissed the lawsuit with prejudice. Plaintiffs filed a notice of appeal on September 22, 2006. The briefs to the Ninth Circuit were completed in June 2007, and the Company anticipates oral argument and a decision in 2008. However, due to the inherent uncertainties of litigation, the Company cannot accurately predict the ultimate timing or outcome of the matter.

On or about April 6, 2005, another purported shareholder derivative lawsuit was filed against certain of the Company's officers and directors, and also naming the Company as a nominal defendant, in the Circuit Court for the State of Oregon for the County of Washington containing similar allegations to the complaints discussed above. That case was stayed pending the report of the Board committee referenced above, and was ultimately dismissed following the Board committee's investigation.

Beginning in May 2001, a number of substantially identical class action complaints alleging violations of the federal securities laws were filed in the United States District Court for the Southern

DIGIMARC CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(UNAUDITED)

11. Commitments and Contingencies (Continued)

District of New York naming approximately 300 companies, including the Company, and their officers and directors and underwriters as defendants in connection with the initial public offerings of these companies. The plaintiffs allege that the defendants fraudulently inflated the share prices of these companies during and after their initial public offerings through an elaborate scheme characterized by tie-in agreements, undisclosed compensation and analyst conflicts. The plaintiffs also allege that the underwriter defendants required some substantial investors who requested allocations in the initial public offerings to participate in the scheme. Some of the Company's officers and directors are named in the amended complaint pursuant to Section 11 of the Securities Act of 1933 and Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 on the basis of an alleged failure to disclose the underwriters' alleged compensation arrangements and manipulative practices. The complaint seeks unspecified damages. The individual officer and director defendants entered into tolling agreements and, pursuant to a court order dated October 9, 2002, were dismissed from the litigation without prejudice. The plaintiffs have continued to litigate their claims primarily against the underwriter defendants. The district court directed that the litigation proceed within a number of "focus cases" rather than in all of the 309 cases that have now been consolidated. The Company's case is not one of these focus cases. On December 5, 2006, the Court of Appeals for the Second Circuit reversed the district court's class certification decision for these six focus cases. In response to that ruling, the plaintiffs amended their master allegations and the focus case complaints, and the defendants moved to dismiss those amended complaints. The court issued an opinion and order on March 26, 2008, essentially denying the motion to dismiss and allowing the case to continue. The cases are currently in settlement discussions. Due to the inherent uncertainties of litigation, the Company cannot accurately predict the ultimate outcome of the matter.

On October 10, 2007, a stockholder of the Company filed a lawsuit in the United States District Court for the Western District of Washington against several companies that acted as lead underwriters on the initial public offering of the Company. The complaint, which also named the Company as a nominal defendant but did not assert any claims against the Company, asserted claims against the underwriters under Section 16(b) of the Securities Exchange Act of 1934 for recovery of alleged short-swing profits on trades of the Company's stock. On February 28, 2008, an amended complaint was filed, with the Company still named only as a nominal defendant. Similar complaints have been filed by this same plaintiff against a number of other issuers in connection with their initial public offerings, and the factual allegations are closely related to the allegations in the litigation pending in the United States District Court for the Southern District of New York which is described above in this Form 10-Q.

Certain of the Company's product license and services agreements include an indemnification provision for claims from third parties relating to the Company's intellectual property. Such indemnification provisions are accounted for in accordance with SFAS No. 5, *Accounting for Contingencies*. To date, there have been no claims made under such indemnification provisions.

The Company is subject from time to time to other legal proceedings and claims arising in the ordinary course of business. Although the ultimate outcome of these matters cannot be determined, management believes that, as of June 30, 2008, the final disposition of these proceedings will not have a material adverse effect on the consolidated financial position, results of operations, or liquidity of the

DIGIMARC CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(UNAUDITED)

11. Commitments and Contingencies (Continued)

Company. No accrual has been recorded because the amounts are not probable or reasonably estimatable in accordance with SFAS No. 5, *Accounting for Contingencies*.

Performance Bonds

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

DIGIMARC CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(UNAUDITED)

12. Quarterly Financial Information

Quarter ended:	**March 31**	**June 30**	**September 30**	**December 31**
2008				
Total revenue	$ 30,570	$ 30,745		
Total cost of revenue	18,623	19,339		
Gross profit	11,947	11,406		
Gross profit percent	39%	37%		
Sales and marketing	4,623	4,473		
Research, development and engineering	2,278	2,488		
General and administrative	4,584	4,136		
Amortization of intangibles	420	463		
Intellectual property	545	513		
Acquisition related costs	1,089	1,448		
Operating income (loss)	(1,592)	(2,115)		
Net income (loss)	(1,361)	(1,955)		
Net income (loss) per share basic	(0.06)	(0.09)		
Net income (loss) per share diluted	(0.06)	(0.09)		
2007				
Total revenue	$ 26,846	$ 27,364	$ 27,132	$ 28,422
Total cost of revenue	16,815	17,077	16,367	17,769
Gross profit	10,031	10,287	10,765	10,653
Gross profit percent	37%	38%	40%	37%
Sales and marketing	4,277	4,365	4,103	3,870
Research, development and engineering	2,042	1,883	1,691	1,707
General and administrative	4,098	3,809	3,724	3,978
Amortization of intangibles	500	509	451	532
Intellectual property	499	476	429	432
Operating income (loss)	(1,385)	(755)	367	134
Net income (loss)	(1,022)	(495)	772	300
Net income (loss) per share basic	(0.05)	(0.02)	0.04	0.01
Net income (loss) per share diluted	(0.05)	(0.02)	0.04	0.01

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

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

The following discussion should be read in conjunction with our consolidated financial statements and the related notes and other financial information appearing elsewhere in this Form 10-Q. Readers are also urged to carefully review and consider the various disclosures made by us which attempt to advise interested parties of the factors which affect our business, including without limitation the disclosures made in Part II, Item 1A (Risk Factors) of this Form 10-Q and in the audited consolidated financial statements and related notes included in our Annual Report on Form 10-K for the year ended December 31, 2007 filed on February 29, 2008, and other reports and filings made with the Securities and Exchange Commission ("SEC").

Pending Acquisition of Digimarc and Spin-Off of Digital Watermarking Business

On March 23, 2008, we entered into the Original Merger Agreement with L-1 pursuant to which a subsidiary of L-1 will be merged with and into Digimarc, with Digimarc continuing after the merger as a wholly-owned subsidiary of L-1. Immediately prior to the merger, we would contribute all of the assets and liabilities related to our digital watermarking business, together with all of our cash, to our wholly-owned subsidiary, the shares of which will be distributed to our stockholders in a taxable spin-off transaction. The Original Merger Agreement provided for a combination of cash and L-1 common stock to be paid to the Company's stockholders upon effectiveness of the Merger, with an aggregate transaction value of approximately $250 million based on the market value of L-1 common stock on the date of the Original Merger Agreement.

On June 29, 2008, the Company and L-1 entered into an Amended and Restated Agreement and Plan of Merger, which provides for cash consideration to the Company's stockholders in an aggregate amount of $310 million following the spin-off of the Company's digital watermarking business and cash on hand. The proposed transaction will be effected through a tender offer by L-1 for the Company's common stock, followed by a second-step merger of a wholly-owned subsidiary of L-1 with and into the Company, with the Company continuing after the merger. In addition, all outstanding options to purchase shares of the Company's common stock will vest and become fully exercisable prior to the Spin-Off Record Date. Holders of Digimarc stock options will be given the opportunity to exercise their stock options on or prior to the Spin-Off Record Date and, to the extent the stock options are exercised, the holders of shares of the Company's common stock issued upon exercise can participate in the tender offer or receive cash consideration for their shares in the merger. All outstanding shares of Digimarc restricted stock will become fully vested on or prior to the spin-off record date, and holders of shares of Digimarc restricted stock will be stockholders for purposes of the spin-off and can participate in the tender offer or receive cash consideration for their shares in the merger.

L-1 commenced a tender offer for the Company's common stock on July 3, 2008 pursuant to the Offer to Purchase. The amended offer price is $12.25 per share of the Company's common stock (including associate preferred stock purchase rights). Completion of the tender offer is subject to a minimum number of shares of the Company's common stock being tendered, completion of the spin-off and certain other customary conditions, as described in the Offer to Purchase. If the Registration Statement on Form 10 filed by DMRC Corporation, an indirect wholly owned subsidiary of the Company that will be the surviving entity of the spin-off, has not been declared effective by the SEC prior to the spin-off, the equity interests of the spin-off entity will be transferred to a newly-created trust for the benefit of the Company's stockholders as of the Spin-Off Record Date, and the trust will distribute the equity interests to Company's stockholders as of the Spin-Off Record Date upon effectiveness of the Registration Statement on Form 10.

The completion of the merger is subject to payment by L-1 for the shares of the Company's common stock tendered in the tender offer, approval of the merger agreement by our stockholders, if required by law, and completion of the Spin-Off prior to the expiration of the ender offer and other customary closing conditions. On June 12, 2008 the Federal Trade Commission granted early termination of the antitrust review process under the Hart-Scott-Rodino Act. The transaction is not subject to any financing condition. There is no assurance that the tender offer, the merger and the spin-off will be consummated in a timely manner, if at all.

The tender offer statement (including the offer to purchase, letter of transmittal and related tender offer documents) filed by L-1 with the SEC and the solicitation/recommendation statement filed by Digimarc with the SEC contain important information which we encourage investors and securityholders to read.

All forward-looking statements in this Quarterly Report on Form 10-Q, including those in the Management's Discussion and Analysis of Financial Condition, Results of Operations and Risk Factors, are based on management's plans for future operations without consideration given to the pending transaction.

Overview

Digimarc Corporation ("Digimarc," "our" or "we") is a leading supplier of secure identity solutions, and a leading innovator of technology used to enrich everyday living by giving persistent digital identities to media objects that computers can see, hear, understand and react to. Our solutions and technologies enable governments and businesses around the world to identify and manage all forms of media, enhance traffic safety and national security, combat identity theft and fraud, deter counterfeiting and piracy, extend the value and communication ability of media content, and support new digital media distribution models that provide consumers with more choice and access to media content. Our mission is two-fold:

- Foster large-scale adoption of media identification and management solutions licensed under Digimarc's intellectual property; and

- Be the most desired profitable supplier of driver license issuance systems.

We issue more than 60 million identification documents ("IDs") annually and are the leading supplier of government-issued citizen IDs in North America, including supplying systems that produce more than two-thirds of all driver licenses issued in the U.S. We are also a leading technology innovator and owner of intellectual property in a signal processing technology innovation known as "digital watermarking" which allows imperceptible digital information to be embedded in all forms of produced or distributed media content and certain objects, including personal identification documents, financial instruments, photographs, movies, music, television, and product packages. The embedded data gives media and objects a digital identity that can be detected and read by software or hardware detectors in personal computers and other digital devices making intuitive computing possible as these computing devices can then become aware of and respond to their surroundings.

Digital watermarking is a strategic component of nearly all of our product offerings. We provide media identification and management solutions based on this and related technologies directly and through our licensees. Digital watermarking has already proven to be a powerful element of document security, giving rise to our long-term relationship with a consortium of Central Banks and many leading companies in the information technology industry. We are working to achieve a similar success in secure identity management systems. We anticipate that by the middle of 2008 more than one out of two driver licenses being produced in the U.S. will carry digital watermarks as a means to provide cross-jurisdictional machine authentication. In addition, Digimarc and its licensees have successfully propagated digital watermarking in music, movies, television broadcasts, images and printed materials. Digital watermarks have been used in these applications to provide improved media rights and asset management, reduce piracy and counterfeiting losses, enhance marketing programs, enable more efficient and effective distribution of valuable media content, and open up new consumer experiences.

Our principal administrative, marketing, research, and intellectual property development facility is located in Beaverton, Oregon. Our secure ID systems business is headquartered in Burlington, Massachusetts, and our logistics center is in Fort Wayne, Indiana.

Our ID systems revenue is primarily generated pursuant to long-term contracts with government ID issuers primarily U.S. State government agencies responsible for driver license issuance and national governments of a number of countries. These customers rely on our systems design, integration and materials science expertise, and proprietary technologies such as digital watermarking, to implement issuance systems and processes that improve the security of identity documents and banknotes.

Our media identification and management revenue is generated through commercial and government applications of our digital watermarking and related technologies, primarily from patent and technology license fees paid by business partners and our contracts with a consortium of Central Banks and with The Nielsen Company. Our licensing program, which is a core part of our business, is built upon our extensive patent portfolio, which contains over 370 issued U.S. patents, and numerous foreign patents, as of June 30, 2008. Private sector media and entertainment industry customers use secure solutions from our business partners and us to identify, track, manage and protect content as it is distributed and consumed either digitally or physically and to enable new consumer applications to improve access to networks and information from personal computers and mobile devices. We expect that patent and technology licensing will continue to contribute most of our revenues from non-government customers for the foreseeable future.

Secure ID Systems

We issue more than 60 million IDs annually and are the leading supplier of driver licenses and citizen IDs in North America. We also provide secure ID solutions to approximately 25 foreign governments.

In North America, we generate most of our revenue through the issuance of State driver licenses and other IDs on a fixed price per credential issued basis. In North America, we are generally a prime contractor, providing full issuance systems to Federal, State, and provincial departments of motor vehicles or other government issuing authorities. These systems typically include hardware (including specialized cameras, printers, personal computers and servers), software, consumable supplies (such as ribbons, blank or preprinted card materials and laminated and related consumables) and ongoing support services. These systems may also involve software and/or hardware development, integration services, and implementation services. When we provide a full issuance system to a customer, we generally retain title to all equipment, software and consumables associated with the system and are responsible for maintaining the system over the contractual period.

Our strategy regarding the REAL ID Act, a federal legislation passed in May 2005, is to provide complete solutions that address the requirements of the REAL ID Act: identity verification; document scanning and archiving; individual background checking; data and image sharing; and migration to and production of REAL ID Act compliant driver license documents. These solutions are available to customers as upgrades or complete issuance systems. Digimarc is currently offering the States program management assistance to develop transition plans and safely migrate to current systems to those that are REAL ID Act compliant.

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

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

Media Identification and Management

We license our technology and patents and otherwise foster development of the market for solutions enabled by our technologies, including digital watermarking, through our participation in industry activities and events for commercial as well as governmental uses. Our licenses primarily involve use of our technology and patents in the media and entertainment area, but also support industrial and commercial enterprise applications as well as applications in Federal programs. We also have a multi-year contract with an international consortium of Central Banks pursuant to which we have been, since 1997, developing, deploying, supporting and continuing to enhance a system to deter digital counterfeiting of currency using personal computers and digital reprographics.

Commercial customers use secure media solutions from our business partners and us to identify, track, manage and protect content as it is distributed and consumed either digitally or physically and to enable new consumer applications to access networks and information from personal computers and mobile devices. Many movie studios, record labels, broadcasters, creative professionals and other customers rely on digital watermarking as a cost-effective means to:

- deter piracy and illegal use of movies, music and images;
- protect entertainment content from copyright infringement;
- track and monitor entertainment content for rights usage and licensing compliance;
- monitor advertisements to verify ad placement and measure return on investment;
- enhance information access, search and marketing capabilities related to media content; and
- enable fair and legitimate use of content by consumers.

Our business partners and customers include AquaMobile, Cinea, Inc., a subsidiary of Dolby Laboratories, Inc., GCS Research LLC, MarkAny, MediaGrid, Microsoft Corporation, Media Science International, Mobile Data Systems, Inc., The Nielsen Company, Overdrive, Royal Philips, Signum Technologies Limited, Thomson Multimedia, S.A., USA Video, Verance Corporation, Verimatrix, Inc. and VCP (an affiliate of VEIL Interactive Technologies). Although each partner or customer addresses particular needs, as a whole these partners and customers are propagating digital watermarking in music, movies, images and television as a means to improve media rights and asset management, reduce piracy losses, improve marketing programs, and provide more efficient and effective distribution of valuable media content.

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

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

Depreciation. Our policy for depreciating fixed assets that are specifically used to provide services under long-term contracts to the shorter of the original contract term plus 2.75 years or estimated useful life. Historically, 95% of contracts were extended beyond the original contract term, that the average contract had at least two contract extensions during its life and that these extensions added on average 2.75 years to the length of the contracts' original terms.

Since contract-specific program assets are tracked on a contract basis, the finding that contracts are routinely extended beyond the original term and that these extensions are not generally accompanied by significant incremental capital investment indicates that the useful life of contract-related assets is generally longer than the original term of the contract. Given these findings, we concluded that it was appropriate to change the estimated useful lives of these assets for purposes of depreciation. In addition, the change in useful lives achieves a better matching of the utility of these assets with the resulting revenues. For the year ended December 31, 2007, we performed an updated analysis on contract specific assets which resulted in no change to our previous conclusions. We will continue to analyze the useful lives of contract specific assets in future periods. The financial impact of this change is discussed below under the "Cost of Revenue" heading.

Backlog.

	Total	Revenue to be Recognized for the Remainder of 2008
	(in millions)	
Backlog by source:		
Media identification and management	$ 60	$ 9
Identification	210	35
Total	$270	$ 44

Based on projected government-issued credential production volumes and other commitments we have for the periods under contract with our respective customers, we anticipate our current contracts as of June 30, 2008 will generate approximately $270 million in revenue during the contractual terms of such contracts, currently up to seven years. This amount includes production volumes reasonably expected to be achieved under currently effective contracts and government orders that are firm but not yet funded, and government contracts awarded but not yet signed. Backlog as of December 31, 2007 was approximately $225 million. The increase in backlog reflects factors noted below.

Some factors that lead to increased backlog are:

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

Some factors that lead to decreased backlog are:

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

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

Over the next few years, we anticipate several states to request bids on their driver license issuance system programs. This period of expected high bid activity could lead to additional backlog if we are successful with our bids. Another factor that could affect backlog in this period is the revenue model utilized for a particular customer. From time to time we have sales to our customers that are not made on a price-per-card basis, but instead include hardware and consumable sales. Although these types of revenue models are positive growth indicators for our business, they can lead to lower reported backlog.

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

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

Additional Information

A more detailed discussion of our business is contained in our Annual Report on Form 10-K for the fiscal year ended December 31, 2007.

Critical Accounting Policies and Estimates

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

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

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

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

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

Also, we periodically review the useful lives of long-lived assets whenever events or changes in circumstances indicate that the useful life may have changed. If the estimated useful lives of such assets do change, we adjust the depreciation or amortization period to a shorter or longer period, based on the circumstances identified.

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

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

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

Stock-based compensation: We account for stock-based compensation in accordance with SFAS No. 123(R), *Share-Based Payment (Revised 2004)*, which requires the measurement and recognition of compensation for all stock-based awards made to employees and directors including stock options and employee stock purchases under a stock purchase plan based on estimated fair values. We use the Black-Scholes option pricing model as our method of valuation for stock-based awards. Our determination of the fair value of stock-based awards on the date of grant using an option pricing model is affected by our stock price as well as assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited, to the expected life of the award, our expected stock price, volatility over the term of the award and actual and projected exercise behaviors. Although the fair value of stock-based awards is determined in accordance with SFAS 123(R), the Black-Scholes option pricing model requires the input of highly subjective assumptions, and other reasonable assumptions could provide differing results. The fair value of restricted stock awards granted is based on the fair market value of our common stock on the date of the grant (measurement date), and is being recognized over the vesting period of the related restricted stock using the straight-line method. The fair value of performance vesting share awards granted is based on a Monte Carlo valuation model that resulted in a factor applied to the fair market value of our common stock on the date of the grant (measurement date), and is being recognized over the derived service period using the straight-line method.

Results of Operations

The following table presents our consolidated statements of operations data for the periods indicated as a percentage of total revenue. Unless otherwise indicated, all references to the three- and six-month periods relate to the three- and six-month periods ended June 30, 2008 and all changes discussed with respect to such period reflect changes as compared to the three- and six-month periods ended June 30, 2007.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	**2007**	**2008**	**2007**
Revenue:				
Service	84%	82%	83%	81%
Product and subscription	16	18	17	19
Total revenue	100	100	100	100
Cost of revenue:				
Service	57	55	55	55
Product and subscription	6	7	7	8
Total cost of revenue	63	62	62	63
Gross profit	37	38	38	37
Operating expenses:				
Sales and marketing	15	16	15	15
Research, development and engineering	8	7	8	7
General and administrative	13	14	14	15
Amortization of intangibles	1	2	1	2
Intellectual property	2	2	2	2
Acquisition related costs	5		4	
Total operating expenses	44	41	44	41
Operating income (loss)	(7)	(3)	(6)	(4)
Other income (expense), net	1	1	1	1
Income (loss) before provision for income taxes	(6)	(2)	(5)	(3)
Provision for income taxes	0	0	0	0
Net income (loss)	(6)%	(2)%	(5)%	(3)%

Our total revenue for the three- and six-months ended June 30, 2008 was $30.7 million and $61.3 million, or 12% and 13% higher as compared to $27.4 million and $54.2 million for the prior year periods, respectively.

We reported a net loss for the three- and six-month periods ended June 30, 2008 of $2.0 million and $3.3 million, respectively, or $0.09 and $0.15 per share, respectively, compared to a net loss of $0.5 million and $1.5 million for the corresponding three- and six-month periods ended June 30, 2007, respectively, or $0.02 and $0.07 per share, respectively. Our results reflect increases in primarily two areas of cost. For the three- and six-month periods ended June 30, 2008 we incurred $1.4 million and $2.5 million, respectively, or $0.07 and $0.12 per share, respectively, of non-recurring costs in connection with the pending acquisition of our ID Systems business by L-1. We also accrued $1.1 million and $1.9 million for the three- and six-month periods ended June 30, 2008, respectively, or $0.05 and $0.09 per share, respectively, of costs associated with the corporate incentive bonus program. In 2007, there were no accrued amounts for the corporate incentive bonus program.

Revenue

	Three Months Ended June 30, 2008	Three Months Ended June 30, 2007	Dollar Increase (Decrease)	Percent Increase (Decrease)	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007	Dollar Increase (Decrease)	Percent Increase (Decrease)
				(in 000's)				
Revenue:								
Service	$25,920	$22,538	$ 3,382	15%	$50,594	$43,837	$ 6,757	15%
Product and subscription	4,825	4,826	(1)	0%	10,721	10,373	348	3%
Total	$30,745	$27,364	$ 3,381	12%	$61,315	$54,210	$ 7,105	13%
Revenue (as % of total revenue):								
Service	84%	82%			83%	81%		
Product and subscription	16%	18%			17%	19%		
Total	100%	100%			100%	100%		

Service. Service revenue consists primarily of:

- card production on a price-per-card basis,
- software development and consulting services, and
- hardware and software maintenance.

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

The increase in service revenue for the three-month period ended June 30, 2008 compared to the corresponding three-month period ended June 30, 2007 was due primarily to:

- higher production volumes under our Mexico contract relating to governmental initiatives to increase voter registration,
- additional service revenue related to the roll out of the central issue card production facility in New Mexico, and
- consulting revenues generated from our new contract with The Nielsen Company that was signed in late 2007.

The increase in service revenue for the six-month period ended June 30, 2008 compared to the corresponding six-month period ended June 30, 2007 was due primarily to:

- higher production volumes under our Mexico contract relating to governmental initiatives to increase voter registration,
- higher issuance revenues, primarily attributable to price and volume mix changes,
- additional service revenue related to the roll out of the central issue card production facility in New Mexico, and

consulting revenues generated from our new contract with The Nielsen Company that was signed in late 2007.

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

The product and subscription revenue for the three- and six-month periods ended June 30, 2008 compared to the corresponding three- and six-month periods ended June 30, 2007 reflect mix changes in both periods and an overall increase for the six-month period primarily due to:

- increased license revenues from the Nielsen contract, and
- reduction of consumables revenues associated with the elimination of our United Kingdom contract that ended production in the second quarter of 2007.

Revenue by Geography

	Three Months Ended June 30, 2008	Three Months Ended June 30, 2007	Dollar Increase (Decrease)	Percent Increase (Decrease)	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007	Dollar Increase (Decrease)	Percent Increase (Decrease)
				(in 000's)				
Revenue by geography:								
Domestic	$25,388	$21,219	$ 4,169	20%	$49,810	$41,739	$ 8,071	19%
International	5,357	6,145	(788)	(13)%	11,505	12,471	(966)	(8)%
Total	$30,745	$27,364	$ 3,381	12%	$61,315	$54,210	$ 7,105	13%
Revenue (as % of total revenue):								
Domestic	83%	78%			81%	77%		
International	17%	22%			19%	23%		
Total	100%	100%			100%	100%		

Domestic revenue increased for the three- and six-month periods ended June 30, 2008 compared to the corresponding three- and six-month periods ended June 30, 2007 due primarily to:

- service and license revenues associated with the Nielsen contract,
- service revenue related to the roll out of the central issue card production facility in New Mexico, and
- higher driver license production revenues from various states.

International revenue decreased for the three- and six-month periods ended June 30, 2008 compared to the corresponding three- and six-month periods ended June 30, 2007 due primarily to:

- the expiration of the United Kingdom contract, offset by
- higher production volumes from our Mexico, and to a lesser extent, Atlantic Canada operations.

Revenue by Source

	Three Months Ended June 30, 2008	Three Months Ended June 30, 2007	Dollar Increase (Decrease)	Percent Increase (Decrease)	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007	Dollar Increase (Decrease)	Percent Increase (Decrease)
				(in 000's)				
Revenue by source:								
Media identification and management	$ 5,118	$ 3,025	$ 2,093	69%	$10,206	$ 6,510	$ 3,696	57%
Identification	25,627	24,339	1,288	5%	51,109	47,700	3,409	7%

Total	$30,745	$27,364	$ 3,381	12%	$61,315	$54,210	$ 7,105	13%
Revenue (as % of total revenue):								
Media identification and management	17%	11%			17%	12%		
Identification	83%	89%			83%	88%		
Total	100%	100%			100%	100%		

The increase in media identification and management revenue for the three- and six-month periods ended June 30, 2008 compared to the corresponding three- and six-month periods ended June 30, 2007 was due primarily to higher service and licensing revenue from the Nielsen contract.

The increase in identification revenue for the three- and six-month periods ended June 30, 2008 compared to the corresponding three- and six-month periods ended June 30, 2007 was due primarily to higher production volumes from our Mexico and Atlantic Canada operations, and higher revenues from various states primarily from a volume mix, including California and Iowa, offset by the expiration of the United Kingdom contract.

Cost of Revenue

	Three Months Ended June 30, 2008	Three Months Ended June 30, 2007	Dollar Increase (Decrease)	Percent Increase (Decrease)	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007	Dollar Increase (Decrease)	Percent Increase (Decrease)
				(in 000's)				
Cost of Revenue:								
Service	$17,432	$15,089	$ 2,343	16%	$33,635	$29,804	$ 3,831	13%
Product and subscription	1,907	1,988	(81)	(4)%	4,327	4,088	239	6%
Total	$19,339	$17,077	$ 2,262	13%	$37,962	$33,892	$ 4,070	12%
Cost of Revenue (as % of related revenue components):								
Service	67%	67%			66%	68%		
Product and subscription	40%	41%			40%	39%		

Service. Cost of service revenue primarily includes:

- costs of consumables used in delivering a service,
- compensation, benefits and related costs of software developers, quality assurance personnel, product managers and field operations personnel,
- payment to outside contractors,
- depreciation charges for machinery, equipment, software and capitalized labor,
- deployment costs used specifically for service delivery,
- provisions for obsolete and excess inventories,
- travel costs directly attributable to service and development contracts,
- stock-based compensation expense, and
- charges for infrastructure and centralized costs.

Cost of service revenue increased for the three-month period ended June 30, 2008 compared to the corresponding three-month period ended June 30, 2007 primarily due to:

increased depreciation expense of $1.1 million related primarily to programs completed in the later half of 2007 or implemented during the first half of 2008 and, to a lesser extent, acceleration of depreciation on programs the systems of which will be replaced under upgrade contracts,

increased direct material and service costs of $0.9 million related to increased revenue,

increased compensation related costs and accrued benefits of $0.3 million related to increased resources to address new or enhanced revenue programs with existing customers, offset by

- decreased costs of approximately $0.3 million related to higher resource allocations to capital and deferred cost projects.

Cost of service revenue increased for the six-month period ended June 30, 2008 compared to the corresponding six-month period ended June 30, 2007 primarily due to:

- increased direct material, hardware and software costs of $2.0 million related to increased revenue,

- increased depreciation expense of $1.5 million related to programs completed in the later half of 2007 or implemented during the first half of 2008, and to a lesser extent to acceleration of depreciation on programs whose systems will be replaced under upgrade contracts,

- increased compensation related costs and accrued benefits of $0.6 million related to increased resources to address new or enhanced revenue programs with existing customers, offset by

- decreased costs of approximately $0.5 million related to higher resource allocations to capital and deferred costs projects.

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

Cost of product and subscription revenue decreased for the three-month period ended June 30, 2008 compared to the corresponding three-month period ended June 30, 2007 primarily due to lower consumables sales related to the expiration of the United Kingdom contract, offset by increased consumables sales to other international customers.

Cost of product and subscription revenue increased for the six-month period ended June 30, 2008 compared to the corresponding six-month period ended June 30, 2007 primarily due to corresponding increases in revenues, including issuance production revenues, higher add-ons and upgrade revenues, and a large consumable film sale to an international customer, offset by lower consumables sales related to the expiration of the United Kingdom contract.

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

Cost of Revenue Components

	Three Months Ended June 30,		Dollar Increase (Decrease)	Percent Increase (Decrease)	Six Months Ended June 30,		Dollar Increase (Decrease)	Percent Increase (Decrease)
	2008	2007			2008	2007		
				(in 000's)				
Cost of revenue:								
Variable	$ 8,799	$ 7,771	$ 1,028	13%	$ 17,839	$ 15,382	$ 2,457	19%
Fixed field support and manufacturing	6,730	6,586	144	2%	13,107	13,025	82	1%
Program depreciation	3,810	2,720	1,090	40%	7,016	5,485	1,531	28%
Total	$ 19,339	$ 17,077	$ 2,262	13%	$ 37,962	$ 33,892	$ 4,070	12%
Cost of revenue (as % of total revenue):								
Variable	29%	28%			29%	29%		
Fixed field support and manufacturing	22%	24%			22%	24%		
Program depreciation	12%	10%			11%	10%		
Total	63%	62%			62%	63%		

Variable. Variable costs include:

- price of materials to produce an identification card,
- direct costs of hardware and software, and related labor, delivered to customers, and
- other costs that are variable in nature.

The increase in variable costs for the three- and six-month periods ended June 30, 2008 compared to the corresponding three- and six-month periods ended June 30, 2007 was primarily due to increased sales from a combination of issuances and various products to domestic and international customers, offset by lower sales of consumables related to the end of the United Kingdom contract.

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

- field operations and support costs,
- manufacturing costs,
- supply chain costs, and
- charges for infrastructure and centralized costs.

Fixed costs remained relatively consistent for the three- and six-month periods ended June 30, 2008 compared to the corresponding three- and six-month periods ended June 30, 2007.

Program depreciation. Program depreciation primarily consists of amortization and depreciation of costs incurred during the delivery process, where such costs are capitalized and then amortized or depreciated over the useful lives of the assets to which the costs relate. Costs capitalized during the delivery process typically include equipment, purchased software, capitalized labor for software development and implementation and travel.

The increase in program depreciation was primarily due to delivery of new programs in the later half of 2007 or implemented during the first half of 2008, and to a lesser extent to acceleration of depreciation on programs whose systems will be replaced under upgrade contracts.

Gross Profit

	Three Months Ended June 30, 2008	Three Months Ended June 30, 2007	Dollar Increase (Decrease)	Percent Increase (Decrease)	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007	Dollar Increase (Decrease)	Percent Increase (Decrease)
				(in 000's)				
Gross Profit:								
Service	$ 8,488	$ 7,449	$ 1,039	14%	$16,959	$14,033	$ 2,926	21%
Product and subscription	2,918	2,838	80	3%	6,394	6,285	109	2%
Total	$11,406	$10,287	$ 1,119	11%	$23,353	$20,318	$ 3,035	15%
Gross Profit (as % of related revenue components):								
Service	33%	33%			34%	32%		
Product and subscription	60%	59%			60%	61%		
Total	37%	38%			38%	37%		

The changes in gross profit as a percentage of revenue, for both the revenue components and overall gross profit, for the three- and six-month periods ended June 30, 2008 compared to the three- and six-month periods ended June 30, 2007 were primarily due to commensurate changes in revenues and costs of revenues, as described above. In particular, the increase in gross profit for services for the six-month period reflects significant operating leverage improvement in the field support and manufacturing areas from significant cost reductions and improved operating efficiencies.

Operating Expenses

Sales and marketing

	Three Months Ended June 30, 2008	Three Months Ended June 30, 2007	Dollar Increase (Decrease)	Percent Increase (Decrease)	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007	Dollar Increase (Decrease)	Percent Increase (Decrease)
				(in 000's)				
Sales and marketing	$4,473	$4,365	$ 108	2%	$9,096	$8,642	$ 454	5%
Sales and marketing (as % of total revenue)	15%	16%			15%	15%		

Sales and marketing expenses consist primarily of:

- compensation, benefits and related costs of sales and marketing employees, product managers and sales engineers,
- travel and market research costs, and costs associated with marketing programs, such as trade shows, public relations and new product launches,
- stock-based compensation expense, and
- charges for infrastructure and centralized costs.

The increase in sales and marketing expense for the three- and six-month periods ended June 30, 2008 compared to the corresponding three- and six-month periods ended June 30, 2007 resulted primarily due to:

- increased accrued benefits of $0.2 million and $0.4 million, respectively, for corporate incentive bonus program.

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

Research, development and engineering

	Three Months Ended June 30, 2008	Three Months Ended June 30, 2007	Dollar Increase (Decrease)	Percent Increase (Decrease)	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007	Dollar Increase (Decrease)	Percent Increase (Decrease)
				(in 000's)				
Research, development and engineering	$2,488	$1,883	$ 605	32%	$4,766	$3,925	$ 841	21%
Research, development and engineering (as % of total revenue)	8%	7%			8%	7%		

Research, development and engineering expenses consist primarily of:

- compensation, benefits and related costs of software developers and quality assurance personnel,
- payments to outside contractors,
- the purchase of materials and services for product development, primarily in the card systems area,
- stock-based compensation expense, and
- charges for infrastructure and centralized costs.

The increase in research, development and engineering expense for the three- and six-month periods ended June 30, 2008 compared to the corresponding three- and six-month periods ended June 30, 2007 resulted primarily from increased employee compensation-related expenses of $0.5 million and $1.0 million, respectively resulting from additional headcount and corporate incentive bonus program.

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

General and administrative

	Three Months Ended June 30, 2008	Three Months Ended June 30, 2007	Dollar Increase (Decrease)	Percent Increase (Decrease)	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007	Dollar Increase (Decrease)	Percent Increase (Decrease)
				(in 000's)				
General and administrative	$4,136	$3,809	$ 327	9%	$8,720	$7,907	$ 813	10%
General and administrative (as % of total revenue)	13%	14%			14%	15%		

General and administrative expenses consist primarily of:

- compensation, benefits and related costs of executive, finance and administrative personnel,
- legal, human resources and other professional fees,
- stock-based compensation expense, and
- charges for infrastructure and centralized costs.

The increase in general and administrative expenses for the three- and six-month periods ended June 30, 2008 compared to the corresponding three-and six-month periods ended June 30, 2007 resulted primarily due to increased accrued benefits of $0.3 million and $0.6 million, respectively, for the corporate incentive bonus program.

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

Amortization of intangible assets

	Three Months Ended June 30, 2008	Three Months Ended June 30, 2007	Dollar Increase (Decrease)	Percent Increase (Decrease)	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007	Dollar Increase (Decrease)	Percent Increase (Decrease)
				(in 000's)				
Amortization of intangibles	$463	$509	$ (46)	(9)%	$883	$1,009	$ (126)	(12)%
Amortization of intangibles (as % of total revenue)	1%	2%			1%	2%		

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

The decrease in amortization of intangible assets for the three- and six-month periods ended June 30, 2008 compared to the corresponding three- and six-month periods ended June 30, 2007 resulted primarily from extended amortization periods from contract extensions with several domestic customers and the impact of certain international programs being fully amortized.

Intellectual property

	Three Months Ended June 30, 2008	2007	Dollar Increase (Decrease)	Percent Increase (Decrease)	Six Months Ended June 30, 2008	2007	Dollar Increase (Decrease)	Percent Increase (Decrease)
	(in 000's)							
Intellectual property	$513	$476	$ 37	8%	$1,058	$975	$ 83	9%
Intellectual property (as % of total revenue)	2%	2%			2%	2%		

Intellectual property costs primarily consist of:

- compensation, benefits and related costs of attorneys and legal assistants,
- costs associated with documenting, applying for, and maintaining patents and trademarks,
- stock-based compensation expense, and
- charges for infrastructure and centralized costs.

Intellectual property expense remained relatively consistent for the three- and six-month periods ended June 30, 2008 compared to the corresponding three- and six-month periods ended June 30, 2007 with the slight increase for both periods attributable to the corporate incentive bonus program as explained in other areas of our operating expenses. We anticipate that we will continue to invest in intellectual property expenses at current levels or slightly higher.

Acquisition related costs. During the quarter, we entered into the Amended and Restated Agreement and Plan of Merger to sell our ID Systems business in an all cash transaction effected through a tender offer by L-1 for our common stock following the spin-off of our digital watermarking business and cash on hand. In connection with the sale we have incurred professional fees for legal, accounting and investment banking costs of $1.4 million and $2.5 million for the three-and six-month periods ended June 30, 2008, respectively.

We anticipate that we will continue to incur acquisition related costs at or above current levels in the near term until the proposed transactions are completed.

Stock-based compensation. Stock-based compensation includes expense charges for all stock-based awards to officers, employees and directors. Such awards include option grants, restricted stock awards, and shares expected to be purchased under an employee stock purchase plan. We account for stock-based compensation in accordance with SFAS 123(R), which requires the measurement and recognition of compensation for all stock-based awards made to officers, employees and directors including stock options and employee stock purchases under a stock purchase plan based on estimated fair values. SFAS 123(R) supersedes previous accounting under Accounting Principles Board Opinion ("APB") No. 25, *Accounting for Stock Issued to Employees,* for periods beginning in fiscal 2006. In March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin ("SAB") No. 107 relating to the application of SFAS 123(R). We have applied the provisions of SAB 107 in our adoption of SFAS 123(R).

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

Upon adoption of SFAS 123(R), we continued to use the Black-Scholes option pricing model as its method of valuation for stock-based awards. Our determination of the fair value of stock-based awards on the date of grant using an option pricing model is affected by our stock price as well as assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to the expected life of the award, our expected stock price volatility over the term of the award and actual and projected exercise behaviors. Although the fair value of stock-based awards is determined in accordance with SFAS 123(R) and SAB 107, the Black-Scholes option pricing model requires the input of highly subjective assumptions, and other reasonable assumptions could provide differing results. The fair value of restricted stock awards granted is based on the fair market value of our common stock on the date of the grant (measurement date), and is being recognized over the vesting period of the related restricted stock using the straight-line method. The fair value of performance vesting share awards granted is based on a Monte Carlo valuation model that resulted in a factor applied to the fair market value of our common stock on the date of the grant (measurement date), and is being recognized over the Stock-based compensation expense was recorded in the respective statement of operations expense categories for the employees to whom it applies, as set forth in the table below:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	**2007**	**2008**	**2007**
	(in 000's)			
Cost of revenue	$ 121	$ 109	$ 235	$ 215
Sales and marketing	191	185	359	392
Research, development and engineering	119	101	232	173
General and administrative	760	599	1,462	1,207
Intellectual property	17	13	34	25
Total	$ 1,208	$ 1,007	$ 2,322	$ 2,012

The increase in stock-based compensation expense for the three- and six-month periods ended June 30, 2008 compared to the corresponding three- and six-month periods ended June 30, 2007 was primarily due to an additional layer of stock-based awards being expensed pursuant to SFAS 123(R). We anticipate incurring an additional $9.5 million in stock-based compensation expense through fiscal 2012 for awards outstanding as of June 30, 2008. The future effect of the adoption of this statement on our financial position and results of operations will be determined by stock-based awards granted in future periods and the assumptions on which the value of those stock-based awards is based. Our tax accounting may also be affected by actual exercise behavior and the relative market prices at exercise.

Other income (expense), net

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	**2007**	**2008**	**2007**
	(in 000's)			
Interest income	$235	$362	$553	$774
Interest expense	(44)	4	(92)	(15)
Foreign currency and other	171	36	254	25
	$362	$402	$715	$784

The slight decrease in other income (expense) was due primarily to lower interest earned on cash and investment balances and, increased interest expense related to additional capitalized leases, offset by the increases in both the realized and unrealized gain on foreign currency translation.

Provision for Income Taxes. The provision for income taxes reflects expected tax expense from profitability in certain foreign jurisdictions. We have recorded a full valuation allowance against net deferred tax assets at June 30, 2008 due to the uncertainty of realization of the Company's net operating losses. We will continue to evaluate the realizability of our domestic and foreign net deferred tax assets in future periods and may recognize income tax benefits in future earnings if we determine the realization of these assets is more likely than not.

Liquidity and Capital Resources

As of June 30, 2008, we had cash and cash equivalents, restricted cash, and short-term investments of $36.9 million, representing an increase of approximately $4.2 million from $32.7 million at December 31, 2007. As of June 30, 2008, $8.6 million of cash and cash equivalents is restricted as a result of the requirements of performance bonds that we are obligated to maintain in connection with some of our long-term contracts in our personal identification systems business. Working capital at June 30, 2008 was $35.6 million, compared to working capital of $35.6 million at December 31, 2007. The increase in cash primarily relates to improved cash flow from operating activities.

Operating Cash Flow. The components of operating cash flows were:

	Six Months Ended June 30,	
	2008	**2007**
	(in 000's)	
Net income (loss)	$ (3,316)	$(1,517)
Non-cash items	11,439	9,764
Changes in operating assets and liabilities	5,857	(1,536)
Net cash provided by (used in) operating activities	$13,980	$ 6,711

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

- increases in depreciation and amortization from $7.8 million to $9.1 million primarily related to delivery of new programs in the later half of 2007 or implemented during the first half of 2008, and

- increased stock-based compensation expense from $2.0 million to $2.3 million primarily related to the effect of the timing of grants of stock-based awards.

The major changes in the operating assets and liabilities for the six-month period ended June 30, 2008 primarily related to:

- a decrease in inventory, net of $2.3 million primarily reflecting the sale of a large consumables order purchased in the fourth quarter of 2007 and recognition of revenues and related costs incurred and deferred in prior quarters,
- a decrease in trade accounts receivable, net of $1.0 million primarily reflecting lower, unpaid deferred revenues in the receivables balance,
- an increase in compensation related liabilities of $1.9 million for the Company's 2008 incentive bonus program compared to none recorded in the prior year and $0.3 million of other accrued liabilities in the normal course of business, and
- an increase in trade accounts payable of $1.4 million primarily reflecting increased costs associated with increased revenue and the impact of acquisition related costs, offset by
- a decrease in deferred revenue of $1.0 million primarily reflecting previously invoiced receivables.

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

- an increase in trade accounts receivable, net of $2.0 million primarily reflecting increased revenues during the second quarter of fiscal 2007 as compared to the fourth quarter of fiscal 2006,
- a decrease in accrued payroll and related costs of $1.9 million reflecting payment of accrued benefits related to the prior year, offset by
- an increase in deferred revenue of $2.7 million resulting from advanced billings and cash collected on future revenues.

The $11.1 million of cash used in investing activities for the six-month period ended June 30, 2008 primarily related to $10.8 million for expenditures of property and equipment on contracts signed over the prior two and one-half years, including capitalization of labor costs of $3.1 million, and $0.3 million in net purchase of short-term investments.

The $12.8 million of cash used in investing activities for the six-month period ended June 30, 2007 primarily related to $1.7 million in net purchase of short-term investment activities and $11.1 million for the purchase of property and equipment related to new customer contracts, including capitalization of labor costs of $2.9 million.

The $2.0 million of cash provided by financing activities for the six-month period ended June 30, 2008 resulted primarily from the net issuance of stock of $2.3 million, offset by principal payments on capital leases of $0.3 million.

The $0.6 million of cash provided by financing activities for the six-month period ended June 30, 2007 resulted primarily from the net issuance of stock of $0.9 million, offset by principal payments on capital leases of $0.3 million.

Our significant commitments consist of obligations under non-cancelable operating leases, which totaled $6.3 million as of June 30, 2008, and are payable in monthly installments through June 2012. Our obligations under non-cancelable capital leases, which totaled $1.3 million as of June 30, 2008, are payable in monthly installments through April 2012.

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

We have driver license contracts with various states that are not yet fully deployed and we have pending add-on and upgrade orders. In order to complete these contracts and pending orders, we estimate we will incur approximately $18 million of expenditures. The estimates are derived from information known to us as of quarter end, the time the estimates were prepared. Actual expenditures may vary from our estimates. We anticipate that these expenditures will be recouped through receipts from the related long-term price-per-card agreements and from the value of the add-on and upgrade orders we have received.

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

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

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

In April 2007, we filed a shelf registration with the SEC. The shelf registration is intended to provide us flexibility to raise funds from time to time over a period of up to 3 years, subject to market conditions and our capital needs. Should we complete the pending acquisition of our ID Systems business by L-1, we will withdraw the shelf registration.

Off-Balance Sheet Arrangements

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

Recent Accounting Pronouncements

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

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

In April 2008, FASB issued Staff Position No. FAS 142-3 *Determination of the Useful Life of Intangible Assets* (FSP 142-3). FSP 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142, *Goodwill and Other Intangible Assets*. The intent of this Staff Position is to improve the consistency between the useful life of a recognized intangible asset under SFAS No. 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS No. 141 (revised 2007), *Business Combinations*, and other U.S. generally accepted accounting principles. FSP 142-3 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Early adoption is prohibited. The Company is currently reviewing the effect, if any, the proposed guidance will have on its consolidated financial statements.

In May 2008, the FASB issued SFAS NO. 162, *The Hierarchy of Generally Accepted Accounting Principles*, which identifies the sources of accounting principles and the framework for selecting principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles in the United States. This statement shall be effective 60 days following the SEC's approval of the Public Company Accounting Oversight Board's amendments to AU section 411, The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles. The Company is currently evaluating the impact of SFAS 162, but does not expect the adoption of this pronouncement will have a material impact on the Company's financial statements.

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

Because this Report on Form 10-Q contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, any of the risk factors set forth in Part II, Item 1A or elsewhere in this Report on Form 10-Q or incorporated herein by reference could cause our actual results to differ materially from those results projected or suggested in such forward-looking statements. Statements that are not historical facts are hereby identified as "forward-looking statements" for the purposes of the safe harbor provided by Section 21E of the Securities Exchange Act of 1934 and Section 27A of the Securities Act of 1933. Such forward-looking statements include but are not limited to statements relating to:

- the timing and completion of the tender offer by, or the merger with, L-1 and spin-off of our digital watermarking business;
- the scale and timing of adoption of digital watermarking in the U.S.;
- trends and expectations in revenue growth, including, but not limited to, statements regarding the temporary nature of the decrease in ID systems bid activity and the expected increase of such activity in the future, and statements regarding anticipated growth in U.S. driver license revenues due to broadening use of the driver license as a secure credential;
- our future level of investment in our business, including investment in development of products and technology, acquisition of new customers and development of new market opportunities;
- our ability to improve margins;
- anticipated expenses, costs, margins and investment activities in the foreseeable future;
- anticipated revenue to be generated from current contracts and as a result of new programs;

- the investments required to complete certain driver license programs and our ability to recoup those expenses under the relevant contract;
- our profitability in future periods;
- business opportunities that could require that we seek additional financing;
- opportunities for increased participation in the global market for ID systems;
- the size and growth of our markets, including the U.S. driver license market;
- the existence of international growth opportunities and our future investment in such opportunities;
- the source of our future revenue;
- our expected short-term and long-term liquidity positions;
- our ability to fund our capital needs through cash flow from operations;
- our use of cash in upcoming quarters;
- anticipated levels of backlog and bid activity in future periods;
- anticipated levels of stock-based compensation expense in future periods and the future effect of our adoption of SFAS 123(R); and
- the likelihood or outcome of legal proceedings and claims and their effect on our business.

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

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

The market risk disclosures as set forth in Item 7A of our Annual Report on Form 10-K for the year ended December 31, 2007 have not changed materially.

Item 4. Controls and Procedures.

Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, have evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934) as of the end of the period covered by this Form 10-Q. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures, as of the end of the period covered by this Form 10-Q, were effective in ensuring that information required to be disclosed by us in reports that we file or submit under the Securities Exchange Act of 1934 is (i) recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and (ii) accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

Changes in Internal Controls

There was no change in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) of the Securities Exchange Act of 1934) that occurred during the quarter ended June 30, 2008 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION.

Item 1. Legal Proceedings.

In 2004, three purported class action lawsuits were filed in the U.S. District Court for the District of Oregon against us and certain of our current and former directors and officers on behalf of purchasers of our securities during the period April 17, 2002 to July 28, 2004. These lawsuits were later consolidated into one action for all purposes. The amended complaint, which sought unspecified damages, asserted claims under the federal securities laws relating to the restatement of our financial statements for 2003 and the first two quarters of 2004 and alleged that we issued false and misleading financial statements and issued misleading public statements about our operations and prospects. On August 4, 2006, the court granted our motion to dismiss the lawsuit with prejudice and entered judgment in our favor. Plaintiffs appealed to the Ninth Circuit Court of Appeals. The appeal has been fully briefed but not yet scheduled for oral argument. Due to the inherent uncertainties of litigation, we cannot accurately predict the ultimate timing of a decision in or the outcome of this matter.

On or about October 19, 2004, two purported shareholder derivative lawsuits were filed against certain of our officers and directors, naming us as a nominal defendant, in the Superior Court of the State of California for the County of San Luis Obispo. These lawsuits were consolidated into one action for all purposes on March 14, 2005. This suit claims that certain of these officers and directors breached their fiduciary duties to our stockholders and to us. The complaint is derivative in nature and does not seek relief from us. The Board of Directors appointed an independent committee to investigate the claims asserted in this derivative lawsuit. On July 19, 2005, the court granted our motion to dismiss these consolidated actions in favor of a shareholder derivative action to be filed by plaintiffs in the Circuit Court of the State of Oregon for the County of Washington. On August 25, 2005, the California plaintiffs filed two new derivative lawsuits in the United States District Court for the District of Oregon. On October 17, 2005, the defendants filed a motion to dismiss these complaints for lack of subject matter jurisdiction and failure to state a claim. In May of 2006, the Board committee, after completing its investigation, concluded that pursuit of the allegations would not be in the best interests of Digimarc or its stockholders. On August 24, 2006, the court granted the defendants' motion and dismissed the lawsuit with prejudice. Plaintiffs filed a notice of appeal on September 22, 2006. The briefs to the Ninth Circuit were completed in June 2007, and we anticipate oral argument and a decision in 2008. However, due to the inherent uncertainties of litigation, we cannot accurately predict the ultimate timing or outcome of the matter.

On or about April 6, 2005, another purported shareholder derivative lawsuit was filed against certain of our officers and directors, and also naming us as a nominal defendant, in the Circuit Court for the State of Oregon for the County of Washington containing similar allegations to the complaints discussed above. That case was stayed pending the report of the Board committee referenced above, and was ultimately dismissed following the Board committee's investigation.

Beginning in May 2001, a number of substantially identical class action complaints alleging violations of the federal securities laws were filed in the United States District Court for the Southern District of New York naming approximately 300 companies, including Digimarc, and their officers and directors and underwriters as defendants in connection with the initial public offerings of these companies. The plaintiffs allege that the defendants fraudulently inflated the share prices of these companies during and after their initial public offerings through an elaborate scheme characterized by tie-in agreements, undisclosed compensation and analyst conflicts. The plaintiffs also allege that the underwriter defendants required some substantial investors who requested allocations in the initial public offerings to participate in the scheme. Some of our officers and directors are named in the amended complaint pursuant to Section 11 of the Securities Act of 1933 and Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 on the basis of an alleged failure to disclose the underwriters' alleged compensation arrangements and manipulative practices. The complaint seeks unspecified damages. The individual officer and director defendants entered into tolling agreements and, pursuant to a court order dated October 9, 2002, were dismissed from the litigation without prejudice. The plaintiffs have continued to litigate their claims primarily against the underwriter defendants. The district court directed that the litigation proceed within a number of "focus cases" rather than in all of the 309 cases that have now been consolidated. We are not one of these focus cases. On December 5, 2006, the Court of Appeals for the Second Circuit reversed the district court's class certification decision for the six focus cases. In response to that ruling, the plaintiffs amended their master allegations and the focus case complaints, and the defendants moved to dismiss those amended complaints. The court issued an opinion and order on March 26, 2008, essentially denying the motion to dismiss and allowing the case to continue. The cases are currently in settlement discussions. Due to the inherent uncertainties of litigation, we cannot accurately predict the ultimate outcome of the matter.

On October 10, 2007, a Digimarc stockholder filed a lawsuit in the United States District Court for the Western District of Washington against several companies that acted as lead underwriters for the Digimarc initial public offering. The complaint names Digimarc as a nominal defendant, and asserts claims against the underwriters under Section 16(b) of the Securities Exchange Act of 1934 for recovery of alleged short-swing profits on trades of Digimarc stock. On February 28, 2008, an amended complaint was filed, with Digimarc still named only as a nominal defendant. Similar complaints have been filed by this same plaintiff against a number of other issuers in connection with their initial public offerings, and the factual allegations are closely related to the allegations in the litigation pending in the United States District Court for the Southern District of New York which is described above in this Form 10-Q.

Item 1A. Risk Factors

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

(1) Failure to complete the tender offer by, and the merger with, L-1 could negatively affect our stock price and our future businesses and financial results.

Completion of the tender offer is subject to a minimum tender condition and completion of the spin-off to Digimarc's stockholders or the trust transfer for the benefit of Digimarc's stockholders, and completion of the merger is subject to a number of closing conditions, including obtaining requisite stockholder approvals, if required by law, and completion of the spin-off. Digimarc and L-1 may be unable to satisfy such conditions on a timely basis or at all. If the tender offer and merger are not completed, the price of our common stock may decline and our ongoing businesses may be adversely affected. If we fail to complete and realize any benefits from the merger, we will be subject to a number of risks, including the following:

- we may be required to pay a termination fee of $10.9 million if the merger is terminated under certain circumstances, plus reimbursement of fees and expenses of up to $6.0 million, and if any of these fees and expenses were to be paid we would experience a material negative impact on our financial condition and results of operations;

- we will be required to pay our costs relating to the tender offer and merger, such as legal, accounting, financial advisor and printing fees, whether or not the tender offer and merger are completed, which could be significant; and

- matters relating to the tender offer, merger and spin-off (including integration planning) may require substantial commitments of time and resources by our management, which could otherwise have been devoted to other opportunities that may have been beneficial to us.

We could also be subject to litigation related to any failure to complete the tender offer, merger and spin-off. If the tender offer, merger and spin-off are not completed, these risks may materialize and may adversely affect our financial results, stock price and ongoing businesses.

(2) Our obligation to pay a termination fee under certain circumstances and the restrictions on our ability to solicit other acquisition proposals may discourage other companies from trying to acquire Digimarc.

Until the shares are first accepted for payment by L-1 pursuant to the tender offer, or the merger agreement is terminated, with limited exceptions, the merger agreement prohibits us from entering into or soliciting any acquisition proposal or offer for a merger or other business combination with a party other than L-1. In addition, we have agreed to pay L-1 a termination fee of $10.9 million and/or fees and expenses incurred in connection with the tender offer, the merger agreement and performance under the merger agreement of up to $6.0 million under specified circumstances. These provisions could discourage other parties from trying to acquire Digimarc for a higher price.

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

Except for the year 2003, we have incurred significant net losses from inception. Our accumulated deficit as of June 30, 2008 was $103.4 million. In the second half of 2005 and continuing through 2006, we restructured our operations to improve productivity and reduce fixed costs. During the second quarter of 2006, we accelerated those activities significantly, resulting in a reduction of our workforce by nearly 20%. Overall, our workforce has been reduced by 30% since mid 2005. These actions resulted in an increase in earnings to a near break even level in the second half of 2006. However, in order to achieve sustained profitability, we will need to generate higher revenue than we have in prior years while controlling expenditures. Achieving sustained profitability will depend upon a variety of factors, including the impact of financial accounting mandates requiring us to expense stock options, as well as the extent to which we may be required to increase the size of our workforce in order to execute our business strategy and capitalize on new opportunities. In addition, we evaluate our strategy and market opportunities on an ongoing basis and will adjust our approach to market conditions that prevail from time to time. Finally, various adverse developments including the loss of large contracts or cost overruns on our existing contracts could have a negative impact on our revenue or our margins. Accordingly, increases in our expenses may not be offset by revenue increases and as a result we may not be able to achieve or sustain profitability.

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

Contracts between government agencies and Digimarc have varying durations, generally five or more years in length. Some contracts we enter into contain termination for convenience provisions. In addition, as a contract nears expiration, generally the government agency begins a competitive procurement process. We anticipate that several of our significant customers will award new contracts through such a competitive procurement process during the coming quarters. If we were to lose a contract due to termination for convenience or in a competitive procurement situation, then, in addition to the loss of revenue and margin on a prospective basis, we could also incur impairment of capital and/or intangible assets related to the customer, which could adversely affect our financial results.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

In the competitive environment in which we operate, product generation, development and marketing processes relating to technology are uncertain and complex, requiring accurate prediction of demand as well as successful management of various development risks inherent in technology development. In light of these dependencies, it is possible that failure to successfully manage future changes in technology with respect to our technology could have a long-term impact on our growth and results of operations.

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

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

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

Due to the high level of technical expertise that our industry requires, our ability to successfully develop, market, sell, license and support our products, services, and intellectual property depends to a significant degree upon the continued contributions of our key personnel in engineering, sales, marketing, operations, legal and licensing, many of whom would be difficult to replace. Similarly, without the continued contributions of our key finance personnel, we believe that our ability to meet our reporting obligations and operate successfully as a public company may be limited. We believe our future success will depend in large part upon our ability to retain our current key employees and our ability to attract, integrate and retain such personnel in the future. It may not be practical for us to match the compensation certain of our employees could garner at other employment. In addition, we may encounter difficulties in hiring and retaining employees because of concerns related to our financial performance. In addition, these circumstances may have a negative effect on the market price of our common stock, and employees and prospective employees may factor in the uncertainties relating to our stability and the value of any equity-based incentives in their decisions regarding employment opportunities and decide to leave our employ. In addition, our business is based in part on patented technology, which is unique and not generally known. New employees require substantial training, involving significant resources and management attention. Competition for experienced personnel in our business can be intense. If we do not succeed in attracting new, qualified personnel or in integrating, retaining and motivating our current personnel, our growth and ability to deliver products and services that our customers require may be hampered. Although our employees generally have executed agreements containing non-competition clauses, there is no assurance that a court would enforce all of the terms of these clauses or the clauses generally. If these clauses were not fully enforced, our employees could be able to freely join our competitors. Although we generally attempt to control access to and distribution of our proprietary information by our employees, there are no assurances that the confidential nature of our proprietary information will be maintained in the course of such future employment. Any of these events could have a material adverse effect on our financial and business prospects.

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

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

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

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

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

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

continue to develop our technical expertise; and

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

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

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

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

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

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

(12) We expect our secure ID systems business to experience variability in gross margins.

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

delays in project implementation;

failure to achieve add-on sales to existing customers;

- governmental regulation of credentials and issuance policies;
- private sector usage trends for driver licenses and other credentials;
- level of commodity vs. proprietary components applicable to customer system specifications;
- whether contracts have been extended or renewed, and the amount of capital expenditure associated with such extension or renewal;
- price competition in competitive bids, contract renewals and contract extensions;
- variations in costs of materials and manufacturing;
- varying levels of efficiency of our workforce in delivering, implementing, and servicing contracts;
- seasonality of issuance volumes;
- sales mix related to card issuance revenues compared to product sales;
- sales mix related to domestic sales compared to international sales;
- sales mix related to adoption of new products compared to sales of current products;
- strategic decisions on new business;
- depreciation and amortization of capitalized project costs related to new or upgraded programs; and
- variability in the extent to which we are able to allocate personnel expenses to capital projects and thereby amortize such costs over the life of the relevant contract, rather than expensing such costs in the quarter in which they are incurred.

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

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

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

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

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

- changes in foreign government regulations and security requirements;
- export license requirements, tariffs and taxes;
- trade barriers;
- difficulty in protecting intellectual property;
- difficulty in collecting accounts receivable;
- currency fluctuations;
- longer payment cycles than those for customers in the U.S.;
- difficulty in managing foreign operations; and
- political and economic instability.

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

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

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

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

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

Our contracts for driver license and other identification issuance systems and related products typically include provisions imposing (i) development, delivery and installation schedules and milestones, (ii) customer acceptance and testing requirements and (iii) other performance requirements. Such provisions are common in large scale government contracts at the state and federal levels. To the extent these provisions involve performance over extended periods of time, there may be increased risk of noncompliance. From time to time we have experienced delays in identification system implementation, timely acceptance for identification systems programs, concerns regarding identification system program performance and other contractual disputes. Customers have asserted from time to time, and may in the future assert, claims for compensatory or liquidated damages, or breach of contract, or other claims alleging that we have failed to meet timing or delivery requirements and milestones pursuant to the terms of such contracts. Consequently, our failure to meet contractual milestones or other performance requirements as promised, or to successfully resolve customer disputes, could result in our having to 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. Such unexpected increases in costs to meet our contractual obligations or any other requirements necessary to address claims and damages with regard to our customer contracts could have a material adverse effect on our business and financial results. We anticipate that future contracts will continue to have such provisions unless and until industry practices change.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

We have invested significant time and resources in product development activities for new secure identification markets, including designing and developing numerous enhancements to our driver license systems and improving our cards' ability to withstand intrusions or alterations without detection. If we do not experience a timely, positive reaction from issuing authorities to our new offerings, our projected revenues, margins and earnings may be negatively impacted.

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

We currently are engaged in litigation relating to the initial public offering of our securities, in addition to the actions filed against us in connection with our previously announced accounting errors. These matters are discussed in greater detail in Part II, Item 1 (Legal Proceedings) of this Quarterly Report on Form 10-Q and in Note 11 (Commitments and Contingencies) of the Notes to Consolidated Financial Statements included in this Quarterly Report on Form 10-Q. We have incurred significant costs relating to these matters. Due to the inherent uncertainties of such litigation, the ultimate cost and outcome cannot be predicted.

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

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

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

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

(26) If a judgment were to be entered against us and certain of our officers and directors and our director and officer liability insurance is inadequate or unavailable, the obligation to pay the judgment may materially harm our business and financial condition.

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

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

The following table sets forth information regarding purchases of our equity securities during the three-months ended June 30, 2008, all of which were shares subject to restricted stock awards that we purchased to cover applicable tax withholding obligations when these awards vested.

Period	(a) Total number of shares (or units) purchased	(b) Average price paid per share (or unit)	(c) Total number of shares (or units) purchased as part of publicly announced plans or programs	(d) Maximum number (or approximate dollar value) of shares (or units) that may yet be purchased under the plans or programs
Month 1				
April 1, 2008 to April 30, 2008	38	$ 10.03		
Month 2				
May 1, 2008 to May 31, 2008				
Month 3				
June 1, 2008 to June 30, 2008	84	$ 13.29		
Total	122	$ 12.27		

Item 4. Submission of Matters to a Vote of Security Holders.

We held our annual meeting of stockholders on May 1, 2008. Two proposals were voted on by our stockholders.

Proposal 1: Election of Three Class III Directors

Bruce Davis, Brian J. Grossi and James T. Richardson were elected as Class III directors for a term of 3 years. The voting for each director was as follows:

	For	Withheld
Bruce Davis	16,215,489	494,453
Brian J. Grossi	16,028,264	681,678
James T. Richardson	16,222,564	487,378

The Company's Class I and II directors did not stand for reelection at the annual meeting. The terms of the Company's Class II directors, William J. Miller, Jim Roth and Lloyd G. "Buzz" Waterhouse will continue until the 2009 annual meeting of stockholders. The terms of the Company's Class II directors, Philip J. Monego, Sr., Peter W. Smith and Bernard Whitney, will continue until the 2010 annual meeting of stockholders.

Proposal 2: Ratification of the Appointment of Grant Thornton LLP as the Company's Independent Certified Public Accountants

Grant Thornton was ratified as our independent certified public accountants for the fiscal year ending December 31, 2008 with 15,888,856 votes in favor, 806,240 votes against and 14,845 abstentions.

Item 6. Exhibits.

See attached exhibit index.

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: August 1, 2008	DIGIMARC CORPORATION
	By: /s/ MICHAEL MCCONNELL
	Michael McConnell *Chief Financial Officer and Treasurer* *(Duly Authorized Officer* *and Principal Financial Officer)*

EXHIBIT INDEX-*

Exhibit Number	Document
2.1	Amended and Restated Agreement and Plan of Merger, dated June 29, 2008, by and among Digimarc Corporation, L-1 Identity Solutions, Inc. and Dolomite Acquisition Co. (incorporated by reference to Exhibit 2.1 to Digimarc's Report on Form 8-K, as filed with the Securities and Exchange Commission on July 3, 2008)
2.2	Amendment No. 1 to the Amended and Restated Agreement and Plan of Merger, dated July 17, 2008, by and among Digimarc Corporation, L-1 Identity Solutions, Inc. and Dolomite Acquisition Co. (incorporated by reference to Exhibit 2.1 to Digimarc's Report on Form 8-K, as filed with the Securities and Exchange Commission on July 17, 2008)
3.1	Second Amended and Restated Certificate of Incorporation of the Registrant, as amended (incorporated by reference to Exhibit 3.1 of Exhibits to the Digimarc's Annual Report on Form 10-K, as filed with the Securities and Exchange Commission on March 13, 2006)
3.2	Amended and Restated Bylaws of the Registrant (incorporated by reference to Exhibit 3.3 of Exhibits to Digimarc's Quarterly Report on Form 10-Q, as filed with the Securities and Exchange Commission on August 9, 2005)
31.1	Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer
31.2	Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer
32.1	Section 1350 Certification of Chief Executive Officer
32.2	Section 1350 Certification of Chief Financial Officer

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