DIGIMARC CORP
Form 10-Q
November 07, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

(Mark One)

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

For the quarterly period ended September 30, 2006

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	**94-3342784**
(State or other jurisdiction of incorporation or organization)	(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 x 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 x Non-accelerated filer 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 x

As of October 31, 2006, there were 21,194,371 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
CONDENSED CONSOLIDATED BALANCE SHEETS
(DOLLARS IN THOUSANDS)
(UNAUDITED)

	September 30, 2006	December 31, 2005(1)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 20,251	$ 23,964
Short-term investments	1,001	739
Trade accounts receivable, net	8,078	9,469
Unbilled trade receivables	6,894	6,228
Inventory, net	6,016	7,451
Other current assets	2,063	2,828
Total current assets	44,303	50,679
Restricted cash	9,938	7,279
Property and equipment, net	61,662	64,108
Intangibles, net	15,853	17,164
Other assets, net	908	1,009
Total assets	$ 132,664	$ 140,239
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 4,795	$ 6,722
Accrued payroll and related costs	4,095	3,731
Deferred revenue	9,155	6,809
Other current liabilities	1,853	2,032
Total current liabilities	19,898	19,294
Other long-term liabilities	1,014	969
Total liabilities	20,912	20,263
Commitments and contingencies (Note 5)		
Stockholders equity:		
Common stock (21,190,545 and 20,808,994 shares issued and outstanding at September 30, 2006 and December 31, 2005, respectively)	22	21
Additional paid-in capital	210,421	209,337
Deferred stock compensation		(1,519)
Accumulated other comprehensive income	137	137
Accumulated deficit	(98,828)	(88,000)
Total stockholders equity	111,752	119,976
Total liabilities and stockholders equity	$ 132,664	$ 140,239

(1) Derived from the Company s December 31, 2005 audited consolidated financial statements

See Notes to Unaudited Condensed Consolidated Financial Statements.

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DIGIMARC CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(IN THOUSANDS, EXCEPT PER SHARE DATA)
(UNAUDITED)

	Three Months Ended September 30, 2006	2005	Nine Months Ended September 30, 2006	2005
Revenue:				
Service	$ 22,414	$ 22,372	$ 65,223	$ 63,584
Product and subscription	4,319	4,409	13,610	12,329
Total revenue	26,733	26,781	78,833	75,913
Cost of revenue:				
Service	15,138	15,253	47,239	44,448
Product and subscription	1,581	1,790	5,805	5,232
Total cost of revenue	16,719	17,043	53,044	49,680
Gross profit	10,014	9,738	25,789	26,233
Operating expenses:				
Sales and marketing	3,440	4,295	12,664	11,961
Research, development and engineering	2,158	3,199	8,388	9,535
General and administrative	3,684	4,852	13,066	15,870
Amortization of intangibles	537	1,147	1,660	3,297
Intellectual property	460	528	1,372	1,531
Restructuring charges, net			547	
Total operating expenses	10,279	14,021	37,697	42,194
Operating income (loss)	(265)	(4,283)	(11,908)	(15,961)
Other income (expense):				
Interest income	342	262	1,008	799
Interest expense	(29)	(15)	(73)	(135)
Other	223	(33)	266	31
Total other income, net	536	214	1,201	695
Income (loss) before provision for income taxes	271	(4,069)	(10,707)	(15,266)
Provision for income taxes	(58)	(159)	(121)	(299)
Net income (loss)	$ 213	$ (4,228)	$ (10,828)	$ (15,565)
Net income (loss) per share basic	$ 0.01	$ (0.21)	$ (0.52)	$ (0.76)
Net income (loss) per share diluted	$ 0.01	$ (0.21)	$ (0.52)	$ (0.76)
Weighted average shares outstanding basic	20,670	20,497	20,635	20,473
Weighted average shares outstanding diluted	21,470	20,497	20,635	20,473

See Notes to Unaudited Condensed Consolidated Financial Statements.

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DIGIMARC CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(IN THOUSANDS)
(UNAUDITED)

	Nine Months Ended September 30, 2006	September 30, 2005
Cash flows from operating activities:		
Net loss	$ (10,828)	$ (15,565)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	11,595	13,978
Stock-based compensation expense	2,283	355
Increase (decrease) in allowance for doubtful accounts	(173)	(10)
Other non-cash charges	(286)	(11)
Changes in operating assets and liabilities:		
Restricted cash	(2,659)	993
Trade and unbilled accounts receivable	898	(1,152)
Inventory, net	1,435	319
Other current assets	765	(830)
Other assets, net	101	82
Accounts payable	(1,927)	(4,856)
Accrued payroll and related costs	364	1,846
Deferred revenue	2,346	(257)
Other liabilities	(236)	497
Net cash provided by (used in) operating activities	3,678	(4,611)
Cash flows from investing activities:		
Purchase of property and equipment and capitalized labor costs	(6,940)	(12,639)
Purchase of intangibles	(30)	(20)
Sale or maturity of short-term investments	92,350	133,247
Purchase of short-term investments	(92,612)	(114,484)
Net cash provided by (used in) investing activities	(7,232)	6,104
Cash flows from financing activities:		
Net proceeds from issuance of common stock	321	211
Principal payments under capital lease obligations	(480)	(351)
Net cash provided by (used in) financing activities	(159)	(140)
Net increase (decrease) in cash and cash equivalents	(3,713)	1,353
Cash and cash equivalents at beginning of period	23,964	18,489
Cash and cash equivalents at end of period	$ 20,251	$ 19,842
Supplemental disclosure of cash flow information:		
Cash paid for interest	$ 73	$ 135
Cash paid for income taxes	$ 134	$ 139
Summary of non-cash investing and financing activities:		
Equipment acquired or exchanged under capital lease obligations	$ 582	$ 135
Grant of restricted stock	$ 1,202	$ 2,025

See Notes to Unaudited Condensed Consolidated Financial Statements.

DIGIMARC CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA)
(UNAUDITED)

1. The Company, Basis of Presentation

Description of Business

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

The Company issues more than 60 million identification documents (IDs) annually and is the leading supplier of government-issued citizen IDs in the United States (U.S.), producing more than two-thirds of all driver licenses issued in the U.S. Digimarc also is a pioneer and leading owner of intellectual property in a signal processing technology innovation known as digital watermarking , which allows imperceptible digital information to be embedded in all forms of digitally designed, produced or distributed media content, including personal identification documents, financial instruments, photographs, movies, music and product packages. The embedded data within various types of media content can be detected and read by software or hardware detectors in personal computers and other digital devices. The Company provides solutions based on this technology directly and through the Company s licensees.

As of September 30, 2006, the Company held rights in 286 issued U.S. patents and over 66 issued foreign patents on this technology and related technologies, applications, systems, and processes and had more than 500 U.S. and foreign applications pending.

Digimarc s solutions and technologies are deployed by the Company and its business partners in media objects and digital devices around the world.

The substantial majority of the Company s revenue is generated pursuant to long-term contracts with government agencies primarily U.S. state government agencies responsible for driver license issuance (State driver license issuers), a consortium of leading Central Banks and national governments of a number of foreign countries. These systems rely on the Company s 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.

The remainder of the Company s revenue is generated primarily from patent and technology license fees paid by business partners providing media and rights management solutions to movie studios and music labels, television and radio broadcasters, creative professionals and other customers around the world. Private sector media and entertainment industry customers use secure media management solutions from the Company and its business partners 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 PCs and mobile devices.

Interim Financial Statements

The condensed consolidated financial statements include the accounts of Digimarc and its wholly-owned subsidiaries. All significant inter-company transactions and balances have been eliminated. The condensed 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 U.S. have been condensed or omitted under the rules and regulations of the Securities and Exchange Commission (the SEC).

These condensed 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, 2005, which was filed with the SEC on March 13, 2006. The results of operations for the interim periods presented in these condensed consolidated financial statements are not necessarily indicative of the results for the full year.

Use of Estimates

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

Through December 31, 2005 the Company depreciated program fixed assets that were specifically used to provide services under long term contracts over the shorter of the original contract term or estimated useful life. Starting January 1, 2006, the Company changed its useful lives for depreciating these assets to the shorter of the original contract term plus 2.75 years or estimated useful life. This change in estimate was supported by analysis completed by the Company during the first quarter of 2006 that showed that historically 95% of contracts were extended beyond the original contract term, that the average contract had at least two contract extensions during its life and that these extensions added on average 2.75 years to the length of the contracts original terms. Since contract-specific program assets are tracked on a contract basis, the findings that the contract life is routinely significantly longer than the original contract term and that these extensions are not generally accompanied by significant incremental capital investment indicates that the contract-related asset s useful life was longer than the original term of the contract. Given the findings of the analysis, Digimarc concluded that it was appropriate to change the estimated useful lives so that contract specific assets were being depreciated over the Company s estimate of the useful life of these assets. In addition, the change in useful lives would conservatively achieve a better matching of the utility of these assets with the resulting revenues. Based on the analysis, this change would have the effect of reducing depreciation expense by $1,862 and $6,103 for the three- and nine-month periods ended September 30, 2006, respectively, for assets in service at December 31, 2005. This reduction in depreciation would increase basic and diluted earnings by $0.09 and $0.30 for the three- and nine-month periods ended September 30, 2006, respectively, per share before taxes. Given that the depreciation expense attributed to contract-specific assets is part of cost of revenue, the decrease in depreciation expense will cause gross margins to increase by the amount of the reduction in depreciation expense.

Reclassifications

Certain amounts in the 2005 consolidated financial statements and notes thereon have been reclassified to conform to current year presentation. These reclassifications had no material effect on the results of operations or financial position for any year presented.

Specifically, certain costs were reclassified from general and administrative to cost of revenue, sales and marketing, research, development and engineering and intellectual property as shown on the condensed consolidated statement of operations. The intellectual property category includes costs associated with documenting, applying for, and maintaining patents generated through the Company s research and development efforts. The infrastructure category includes rent, leasehold improvements amortization, insurance expense and infrastructure depreciation. The centralized cost category includes centralized departments that serve all operations such as the Company s information technology department. The methods employed were based on headcount, square footage or a combination of both as appropriate.

Three-months ended September 30, 2005:	**Before**	**Intellectual Property**	**Infrastructure**	**Centralized Cost**	**After**
Cost of revenue service	$ 14,704	$	$ 131	$ 418	$ 15,253
Total cost of revenue	16,494		131	418	17,043
Gross profit	10,287		(131)	(418)	9,738
Sales and marketing	4,291	(264)	109	159	4,295
Research, development and engineering	2,898	(308)	222	387	3,199
General and administrative	6,234	44	(462)	(964)	4,852
Amortization of intangibles	1,147				1,147
Intellectual property		528			528
Total operating expenses	14,570		(131)	(418)	14,021

Nine-months ended September 30, 2005:	**Before**	**Intellectual Property**	**Infrastructure**	**Centralized Cost**	**After**
Cost of revenue service	$ 42,722	$	$ 413	$ 1,313	$ 44,448
Total cost of revenue	47,954		413	1,313	49,680
Gross profit	27,959		(413)	(1,313)	26,233
Sales and marketing	12,004	(862)	317	502	11,961
Research, development and engineering	8,382	(748)	683	1,218	9,535
General and administrative	20,237	79	(1,413)	(3,033)	15,870
Amortization of intangibles	3,297				