Digimarc CORP
Form 10-Q
July 26, 2013
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2013

OR

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

For the transition period from to

Commission File Number: 001-34108

DIGIMARC CORPORATION

(Exact name of registrant as specified in its charter)

Oregon	**26-2828185**
(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 ¨

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

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

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

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

As of July 22, 2013, there were 7,263,484 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 and per share data)

(UNAUDITED)

	June 30, 2013	December 31, 2012
ASSETS		
Current assets:		
Cash and cash equivalents	$ 8,305	$ 6,866
Marketable securities	26,192	25,403
Trade accounts receivable, net	4,519	4,216
Other current assets	1,306	1,016
Total current assets	40,322	37,501
Marketable securities	7,584	6,787
Property and equipment, net	1,408	1,453
Intangibles, net	6,689	6,721
Goodwill	1,114	1,114
Deferred tax assets, net	2,188	3,589
Other assets	212	166
Total assets	$ 59,517	$ 57,331
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable and other accrued liabilities	$ 1,405	$ 1,143
Deferred revenue	3,155	2,512
Total current liabilities	4,560	3,655
Deferred rent and other long-term liabilities	491	673
Total liabilities	5,051	4,328
Commitments and contingencies (Note 13)		
Shareholders equity:		
Preferred stock (par value $0.001 per share, 2,500,000 authorized, 10,000 shares issued and outstanding at June 30, 2013 and December 31, 2012)	50	50
Common stock (par value $0.001 per share, 50,000,000 authorized, 7,264,864 and 7,168,359 shares issued and outstanding at June 30, 2013 and December 31, 2012, respectively)	7	7
Additional paid-in capital	41,360	39,869
Retained earnings	13,049	13,077
Total shareholders equity	54,466	53,003
Total liabilities and shareholders equity	$ 59,517	$ 57,331

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

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DIGIMARC CORPORATION

CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share data)

(UNAUDITED)

	Three Months Ended June 30, 2013	Three Months Ended June 30, 2012	Six Months Ended June 30, 2013	Six Months Ended June 30, 2012
Revenue:				
Service	$ 3,022	$ 2,609	$ 5,951	$ 5,657
Subscription	1,433	317	2,817	595
License	6,015	6,186	11,945	19,906
Total revenue	10,470	9,112	20,713	26,158
Cost of revenue:				
Service	1,432	1,485	2,835	3,182
Subscription	588	45	1,223	92
License	100	53	196	119
Total cost of revenue	2,120	1,583	4,254	3,393
Gross profit	8,350	7,529	16,459	22,765
Operating expenses:				
Sales and marketing	1,563	970	2,840	1,977
Research, development and engineering	2,822	2,146	5,547	4,144
General and administrative	2,348	2,191	4,534	4,949
Intellectual property	261	291	538	610
Total operating expenses	6,994	5,598	13,459	11,680
Operating income	1,356	1,931	3,000	11,085
Net loss from joint ventures				(1,107)
Other income, net	19	33	48	91
Income before income taxes	1,375	1,964	3,048	10,069
Provision for income taxes	(773)	(748)	(1,475)	(3,854)
Net income	$ 602	$ 1,216	$ 1,573	$ 6,215
Earnings per common share:				
Earnings per common share basic	$ 0.08	$ 0.17	$ 0.22	$ 0.88
Earnings per common share diluted	$ 0.08	$ 0.17	$ 0.21	$ 0.84
Weighted average common shares outstanding basic	6,850	6,737	6,844	6,738
Weighted average common shares outstanding diluted	7,090	6,993	7,078	6,999
Cash dividends declared per common share	$ 0.11	$ 0.11	$ 0.22	$ 0.11

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

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DIGIMARC CORPORATION

CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY

(In thousands, except share data)

(UNAUDITED)

	Preferred Stock		Common Stock		Additional Paid-in	Retained	Total Shareholders
	Shares	Amount	Shares	Amount	Capital	Earnings	Equity
BALANCE AT DECEMBER 31, 2011	10,000	$ 50	7,008,031	$ 7	$ 34,511	$ 7,149	$ 41,717
Exercise of stock options			62,500		603		603
Issuance of restricted common stock			129,220				
Forfeiture of restricted common stock			(6,360)				
Purchase and retirement of common stock			(85,019)		(2,187)		(2,187)
Stock-based compensation					2,857		2,857
Tax benefit from stock-based awards					1,538		1,538
Net income						6,215	6,215
Cash dividends declared						(779)	(779)
BALANCE AT JUNE 30, 2012	10,000	$ 50	7,108,372	$ 7	$ 37,322	$ 12,585	$ 49,964
BALANCE AT DECEMBER 31, 2012	10,000	$ 50	7,168,359	$ 7	$ 39,869	$ 13,077	$ 53,003
Exercise of stock options			7,684				
Issuance of restricted common stock			184,390				
Forfeiture of restricted common stock			(61,855)				
Purchase and retirement of common stock			(33,714)		(742)		(742)
Stock-based compensation					2,233		2,233
Tax benefit from stock-based awards							
Net income						1,573	1,573
Cash dividends declared						(1,601)	(1,601)
BALANCE AT JUNE 30, 2013	10,000	$ 50	7,264,864	$ 7	$ 41,360	$ 13,049	$ 54,466

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

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DIGIMARC CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(UNAUDITED)

	Six Months Ended June 30, 2013	Six Months Ended June 30, 2012
Cash flows from operating activities:		
Net income	$ 1,573	$ 6,215
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization of property and equipment	320	292
Amortization and write-off of intangibles	602	154
Gain on reversal of contingent merger consideration	(190)	
Stock-based compensation	2,169	2,757
Net loss from joint ventures		1,107
Deferred income taxes	1,406	62
Tax benefit from stock-based awards		1,893
Excess tax benefit from stock-based awards		(1,538)
Changes in operating assets and liabilities:		
Trade accounts receivable, net	(303)	959
Other current assets	(271)	132
Other assets	(46)	141
Accounts payable and other accrued liabilities	228	(291)
Income taxes payable	24	1,014
Deferred revenue	637	(327)
Net cash provided by operating activities	6,149	12,570
Cash flows from investing activities:		
Purchase of property and equipment	(275)	(254)
Capitalized patent costs and purchased intellectual property	(506)	(657)
Investments in joint ventures, net		(692)
Sale or maturity of marketable securities	35,474	69,136
Purchase of marketable securities	(37,060)	(75,224)
Net cash used in investing activities	(2,367)	(7,691)
Cash flows from financing activities:		
Issuance of common stock		603
Purchase of common stock	(742)	(2,187)
Cash dividends paid	(1,601)	(779)
Excess tax benefit from stock-based awards		1,538
Net cash used in financing activities	(2,343)	(825)
Net increase in cash and cash equivalents	1,439	4,054
Cash and cash equivalents at beginning of period	6,866	3,419
Cash and cash equivalents at end of period	$ 8,305	$ 7,473

Supplemental disclosure of cash flow information:				
Cash paid for income taxes	$	46	$	842
Supplemental schedule of non-cash investing activities:				
Stock-based compensation capitalized to patent costs	$	64	$	50
Supplemental schedule of non-cash financing activities:				
Exercise of stock options	$	128	$	603

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

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DIGIMARC CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except share and per share data)

(UNAUDITED)

1. Description of Business and Significant Accounting Policies

Description of Business

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

Interim Consolidated Financial Statements

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

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

These interim consolidated financial statements should be read in conjunction with the audited consolidated financial statements included in the Company s Annual Report on Form 10-K for the year ended December 31, 2012, which was filed with the SEC on February 22, 2013. The results of operations for the interim periods presented in these consolidated financial statements are not necessarily indicative of the results for the full year.

Reclassifications

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

Goodwill

The Company reviews for impairment in June of each year to determine if events or changes in business conditions indicate that the carrying value of goodwill may not be recoverable. Such reviews assess the fair value of the assets compared to the carrying values.

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

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

2. Fair Value of Financial Instruments

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

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

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

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

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

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

June 30, 2013	Level 1	Level 2	Level 3	Total
Money market securities	$ 6,047	$	$	$ 6,047
Certificates of deposits		492		492
U.S. federal agency notes		333		333
Pre-refunded and other municipal bonds (1)		31,858		31,858
Corporate notes		2,838		2,838
Total	$ 6,047	$ 35,521	$	$ 41,568

December 31, 2012	Level 1	Level 2	Level 3	Total
Money market securities	$ 901	$	$	$ 901
Certificates of deposits		491		491
U.S. treasuries		289		289
U.S. federal agency notes		1,637		1,637
Pre-refunded and other municipal bonds (1)		22,036		22,036
Corporate notes		10,100		10,100
Commercial paper		2,614		2,614
Total	$ 901	$ 37,167	$	$ 38,068

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

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

		Maturities by Period			
	Total	Less than 1 year	1-5 years	5-10 years	More than 10 years
Cash equivalents and marketable securities	$ 41,568	$ 33,984	$ 7,584	$	$

The Company considers all highly liquid marketable securities with original maturities of 90 days or less at the date of acquisition to be cash equivalents. Cash equivalents include money market funds, certificates of deposit, commercial paper, and pre-refunded municipal bonds totaling $7,792 and $5,878 at June 30, 2013 and December 31, 2012, respectively. Cash equivalents are carried at cost or amortized cost, which approximates fair value, due to their short maturities.

3. Acquisition of Attributor Corporation (Attributor)

The Company accounted for the acquisition of Attributor in December 2012 using the acquisition method of accounting. Under the acquisition method of accounting, the total purchase price was allocated to the tangible and identifiable intangible assets acquired and liabilities assumed based on their estimated fair values. The purchase price was allocated using the information currently available, and Digimarc may adjust the preliminary purchase price allocation after obtaining more information. The final purchase price allocation is pending the completion of the Company s review of the acquired tax assets and liabilities, which is expected to be completed by the end of the third quarter of 2013.

The Company recorded a $190 liability in the preliminary purchase price allocation reflecting the estimated fair value of the contingent merger consideration on the acquisition date, which was presented in deferred rent and other long-term liabilities at December 31, 2012. At March 31, 2013, the Company determined that the estimated fair value of the contingent merger consideration

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was $0 based on the Company s most recent projections and therefore reversed the liability. As of June 30, 2013, the Company continued to believe the estimated fair value of the contingent merger consideration was $0. The reversal of the $190 liability is reflected as a reduction in general and administrative expense within the consolidated statements of operations for the six-month period ended June 30, 2013.

4. Revenue Recognition

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

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

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

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

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

(i) persuasive evidence of an arrangement exists,

(ii) delivery has occurred,

(iii) the fee is fixed or determinable, and

(iv) collection is reasonably assured.

Some customer arrangements encompass multiple deliverables, such as patent license, professional services, software subscriptions, and maintenance fees. For arrangements that include multiple deliverables, the Company identifies separate units of accounting at inception based on the consensus reached under ASC 605-25 *Multiple-Element Arrangements*, which provides that revenue arrangements with multiple deliverables should be divided into separate units of accounting if certain criteria are met. The consideration for the arrangement is allocated to the separate units of accounting using the relative selling price method.

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

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

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

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

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

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

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

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

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5. Segment Information

Geographic Information

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

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

	Three Months Ended June 30, 2013	Three Months Ended June 30, 2012	Six Months Ended June 30, 2013	Six Months Ended June 30, 2012
Domestic	$ 6,241	$ 5,522	$ 12,366	$ 19,093
International(1)	4,229	3,590	8,347	7,065
Total	$ 10,470	$ 9,112	$ 20,713	$ 26,158

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

Major Customers

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

	Three Months Ended June 30, 2013	Three Months Ended June 30, 2012	Six Months Ended June 30, 2013	Six Months Ended June 30, 2012
Intellectual Ventures	34%	35%	34%	25%
Central Banks	30%	30%	29%	21%
Verance Corporation (Verance)	*	12%	*	38%
The Nielsen Company (Nielsen)	*	11%	*	*

* Less than 10%

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

6. Stock-Based Compensation

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

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

Determining Fair Value

Preferred Stock

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

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

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Stock Options

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

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

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

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

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

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

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

Restricted Stock

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

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

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

Stock-based Compensation

	Three Months Ended June 30, 2013	Three Months Ended June 30, 2012	Six Months Ended June 30, 2013	Six Months Ended June 30, 2012
Stock-based compensation:				
Cost of revenue	$ 139	$ 154	$ 296	$ 338
Sales and marketing	83	137	195	233
Research, development and engineering	232	212	488	397
General and administrative	560	830	1,066	1,664
Intellectual property	63	68	124	125
Stock-based compensation expense	1,077	1,401	2,169	2,757
Capitalized to patent costs	31	23	64	50

Total stock-based compensation	$ 1,108	$ 1,424	$ 2,233	$ 2,807

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

	As of June 30, 2013	As of December 31, 2012
Unrecognized compensation costs	$ 8,937	$ 8,333

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

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

	Stock Options	Restricted Stock
Weighted average period	0.92 years	1.71 years

Stock Option Activity

As of June 30, 2013, under all of the Company s stock-based compensation plans, equity awards to purchase an additional 716,210 shares were authorized for future grants under the plans. The Company issues new shares upon option exercises.

The following table reconciles the outstanding balance of stock options:

Three- and six-months ended June 30, 2013:	Options	Weighted Average Exercise Price	Weighted Average Grant Date Fair Value	Aggregate Intrinsic Value
Outstanding at December 31, 2012	855,988	$ 15.16	$ 7.88	
Options granted				
Options exercised	(13,300)	$ 9.64	$ 6.30	
Options canceled or expired				
Outstanding at June 30, 2013	842,688	$ 15.24	$ 7.90	$ 6,176
Exercisable at June 30, 2013	724,739	$ 13.53		$ 6,083
Unvested at June 30, 2013	117,949	$ 25.81		$ 93

The aggregate intrinsic value is based on the closing price of $20.77 per share of Digimarc common stock on June 30, 2013, which would have been received by the optionees had all of the options with exercise prices less than $20.77 per share been exercised on that date. The following table summarizes information about stock options outstanding at June 30, 2013:

Range of Exercise Prices	Options Outstanding			Options Exercisable		
	Number Outstanding	Remaining Contractual	Weighted Average	Number Exercisable	Remaining Contractual	Weighted Average

		Life (Years)	Exercise Price		Life (Years)	Exercise Price
$9.64 - $9.91	494,772	5.37	$ 9.66	494,772	5.37	$ 9.66
$14.99 - $18.01	132,916	6.58	$ 15.67	116,876	6.59	$ 15.76
$24.35 - 30.01	215,000	8.08	$ 27.84	113,091	8.03	$ 28.14
$9.64 - $30.01	842,688	6.25	$ 15.24	724,739	5.98	$ 13.53

Restricted Stock Activity

The following table reconciles the unvested balance of restricted stock:

Three-months ended June 30, 2013:	**Number of Shares**	**Weighted Average Grant Date Fair Value**
Unvested balance, March 31, 2013	466,368	$ 21.75
Granted	13,060	$ 22.56
Vested	(12,775)	$ 22.52
Canceled	(59,230)	$ 19.26
Unvested balance, June 30, 2013	407,423	$ 22.11

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Six-months ended June 30, 2013:	Number of Shares	Weighted Average Grant Date Fair Value
Unvested balance, December 31, 2012	369,083	$ 21.72
Granted	184,390	$ 21.86
Vested	(84,195)	$ 21.89
Canceled	(61,855)	$ 19.32
Unvested balance, June 30, 2013	407,423	$ 22.11

7. Earnings Per Common Share

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

Basic earnings per common share excludes dilution and is calculated by dividing net earnings allocable to common shares by the weighted-average number of common shares outstanding for the period. Diluted earnings per common share is calculated by dividing net earnings allocable to common shares by the weighted-average number of common shares, as adjusted for the potential dilutive effect of non-participating securities outstanding as of the balance sheet date. The following table reconciles earnings per common share for the three- and six-month periods ended June 30, 2013:

	Three Months Ended June 30, 2013	Three Months Ended June 30, 2012	Six Months Ended June 30, 2013	Six Months Ended June 30, 2012
Basic EPS:				
Net income	$ 602	$ 1,216	$ 1,573	$ 6,215
Less: Net income allocable to participating securities	(34)	(61)	(88)	(313)
Net income allocable to common shares	$ 568	$ 1,155	$ 1,485	$ 5,902
Weighted average common shares outstanding basic (in thousands)	6,850	6,737	6,844	6,738
Basic earnings per common share	$ 0.08	$ 0.17	$ 0.22	$ 0.88

	Three Months Ended June 30, 2013	Three Months Ended June 30, 2012	Six Months Ended June 30, 2013	Six Months Ended June 30, 2012
Diluted EPS:				
Net income	$ 602	$ 1,216	$ 1,573	$ 6,215
Less: Net income allocable to participating securities	(34)	(61)	(88)	(313)
Net income allocable to common shares	$ 568	$ 1,155	$ 1,485	$ 5,902
Weighted average common shares outstanding basic (in thousands)	6,850	6,737	6,844	6,738
Dilutive effect of non-participating securities (in thousands)	240	256	234	261

Weighted average common shares outstanding dilutive (in thousands)	7,090	6,993	7,078	6,999
Diluted earnings per common share	$ 0.08	$ 0.17	$ 0.21	$ 0.84

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

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There were 175,000 common stock equivalents related to stock options that were anti-dilutive and excluded from diluted earnings per share calculations for the three- and six-month periods ended June, 30, 2012 as their exercise prices were higher than the average market price of the underlying common stock for the period.

8. Trade Accounts Receivable and Allowance for Doubtful Accounts

Trade Accounts Receivable

Trade accounts receivable are recorded at the invoiced amount.

	June 30, 2013	December 31, 2012
Trade accounts receivable	$ 4,522	$ 4,216
Allowance for doubtful accounts	(3)	
Trade accounts receivable, net	$ 4,519	$ 4,216
Unpaid deferred revenue included in trade accounts receivable	$ 1,963	$ 1,589

Allowance for doubtful accounts

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

Unpaid deferred revenue

The unpaid deferred revenue that is included in trade accounts receivable is billed in accordance with the provisions of the contracts with the Company s customers. Unpaid deferred revenue from the Company s cash-basis customers is not included in trade accounts receivable nor deferred revenue accounts.

Major customers

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

	June 30, 2013	December 31, 2012
Central Banks	40%	30%
Nielsen	22%	24%
Civolution	12%	14%

9. Property and Equipment

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

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

	June 30, 2013	December 31, 2012
Office furniture fixtures	$ 428	$ 420
Equipment	2,149	1,886
Leasehold improvements	1,087	1,083
Gross property and equipment	3,664	3,389
Less accumulated depreciation and amortization	(2,256)	(1,936)
Property and equipment, net	$ 1,408	$ 1,453

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10. Intangibles

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

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

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

	June 30, 2013	December 31, 2012
Capitalized patent costs	$ 4,543	$ 3,973
Intangible assets acquired:		
Purchased patents and intellectual property	250	250
Existing technology	1,560	1,560
Customer relationships	290	290
Backlog	760	760
Tradenames	290	290
Non-solicitation agreements	120	120
Gross intangible assets	7,813	7,243
Accumulated amortization	(1,124)	(522)
Intangibles, net	$ 6,689	$ 6,721

11. Joint Venture and Related Party Transactions

In March 2012, Digimarc and Nielsen decided to reduce the investments in their two joint ventures to minimal levels while assessing alternative approaches to achieving each of their goals in the emerging market opportunity of synchronized second screen television. In connection with this plan for the suspension of operations, the joint ventures accrued estimated expenses for the first quarter s operations and severance costs for joint venture employees. Digimarc s share of the one-time severance and suspension costs was approximately $500. Pursuant to the plan of suspending operations of the joint ventures with Nielsen, in April 2012 the Company received $104 of remaining cash from TVaura LLC and contributed $796 to TVaura Mobile LLC to fund both the first quarter s operating expenses as well as the suspension related costs. Payment of all expenses incurred after the suspension of operations of each joint venture is the responsibility of the majority member.

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

12. Income Taxes

The provision for income taxes for the three- and six-month periods ended June 30, 2013 reflect income taxes for federal and state jurisdictions reduced by available tax credit carry-forwards and tax credits claimed during the period. The effective tax rate for the period ended June 30, 2013 was 48%. The effective tax rate is higher than the statutory tax rate due to the impact of permanent items. The effective tax rate for the six-month period ended June 30, 2012 was 38%.

13. Commitments and Contingencies

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

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

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

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

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

14. Stock Repurchases

Summary of common stock shares repurchased:

	Three Months Ended June 30, 2013	Three Months Ended June 30, 2012	Six Months Ended June 30, 2013	Six Months Ended June 30, 2012
Repurchase program		19,940		27,547
Exercise of stock options	5,616	20,391	5,616	22,780
Tax withholding obligations on stock options	2,795	12,270	2,795	14,121
Tax withholding obligations on restricted shares	1,160	1,032	30,919	20,571
Total	9,571	53,633	39,330	85,019

Value of common stock shares repurchased:

	Three Months Ended June 30, 2013	Three Months Ended June 30, 2012	Six Months Ended June 30, 2013	Six Months Ended June 30, 2012
Repurchase program	$	$ 512	$	$ 711
Exercise of stock options	$ 128	$ 530	$ 128	$ 603
Tax withholding obligations on stock options	$ 65	$ 319	$ 65	$ 374
Tax withholding obligations on restricted shares	$ 28	$ 26	$ 677	$ 499
Total	$ 221	$ 1,387	$ 870	$ 2,187

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

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

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

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

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15. Subsequent Events

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

On July 25, 2013, the Board of Directors declared a quarterly dividend of $0.11 per share, payable on August 12, 2013 to shareholders of record on August 5, 2013.

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

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

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

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

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

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

Overview

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

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

- Quickly and reliably identify and effectively manage music, movies, television programming, digital images, e-books, documents and other printed materials, especially in light of new non-linear distribution over the Internet;
- Deter counterfeiting of money, media and goods, and piracy of e-books, movies and music;
- Support new digital media distribution models and methods to monetize media content;
- Leverage the power of ubiquitous computing to instantly link consumers to a wealth of information and/or interactive experiences related to the media and objects they encounter each day;
- Provide consumers with more choice and access to media content when, where and how they want it;
- Enhance imagery and video by associating metadata or authenticating media content for government and commercial uses; and

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

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

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

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

Our business has further expanded in e-commerce with our recent acquisition of Attributor Corporation (Attributor) the global leader in protecting e-books from online piracy. Attributor s software and services protect book revenue and authors rights by finding, reporting on, and assisting in removing pirated content found on the Internet. Online book piracy is a growing and global problem, and with emerging e-book standards and the growing popularity of iPads, Kindles and other e-readers, book piracy is expected to grow dramatically. Attributor is building a promising business in this high growth market, and possesses technical skills and market knowledge that complements our existing organization.

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

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

Critical Accounting Policies and Estimates

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

Results of Operations

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

	Three Months Ended June 30, 2013 (1)	Three Months Ended June 30, 2012 (1)	Six Months Ended June 30, 2013 (1)	Six Months Ended June 30, 2012 (1)
Revenue:				
Service	29%	29%	29%	22%
Subscription	14	3	14	2
License	57	68	58	76
Total revenue	100	100	100	100
Cost of revenue:				
Service	14	16	14	12
Subscription	6		6	
License	1	1	1	

Total cost of revenue	20	17	21	13
Gross profit	80	83	79	87
Operating expenses:				
Sales and marketing	15	11	14	8
Research, development and engineering	27	24	27	16
General and administrative	22	24	22	19
Intellectual property	2	3	3	2
Total operating expenses	67	61	65	45

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	Three Months Ended June 30, 2013 (1)	Three Months Ended June 30, 2012 (1)	Six Months Ended June 30, 2013 (1)	Six Months Ended June 30, 2012 (1)
Operating income	13	21	14	42
Net loss from joint ventures				(4)
Other income, net				
Income before income taxes	13	21	15	38
Provision for income taxes	(7)	(8)	(7)	(15)
Net income	6%	13%	8%	24%

(1) Percentages do not foot due to rounding.

Summary

During the second quarter, we continued to invest in our growth initiatives, including marketing and developing Digimarc Discover and our book piracy deterrence subscription offering, researching and developing our audio and packaging initiatives as well as our second wave of patents. We also continued research efforts to explore strategic opportunities in the mobile payment market.

Total revenue for the three-month period ended June 30, 2013, compared to the corresponding three-month period ended June 30, 2012, increased 15% to $10.5 million primarily a result of increased subscription revenue due to the inclusion of Attributor. Total revenue for the six-month period ended June 30, 2013, compared to the corresponding six-month period ended June 30, 2012, decreased 21% to $20.7 million primarily as a result of the $8.0 million past due royalties payment received from Verance Corporation (Verance) in the first quarter of 2012, partially offset by increased subscription revenue due to the inclusion of Attributor.

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

Revenue

	Three Months Ended June 30, 2013	Three Months Ended June 30, 2012	Dollar Increase (Decrease)	Percent Increase (Decrease)	Six Months Ended June 30, 2013	Six Months Ended June 30, 2012	Dollar Increase (Decrease)	Percent Increase (Decrease)
Revenue:								
Service	$ 3,022	$ 2,609	$ 413	16%	$ 5,951	$ 5,657	$ 294	5%
Subscription	1,433	317	1,116	352%	2,817	595	2,222	373%
License	6,015	6,186	(171)	(3)%	11,945	19,906	(7,961)	(40)%
Total	$ 10,470	$ 9,112	$ 1,358	15%	$ 20,713	$ 26,158	$ (5,445)	(21)%
Revenue (as % of total revenue):								
Service	29%	29%			29%	22%		
Subscription	14%	3%			14%	2%		
License	57%	68%			58%	76%		

Total	100%	100%	100%	100%

Service. Service revenue consists primarily of software development and consulting services. The majority of service revenue arrangements are structured as time and materials consulting agreements, or fixed price consulting agreements. The majority of our service revenue is derived from contracts with the Central Banks, Intellectual Ventures (IV), and government agencies and contractors. The agreements range from several months to several years in length, and our longer term contracts are subject to work plans that are reviewed and agreed upon at least annually. These contracts generally provide for billing hours worked at predetermined rates and, to a lesser extent, reimbursement for third party costs and services. Increases or decreases in the services provided under these contracts are generally subject to both volume and price changes. The volume of work is generally negotiated at least annually

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and can be modified as the customer s needs change. We also have provisions in our longer term contracts that allow for specific hourly rate price increases on an annual basis to account for cost of living variables. Contracts with other government agencies and contractors are generally shorter term in nature, less linear in billings and less predictable than our longer term contracts because the contracts with other government agencies are subject to government budgets and funding.

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

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

The increase in subscription revenue for the three- and six-month periods ended June 30, 2013, compared to the corresponding three- and six-month periods ended June 30, 2012, was due primarily to the inclusion of Attributor.

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

The decrease in license revenue for the three- and six-month periods ended June 30, 2013, compared to the corresponding three- and six-month periods ended June 30, 2012, was primarily the result of lower licensed payments from Verance and the $8.0 million past due royalties payment received from Verance in the first quarter of 2012, partially offset by the increased quarterly license payments from IV.

Revenue by Geography

	Three Months Ended June 30, 2013	Three Months Ended June 30, 2012	Dollar Increase	Percent Increase	Six Months Ended June 30, 2013	Six Months Ended June 30, 2012	Dollar Increase (Decrease)	Percent Increase (Decrease)
Revenue by geography:								
Domestic	$ 6,241	$ 5,522	$ 719	13%	$ 12,366	$ 19,093	$ (6,727)	(35)%
International	4,229	3,590	639	18%	8,347	7,065	1,282	18%
Total	$ 10,470	$ 9,112	$ 1,358	15%	$ 20,713	$ 26,158	$ (5,445)	(21)%
Revenue (as % of total revenue):								
Domestic	60%	61%			60%	73%		
International	40%	39%			40%	27%		
Total	100%	100%			100%	100%		

The increase in domestic revenue for the three-month period ended June 30, 2013, compared to the corresponding three-month period ended June 30, 2012, was due primarily to the inclusion of Attributor and increased quarterly license payment from IV, partially offset by lower license payment from Verance.

The decrease in domestic revenue for the six-month period ended June 20, 2013, compared to the corresponding six-month period ended June 30, 2012, was primarily the result of the $8.0 million past due royalties payment received from Verance and the suspension of operations in the joint ventures in the first quarter of 2012, partially offset by the inclusion of Attributor, increased quarterly license payments from IV and new government related work in the first quarter of 2013.

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

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

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Cost of Revenue

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

- compensation, benefits, incentive compensation in the form of stock-based compensation and related costs of our software developers, quality assurance personnel, product managers, business development managers and other personnel where we bill our customers for time and materials costs;
- payments to outside contractors that are billed to customers;
- charges for equipment directly used by customers;
- depreciation and other charges for machinery, equipment and software directly used by customers;
- travel costs directly attributable to service and development contracts; and
- charges for infrastructure and centralized costs of facilities and information technology.

Subscription. Cost of subscription revenue primarily includes:

- compensation, benefits, incentive compensation in the form of stock-based compensation and related costs of operations personnel and the cost of contractors to provide Attributor s subscription service;
- Internet service provider connectivity charges and image search data fees to support the services offered to our subscription customers; and
- charges for infrastructure and centralized costs of facilities and information technology.

License. Cost of license revenue primarily includes:

- patent or software license costs for any patents licensed from third parties where the party receives a portion of royalties or license revenue received by Digimarc;
- charges for infrastructure and centralized costs of facilities and information technology; and
- amortization of capitalized patent costs and patent maintenance fees.

Gross Profit

	Three Months Ended June 30, 2013	Three Months Ended June 30, 2012	Dollar Increase (Decrease)	Percent Increase (Decrease)	Six Months Ended June 30, 2013	Six Months Ended June 30, 2012	Dollar Increase (Decrease)	Percent Increase (Decrease)
Gross Profit:								
Service	$ 1,590	$ 1,124	$ 466	41%	$ 3,116	$ 2,475	$ 641	26%
Subscription	845	272	845	211%	1,594	503	845	217%
License	5,915	6,133	(218)	(4)%	11,749	19,787	(8,038)	(41)%
Total	$ 8,350	$ 7,529	$ 821	11%	$ 16,459	$ 22,765	$ (6,306)	(28)%

Gross Profit (as % of related revenue components):				
Service	53%	43%	52%	44%
Subscription	59%	86%	57%	85%
License	98%	99%	98%	99%
Total	80%	83%	79%	87%

The increase in total gross profit for the three-month period ended June 30, 2013, compared to the corresponding three-month period ended June 30, 2012, was due primarily to higher billing rates under our new agreement with the Central Banks and the inclusion of Attributor.

The decrease in total gross profit as a percentage of revenue for the three-month period ended June 30, 2013, compared to the corresponding three-month period ended June 30, 2012, was due primarily from the inclusion of Attributor, which has a higher cost component than other subscriptions.

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The decrease in total gross profit and total gross profit as a percentage of revenue for the six-month period ended June 30, 2013, compared to the corresponding six-month period ended June 30, 2012, was due primarily to the receipt of the $8.0 million past due royalties payment from Verance in the first quarter of 2012.

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

The decrease in subscription gross profit as a percentage of subscription revenue for the three- and six-month periods ended June 30, 2013, compared to the corresponding six-month period ended June 30, 2012, resulted primarily from the inclusion of Attributor, which has a higher cost component than other subscriptions.

Operating Expenses

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

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

We expect operating expenses for the full year 2013 to be higher than 2012, primarily due to a full year of Attributor s operations which is estimated to include $1.3 million of non-cash charges for amortization of acquired intangibles and stock compensation expense. In addition, we plan to increase spending in engineering, sales and marketing to accelerate our product development initiatives and our sales and marketing growth initiatives.

Sales and marketing

	Three Months Ended June 30, 2013	Three Months Ended June 30, 2012	Dollar Increase	Percent Increase	Six Months Ended June 30, 2013	Six Months Ended June 30, 2012	Dollar Increase	Percent Increase
Sales and marketing	$ 1,563	$ 970	$ 593	61%	$ 2,840	$ 1,977	$ 863	44%
Sales and marketing (as % of total revenue)	15%	11%			14%	8%		

Sales and marketing expenses consist primarily of:

- compensation, benefits, incentive compensation in the form of stock-based compensation and related costs of sales and marketing employees and product managers;
- travel and market research costs, and costs associated with marketing programs, such as trade shows, public relations and new product launches;
- professional services and outside contractors for product and marketing initiatives; and
- charges for infrastructure and centralized costs of facilities and information technology.

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

- increased marketing and professional fees of $0.3 million primarily related to certain product initiatives;

- increased headcount and compensation-related expenses of $0.1 million and amortization of acquired intangibles of $0.1 million from the inclusion of Attributor.

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

- increased marketing and professional fees of $0.3 million primarily related to certain product initiatives;

- increased headcount and compensation-related expenses of $0.3 million and amortization of acquired intangibles of $0.2 million from the inclusion of Attributor.

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

Research, development and engineering

	Three Months Ended June 30, 2013	Three Months Ended June 30, 2012	Dollar Increase	Percent Increase	Six Months Ended June 30, 2013	Six Months Ended June 30, 2012	Dollar Increase	Percent Increase
Research, development and engineering	$ 2,822	$ 2,146	$ 676	32%	$ 5,547	$ 4,144	$ 1,403	34%
Research, development and engineering (as % of total revenue)	27%	24%			27%	16%		

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

Fundamental Research:

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

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