DIGIMARC CORP
Form 10-Q
August 03, 2007

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 June 30, 2007

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)

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	**Name of Each Exchange on Which Registered**
Common Stock, $0.001 Par Value Per Share	The Nasdaq Stock Market

Securities registered pursuant to Section 12(g) of the Act:

NONE

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 July 31, 2007, there were 21,608,076 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, 2007	December 31, 2006(1)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 17,581	$ 23,135
Restricted cash		378
Short-term investments	1,715	
Trade accounts receivable, net	16,358	14,403
Inventory, net	7,030	6,600
Other current assets	2,605	2,273
Total current assets	45,289	46,789
Restricted cash	9,560	9,560
Property and equipment, net	66,465	61,898
Intangibles, net	14,391	15,374
Other assets, net	956	1,010
Total assets	$ 136,661	$ 134,631
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 5,850	$ 5,708
Accrued payroll and related costs	2,007	3,894
Deferred revenue	6,078	5,050
Other current liabilities	1,666	2,258
Total current liabilities	15,601	16,910
Long-term deferred revenue, net of current portion	6,968	5,345
Other long-term liabilities	1,090	885
Total liabilities	23,659	23,140
Commitments and contingencies (Note 5)		
Stockholders equity:		
Common stock (21,627,455 and 21,191,918 shares issued and outstanding at June 30, 2007 and December 31, 2006, respectively)	22	22
Additional paid-in capital	213,955	211,072
Accumulated other comprehensive income	137	137
Accumulated deficit	(101,112)	(99,740)
Total stockholders equity	113,002	111,491
Total liabilities and stockholders equity	$ 136,661	$ 134,631

(1) Derived from the Company s December 31, 2006 audited consolidated financial statements

See Notes to Unaudited 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, 2007	2006	Six Months Ended June 30, 2007	2006
Revenue:				
Service	$ 22,538	$ 20,519	$ 43,837	$ 42,809
Product and subscription	4,826	4,388	10,373	9,291
Total revenue	27,364	24,907	54,210	52,100
Cost of revenue:				
Service	15,089	15,002	29,804	32,101
Product and subscription	1,988	1,675	4,088	4,224
Total cost of revenue	17,077	16,677	33,892	36,325
Gross profit	10,287	8,230	20,318	15,775
Operating expenses:				
Sales and marketing	4,365	4,685	8,642	9,224
Research, development and engineering	1,883	2,994	3,925	6,230
General and administrative	3,809	4,172	7,907	9,382
Amortization of intangibles	509	550	1,009	1,123
Intellectual property	476	481	975	912
Restructuring charges, net		547		547
Total operating expenses	11,042	13,429	22,458	27,418
Operating income (loss)	(755)	(5,199)	(2,140)	(11,643)
Other income (expense):				
Interest income	362	341	774	666
Interest expense	4	(28)	(15)	(44)
Other	36	(5)	25	43
Total other income, net	402	308	784	665
Income (loss) before provision for income taxes	(353)	(4,891)	(1,356)	(10,978)
(Provision) benefit for income taxes	(142)	22	(161)	(63)
Net income (loss)	$ (495)	$ (4,869)	$ (1,517)	$ (11,041)
Net income (loss) per share basic	$ (0.02)	$ (0.24)	$ (0.07)	$ (0.54)
Net income (loss) per share diluted	$ (0.02)	$ (0.24)	$ (0.07)	$ (0.54)
Weighted average shares outstanding basic	20,898	20,627	20,847	20,617
Weighted average shares outstanding diluted	20,898	20,627	20,847	20,617

See Notes to Unaudited Consolidated Financial Statements.

DIGIMARC CORPORATION
CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY
(In thousands, except share data)

	Common stock Shares	Amount	Additional paid-in capital	Deferred stock compensation	Accumulated other comprehensive income	Accumulated Deficit	Total stockholders equity
BALANCE AT DECEMBER 31, 2005	20,808,994	$ 21	$ 209,337	$ (1,519)	$ 137	$ (88,000)	$ 119,976
Initial adjustment to adopt SFAS 123R			(1,519)	1,519			
Exercise of stock options	44,584	1	201				202
Issuance of employee stock purchase plan shares	52,957		248				248
Issuance of restricted common stock	312,365						
Purchase and retirement of common stock	(26,982)		(208)				(208)
Stock-based compensation expense			3,013				3,013
Net loss						(11,740)	(11,740)
BALANCE AT DECEMBER 31, 2006	21,191,918	22	211,072		137	(99,740)	111,491
Initial adjustment to adopt FIN 48 (Note 10)						145	145
Exercise of stock options	97,399		588				588
Issuance of employee stock purchase plan shares	54,119		423				423
Issuance of restricted common stock	309,490						
Purchase and retirement of common stock	(25,471)		(140)				(140)
Stock-based compensation expense			2,012				2,012
Net loss						(1,517)	(1,517)
BALANCE AT JUNE 30, 2007	21,627,455	$ 22	$ 213,955	$	$ 137	$ (101,112)	$ 113,002

See Notes to Unaudited Consolidated Financial Statements.

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DIGIMARC CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(UNAUDITED)

	Six Months Ended June 30, 2007	June 30, 2006
Cash flows from operating activities:		
Net loss	$ (1,517)	$ (11,041)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	7,801	7,652
Stock-based compensation expense	2,012	1,576
Increase (decrease) in allowance for doubtful accounts	1	(164)
Other non-cash charges	(50)	(73)
Changes in operating assets and liabilities:		
Restricted cash	378	(4,204)
Trade accounts receivable, net	(1,996)	1,765
Inventory, net	(430)	1,102
Other current assets	(332)	232
Other assets, net	54	69
Accounts payable	142	155
Accrued payroll and related costs	(1,887)	(250)
Deferred revenue	2,651	985
Other liabilities	(116)	(321)
Net cash provided by (used in) operating activities	6,711	(2,517)
Cash flows from investing activities:		
Purchase of property and equipment, including capitalized labor costs, and intangibles	(11,109)	(3,437)
Sale or maturity of short-term investments	76,807	62,713
Purchase of short-term investments	(78,522)	(62,975)
Net cash provided by (used in) investing activities	(12,824)	(3,699)
Cash flows from financing activities:		
Issuance of common stock	1,011	264
Purchase of common stock	(140)	
Principal payments under capital lease obligations	(312)	(314)
Net cash provided by (used in) financing activities	559	(50)
Net increase (decrease) in cash and cash equivalents	(5,554)	(6,266)
Cash and cash equivalents at beginning of period	23,135	23,964
Cash and cash equivalents at end of period	$ 17,581	$ 17,698
Supplemental disclosure of cash flow information:		
Cash paid for interest	$ 38	$ 44
Cash paid for income taxes	$ 323	$ 111
Summary of non-cash investing and financing activities:		
Equipment acquired or exchanged under capital lease obligations	$ 244	$ 582

See Notes to Unaudited Consolidated Financial Statements.

DIGIMARC CORPORATION
NOTES TO 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 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.

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 Securities and Exchange Commission (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, 2006, which was filed with the SEC on March 8, 2007. 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 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.

DIGIMARC CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(In thousands, except share and per share data)
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Reclassifications

Certain amounts in the 2006 consolidated financial statements and notes thereon have been reclassified to conform to the current period presentation. These reclassifications had no material effect on the results of operations or financial position for any period presented.

2. Net Income (Loss) Per Share Computation

Net income (loss) per share (or earnings per share (EPS)) is calculated in accordance with Statement of Financial Accounting Standards (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, 2007 Shares (000 s) (Denominator)	2006 Shares (000 s) (Denominator)	Six Months Ended June 30, 2007 Shares (000 s) (Denominator)	2006 Shares (000 s) (Denominator)
Basic EPS				
Weighted average shares outstanding	20,898	20,627	20,847	20,617
Effect of Dilutive Securities				
Options				
Restricted stock and performance vesting shares				
Diluted EPS				
Weighted average shares outstanding	20,898	20,627	20,847	20,617

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 related to stock options and restricted stock of 1,550 and 1,565 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.

The effect of 5,632 and 5,324 outstanding stock options for the three- and six-months periods ended June 30, 2006, respectively, were excluded from the calculation of diluted net loss per share because their exercise price was higher than the average market price of the underlying common stock for the period and therefore their inclusion would be anti-dilutive. In addition, common stock equivalents related to stock

DIGIMARC CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
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options and restricted stock of 759 and 821 for the three- and six-months periods ended June 30, 2006, respectively, were excluded from diluted net loss per share as the Company was in a loss position and their inclusion would be anti-dilutive.

3. 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. On January 1, 2006, the Company adopted Statement of Financial Accounting Standards 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. SFAS 123(R) supersedes previous accounting under Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, for periods beginning in fiscal 2006. In March 2005, the SEC issued Staff Accounting Bulletin No. 107 relating to application of SFAS 123(R). The Company has applied the provisions of Staff Accounting Bulletin (SAB) 107 in the adoption of SFAS 123(R).

The Company 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 its 2006 fiscal year. In accordance with the modified prospective transition method, the Company s consolidated financial statements for periods prior to fiscal year 2006 have not been restated to reflect this change. Stock-based compensation recognized in the three- and six-month periods ended June 30, 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 the Company s consolidated financial statements in the three- and six-month periods ended June 30, 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), the Company continued to use the Black-Scholes option pricing model as its method of valuation for stock-based awards. The Company s determination of the fair value of stock-based awards on the date of grant using an option pricing model is affected by the Company s 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, the Company s 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.

DIGIMARC CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
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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 valuation model. The Company amortizes the fair value of all awards on a straight-line basis over the requisite service periods, which are generally the vesting periods. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model.

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-months ended June 30, 2007 and 2006 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. The volatility factor the Company uses in the Black-Scholes option valuation model is based on its 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 valuation 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.

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 valuation 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,**	
	2007	**2006**	**2007**	**2006**
Expected life (in years)	5.8	6.0	5.8	6.0
Expected volatility	44 %	53 %	44 %	53 %
Risk-free interest rate	4.7 %	4.7 %	4.7 %	4.7 %
Expected dividend yield	0 %	0 %	0 %	0 %
Expected forfeiture rate	16 %	14 %	16 %	14 %
Fair value	$ 4.76	$ 3.80	$ 4.36	$ 3.57

DIGIMARC CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
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(UNAUDITED)

Employee Stock Purchase Plans

The Company also recognizes stock-based compensation in connection with its 1999 Employee Stock Purchase Plan. The plan allowed employees to purchase shares of Digimarc common stock through payroll deductions of up to 15% of their base compensation during each six-month plan period, up to a maximum deduction of $10.6 for each plan period, not to exceed $21 per year. Plan periods were generally from December 1 to May 31 and from June 1 to November 30. The price an employee paid for the shares was 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 52,957 shares purchased under the Company s stock purchase plan during the three- and six-month periods ended June 30, 2006. The plan was suspended effective June 1, 2006.

An amended plan was reinstated effective November 2, 2006 which slightly modified the earlier plan. The changes included changing the plan periods from six to three months and the maximum deduction to $5.3 for each plan period. The plan periods are generally from December 1 to February 28, March 1 to May 31, June 1 to August 31 and from September 1 to November 30. Employees purchased 28,742 shares and 54,119 shares under the plan during the three- and six-month periods ended June 30, 2007, respectively.

Restricted Stock and Performance Vesting Shares

During 2007 and 2006 the Compensation Committee of the Board of Directors 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. In addition the Compensation Committee awarded performance vesting shares under the 1999 Stock Incentive Plan, as amended, to certain officers and employees. The performance vesting shares vest in full (or terminate) based on the achievement of specified performance goals. Specific terms of the restricted stock awards and performance vesting share awards are governed by restricted stock agreements and performance vesting share agreements between the Company and the award recipients.

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.

The fair value of performance vesting share awards granted is based on a Monte Carlo valuation model that results in a factor applied to the fair market value of the Company s common stock on the date of the grant (measurement date), and is recognized over the derived service period using the straight-line method.

DIGIMARC CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
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(UNAUDITED)

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, 2007 and 2006, which was incurred as follows:

	Three Months Ended June 30,		**Six Months Ended June 30,**	
	2007	**2006**	**2007**	**2006**
Stock-based compensation:				
Cost of revenue	$ 109	$ 84	$ 215	$ 138
Sales and marketing	185	134	392	256
Research, development and engineering	101	76	173	190
General and administrative	599	478	1,207	974
Intellectual property	13	10	25	18
Total stock-based compensation	$ 1,007	$ 782	$ 2,012	$ 1,576

At June 30, 2007, the Company had 1.5 million non-vested stock options that had a weighted average grant date price of $7.10. As of June 30, 2007, the Company had $9.1 million 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 1.45 years.

Stock Option Activity

As of June 30, 2007, under all of the Company s stock-based compensation plans, options to purchase an aggregate of 7.2 million shares were outstanding, and options to purchase an additional 7.2 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, 2007:	**Options**	**Weighted** Average Exercise Price	**Weighted** Average Remaining Contractual Life
Outstanding at March 31, 2007	7,278,888	$ 13.53	
Options granted	85,025	9.87	
Options exercised	(33,045)	6.00	
Options canceled	(94,660)	10.13	
Options expired			
Outstanding at June 30, 2007	7,236,208	$ 13.56	6.08 years
Exercisable at June 30, 2007	5,689,784	$ 15.32	5.35 years

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DIGIMARC CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(In thousands, except share and per share data)
(UNAUDITED)

Six-months ended June 30, 2007:	Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life
Outstanding at December 31, 2006	7,045,751	$ 13.67	
Options granted	452,975	9.04	
Options exercised	(97,399)	6.03	
Options canceled	(165,119)	10.20	
Options expired			
Outstanding at June 30, 2007	7,236,208	$ 13.56	6.08 years
Exercisable at June 30, 2007	5,689,784	$ 15.32	5.35 years

The following table summarizes information about stock options outstanding at June 30, 2007:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number Outstanding	Remaining Contractual Life (Years)	Weighted Average Price	Number Exercisable	Weighted Average Price
$ 0.50 - $ 5.96	823,763	7.28	$ 5.06	452,235	$ 4.41
$ 6.00 - $ 6.15	477,773	7.99	$ 6.07	222,101	$ 6.05
$ 6.16 - $ 6.99	530,140	8.61	$ 6.49	176,371	$ 6.49
$ 7.02 - $ 8.97	783,647	8.45	$ 8.42	319,442	$ 8.28
$ 9.00 - $12.23	888,843	6.98	$ 10.93	787,593	$ 11.07
$12.40 - $13.25	578,220	5.60	$ 12.82	578,220	$ 12.82
$13.38 - $14.13	786,500	3.65	$ 14.07	786,500	$ 14.07
$14.40 - $15.24	562,295	5.47	$ 15.10	562,295	$ 15.10
$15.25 - $17.00	672,877	5.43	$ 16.24	672,877	$ 16.24
$17.88 - $26.25	757,900	3.91	$ 21.03	757,900	$ 21.03
$27.50 - $53.94	374,250	2.68	$ 46.74	374,250	$ 46.74
$ 0.50 - $53.94	7,236,208	6.08	$ 13.56	5,689,784	$ 15.32

At December 31, 2006, 5,559,602 options were exercisable at a weighted average price of $15.62.

At June 30, 2007, the aggregate intrinsic value of outstanding and exercisable stock options was $8,646 and $4,471, respectively. The aggregate intrinsic value is based on the Company s closing price of $9.81 on June 29, 2007, which would have been received by the optionees had all of the options with exercise prices less than $9.81 been exercised on that date.

DIGIMARC CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(In thousands, except share and per share data)
(UNAUDITED)

Restricted Stock and Performance Vesting Shares Activity

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

	Number of Shares
Three-months ended June 30, 2007:	
Unvested balance, March 31, 2007	686,062
Granted	24,000
Vested	(19,200)
Canceled	(7,779)
Unvested balance, June 30, 2007	683,083

	Number of Shares
Six-months ended June 30, 2007:	
Unvested balance, December 31, 2006	444,032
Granted	309,490
Vested	(59,660)
Canceled	(10,779)
Unvested balance, June 30, 2007	683,083

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,	
	2007	2006	2007	2006
Domestic	$ 21,219	$ 21,112	$ 41,739	$ 41,307
International	6,145	3,795	12,471	10,793
Total	$ 27,364	$ 24,907	$ 54,210	$ 52,100

DIGIMARC CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(In thousands, except share and per share data)
(UNAUDITED)

Major Customers

No single customer accounted for more than 10% of total revenue for the three- and six-month periods ended June 30, 2007. One customer accounted for approximately 11% of total revenue in the three-month period ended June 30, 2006 and approximately 10% of total revenue in the six-month period ended June 30, 2006.

5. Commitments and Contingencies

Beginning in September 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 have filed a notice of appeal in the Ninth Circuit Court of Appeals. The appeal was stayed pending the recent U.S. Supreme Court s determination in another case of issues relating to the Private Securities Litigation Reform Act, and briefing is scheduled to be completed by the end of the year. 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 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 shareholders and to the Company. The complaint is derivative in nature and does not seek relief from the Company. The Board of Directors 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 stay 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, 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 shareholders. On August 24, 2006, the court granted 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, 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.

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

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New York naming approximately 300 companies, including Digimarc, certain of its officers and directors, and certain underwriters of the Company s initial public offering as defendants. The complaints have since been consolidated into a single action, and a consolidated amended complaint was filed in April 2002. The amended complaint alleges, among other things, that the underwriters of the Company s initial public offering violated securities laws by failing to disclose certain alleged compensation arrangements (such as undisclosed commissions or stock stabilization practices) in the Company s initial public offering registration statement and by engaging in manipulative practices to artificially inflate the price of the Company s stock in the after-market subsequent to the Company s initial public offering. The Company and certain of its 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. Furthermore, in July 2002, the Company and the other defendants in the consolidated cases filed motions to dismiss the amended complaint for failure to state a claim. The motion to dismiss claims under Section 11 was denied as to virtually all the defendants in the consolidated actions, including the Company. The claims against the Company under Section 10(b), however, were dismissed. In June 2003, a committee of the Company s board of directors conditionally approved a proposed partial settlement with the plaintiffs in this matter. In June 2004, an agreement of settlement was submitted to the court for preliminary approval. The settlement would have provided, among other things, a release of the Company and of the individual defendants for the alleged wrongful conduct in the amended complaint in exchange for a guarantee from the Company s insurers regarding recovery from the underwriter defendants and other consideration from the Company regarding its underwriters, including agreeing to assign away, not assert, or release certain potential claims the Company may have against its underwriters. The plaintiffs have continued to litigate against the underwriter defendants. The district court directed that the litigation proceed within a number of focus cases rather than in all of the 310 cases that have been consolidated. The Company s case is not one of these focus cases. On October 13, 2004, the district court certified the focus cases as class actions. The underwriter defendants appealed that ruling, and on December 5, 2006, the Court of Appeals for the Second Circuit reversed the district court s class certification decision. On April 6, 2007, the Second Circuit denied plaintiffs petition for rehearing. In light of the Second Circuit opinion, the Company has informed the district court that this settlement cannot be approved because the defined settlement class, like the litigation class, cannot be certified. The Company cannot predict whether the Company will be able to renegotiate a settlement that complies with the Second Circuit s mandate. Due to the inherent uncertainties of litigation, the Company cannot accurately predict the ultimate outcome of the matter.

The Company s contracts for driver license and other identification issuance systems and their 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. The Company from time to time experiences delays in identification system implementation, timely acceptance for identification systems programs, concerns regarding identification

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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 the Company has failed to meet timing or other delivery requirements and milestones pursuant to the terms of such contracts. Management believes that these assertions are often part of the resolution process involving commercial disagreements over the terms of these contracts. Such disputes are not uncommon and tend to be resolved over time. However, the Company s failure to meet contractual milestones or other performance requirements as promised, or to successfully resolve customer disputes, could result in the Company incurring liability for damages, as well as increased costs, lower margins, or compensatory obligations in addition to other losses, such as harm to the Company s reputation. Such circumstances could have a material adverse effect on the Company s business and financial results. The Company anticipates that future contracts will continue to have such provisions unless and until industry practices change.

In addition to the Company s normal price-per-card issuance contracts, the Company occasionally enters 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 fixed price contracts, the Company provides specific tasks for a specific price and are typically paid on a milestone basis. The Company has experienced low margins or losses on such contracts in the recent past. Such contracts involve greater financial risks because the Company bears the risk if actual project costs exceed the amounts the Company is paid under the contracts. A material percentage of the Company s revenues are derived from fixed price contracts and the Company s reliance on fixed price contracts may grow.

A significant portion of the Company s 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, the Company may generate substantial revenue that may not be subject to future renewal. Further, the Company may face competitive bids for a number of the Company s major accounts in 2007 and 2008. 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.

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 law suits filed or amounts payable under such indemnification provisions, but from time to time, in the normal course of business, potential claims may be raised with and reviewed by the Company.

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, 2007, 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

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

A portion of the Company s revenue each year is generated from licensing of technology. In the competitive environment in which the Company operates, 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 the Company s technology could have a long-term impact on the Company s growth and results of operations.

Performance Bonds

Some governmental authorities require performance bonds that the Company is obligated to maintain during the life of the contract. Often, the terms of these bonds require that the Company obtain letters of credit to secure the Company s obligations under the bonds. The letters of credit may in turn require us to maintain large restricted cash reserves as security, reducing the Company s ability to use these funds for the Company s other business purposes. Even with the availability of such cash reserve guarantees, the Company may not be able to obtain such performance bond underwriting at a favorable rate or at all. The Company s failure to be able to provide such performance bonds may preclude us from bidding on new government contracts or maintaining the Company s existing contracts for their full terms. In addition, these performance bonds may provide for security interests covering the Company s 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 the Company s quarterly results to fluctuate and anticipated revenue to decrease significantly.

6. 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 for first fiscal year beginning after November 15, 2007. The Company is currently assessing the potential impact that adoption of this standard will have on the Company s 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 not determined whether it will adopt the fair value option method permitted by SFAS No. 159.

7. Revenue Recognition

The Company s revenue is comprised of service revenue from its government-issued credentials systems and related maintenance, installation and system integration services as well as product and

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subscription revenue, including hardware and software sales, royalties and revenues from the licensing of digital watermarking products and related authentication services. The Company s revenue recognition policy follows SEC SAB No. 104 *Revenue Recognition* , Statement of Position (SOP) No. 97-2, *Software Revenue Recognition,* as amended by SOP No. 98-9, *Modification of SOP No. 97-2, Software Recognition, With Respect to Certain Transactions,* SOP 81-1 *Accounting for the Performance of Construction Type and Certain Production-Type Contracts,* and Emerging Issues Task Force (EITF) Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables.*

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, *Revenue Arrangements with Multiple Deliverables*. 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 the Company s 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.

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 generally deferred and recognized over the remaining life of the contract. However, if VSOE can be established for the

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delivered items and title passes to those items and all obligations are completed, then the Company recognizes 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 services 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, 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, *Modification of SOP 97-2*, *With Respect to Certain Transactions*. 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. Billing for services rendered generally occurs within one month following when the services are provided.

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

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8. Trade Accounts Receivable

Trade accounts receivable are recorded at the invoiced amount and do not bear interest. Revenue earned that has not been invoiced is classified as unbilled trade receivables in the consolidated balance sheets.

	June 30, 2007	December 31, 2006
Billed trade receivables	$ 9,795	$ 8,990
Unbilled trade receivables	6,750	5,599
Trade accounts receivable	16,545	14,589
Allowance for doubtful accounts	(187)	(186)
Trade accounts receivable, net	$ 16,358	$ 14,403

Trade accounts receivable, net includes $1.5 million at June 30, 2007 and $2.2 million at December 31, 2006 of deferred revenue, billed in accordance with the provisions of the contracts with the Company s customers.

The allowance for doubtful accounts 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. The Company does not have an off-balance sheet credit exposure related to its customers.

Major Customers

No single customer accounted for more than 10% of the Company s trade and unbilled accounts receivable, net at June 30, 2007 and at December 31, 2006.

9. Inventory

Inventory consists primarily of the consumable materials used to manufacture identification cards, such as inks, card stock, laminates, and adhesives (considered raw material), equipment held for sale (considered 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, 2007	December 31, 2006
Equipment and deferred contract costs	$ 1,599	$ 1,046
Consumable materials	5,545	5,654
Inventory	7,144	6,700
Reserve for slow moving and obsolete items	(114)	(100)
Inventory, net	$ 7,030	$ 6,600

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While the Company does not currently expect to be able to sell or otherwise use the reserved inventory on hand based upon the Company s forecast and backlog, it is possible that a customer or customers will decide in the future to purchase a portion of the reserved inventory.

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 domestic net deferred tax assets at June 30, 2007 due to the uncertainty of realization of the Company s domestic net operating losses. The Company did record a foreign deferred tax asset of $124 at March 31, 2007 that it believes is more likely than not to be realized. 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.

The Company adopted the provisions of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement 109* (FIN 48), on January 1, 2007. The Company s consolidated financial statements for 2007 reflect the impact of FIN 48, but the consolidated financial statements for 2006 have not been restated to reflect, and do not include, the impact of FIN 48.

As a result of the implementation of FIN 48, the Company recognized a $145 reduction in the Company s net liability for uncertain tax positions previously recorded, which was accounted for as an adjustment to the January 1, 2007 retained earnings balance. As part of the FIN 48 implementation, the Company adopted a policy to record accrued interest and penalties associated with uncertain tax positions in income tax expense in the accompanying consolidated statements of operations. On initial adoption of FIN 48, the Company recognized an additional $52 of accrued interest and penalties associated with uncertain tax positions in prior years, which reduced the overall adjustment to the January 1, 2007 retained earnings.

A summary reconciliation of the Company s uncertain tax positions is listed below:

Beginning balance at January 1, 2007	$ 289
Additions for tax positions of prior years (interest and penalties)	52
Reductions for net tax positions of prior years	(197)
Revised balance at January 1, 2007	$ 144

The Company s tax years for its foreign jurisdictions are subject to review for up to seven years after filing tax returns. Federal, state and foreign loss carryforwards and credits can generally be adjusted by taxing authorities at any time in the future. The entire amount of the uncertain tax positions if recognized would affect the effective tax rate.

11. 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

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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.

12. Related Party Transactions

During the three- and six-month periods ended June 30, 2007, the Company recognized revenue of $232 and $454, respectively, from a holder of common stock pursuant to a license agreement. In addition the Company recognized revenue of $120 and $245 for the three- and six-month periods ended June 30, 2006, respectively, from this stockholder. Net accounts receivable from this customer was $94 at June 30, 2007 and $329 at December 31, 2006. Deferred revenue from this customer was $188 at June 30, 2007 and $288 at December 31, 2006.

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13. Quarterly Selected Financial Information

The following table shows the quarterly reported numbers.

Quarter ended:	**March 31**	**June 30**	**September 30**	**December 31**
2007				
Total revenue	$ 26,846	27,364		
Total cost of revenue	16,815	17,077		
Gross profit	10,031	10,287		
Sales and marketing	4,277	4,365		
Research, development and engineering	2,042	1,883		
General and administrative	4,098	3,809		
Amortization of intangibles	500	509		
Intellectual property	499	476		
Restructuring charges, net				
Operating income (loss)	(1,385)	(755)		
Net income (loss)	(1,022)	(495)		
Net income (loss) per share basic	(0.05)	(0.02)		
Net income (loss) per share diluted	(0.05)	(0.02)		
2006				
Total revenue	$ 27,193	$ 24,907	$ 26,733	$ 25,414
Total cost of revenue	19,648	16,677	16,719	15,725
Gross profit	7,545	8,230	10,014	9,689
Sales and marketing	4,539	4,685	3,440	3,691
Research, development and engineering	3,236	2,994	2,158	1,881
General and administrative	5,210	4,172	3,684	4,418
Amortization of intangibles	573	550	537	511
Intellectual property	431	481	460	402
Restructuring charges, net		547		
Operating income (loss)	(6,444)	(5,199)	(265)	(1,214)
Net income (loss)	(6,172)	(4,869)	213	(912)
Net income (loss) per share basic	(0.30)	(0.24)	0.01	(0.04)
Net income (loss) per share diluted	(0.30)	(0.24)	0.01	(0.04)

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 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, 2006 filed on March 8, 2007, and other reports and filings made with the Securities and Exchange Commission (SEC).

Overview

Digimarc (Digimarc, the Company, our or we) is a supplier of secure identification documents (IDs) and digital watermarking technology fo use in media management. Our secure ID solutions enable governments and businesses around the world to enhance traffic safety and national security, combat identity theft and fraud and facilitate the effectiveness of voter identification programs. We are also 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, television 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 majority of our revenue is generated pursuant to long-term contracts (normally five or more years) with government agencies primarily state government agencies responsible for driver license issuance, a consortium of central banks, and national governments of foreign countries. These customers rely on our expertise in systems design, integration and materials science, 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 our revenue is generated through commercial applications of our digital watermarking and related technologies, primarily from patent and technology license fees paid by business partners.

Secure ID Solutions

We issue more than 60 million IDs annually and are the leading supplier of government-issued citizen IDs in North America, producing more than two-thirds of all driver licenses issued in the United States (the U.S.). We have also provided secure ID solutions to approximately 25 foreign governments.

In North America, most of our revenue is generated through the issuance of state driver licenses and other IDs and is paid in the form of a fixed price per credential issued. 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.

In the United States, Federal legislation, such as the federal legislation passed in May 2005 known as the REAL ID Act (the REAL ID Act) imposes certain federal requirements for State-issued driver licenses. These requirements will increase the security of driver licenses, require validation of applicants prior to issuance, and mandate certain changes in business processes relating to security and the sharing and storage of data.

The Company s strategy regarding the anticipated opportunities relating to the REAL ID Act is to provide solutions that embody the key elements 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 will also offer the States program management assistance to safely migrate to REAL ID Act compliance.

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, 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.

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 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.

Variability of Capitalized and Deferred Costs. Our driver license and ID issuance programs generally require significant cost to develop, build and deploy new systems. These new systems 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. Starting January 1, 2006, we changed our policy for depreciating fixed assets that were 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. Through December 31, 2005, we depreciated these assets over the shorter of the original contract term or estimated useful life. This change in estimate was supported by an analysis we completed during the first quarter of 2006 which 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 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, 2006, 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.

Backlog

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, 2007 will generate approximately $225 million in revenue during the contractual terms of such contracts, currently up to seven years. We expect more than $40 million of this amount to be recognized as revenue during the remainder of 2007. This amount includes production volumes reasonably expected to be achieved under currently effective contracts and government orders that are firm but not yet funded.

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 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, the Company restructured its 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, 2006.

Critical Accounting Policies and Estimates

The preparation of consolidated financial statements in accordance with accounting principles generally accepted in the United States of America 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, intangible assets, income taxes, restructuring, long-term service contracts, warranties, investments, contingencies and litigation, and inputs related to stock-based compensation calculations. 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 inputs related to stock-based compensation calculations. 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 our financial 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 services 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 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 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 options and employee stock purchases. Our determination of the fair value of these 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 these 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 the Company s 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 the Company s 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, 2007 and all changes discussed with respect to such period reflect changes as compared to the three- and six-month periods ended June 30, 2006.

	Three Months Ended June 30, 2007	2006	Six Months Ended June 30, 2007	2006
Revenue:				
Service	82 %	82 %	81 %	82 %
Product and subscription	18	18	19	18
Total revenue	100	100	100	100
Cost of revenue:				
Service	55	60	55	62
Product and subscription	7	7	8	8
Total cost of revenue	62	67	63	70
Gross profit	38	33	37	30
Operating expenses:				
Sales and marketing	16	19	15	17
Research, development and engineering	7	12	7	12
General and administrative	14	17	15	18
Amortization of intangibles	2	2	2	2
Intellectual property	2	2	2	2
Restructuring charges, net	0	2	0	1
Total operating expenses	41	54	41	52
Operating income (loss)	(3)	(21)	(4)	(22)
Other income (expense):				
Interest income	1	1	1	1
Interest expense	0	0	0	0
Other	0	0	0	0
Total other income, net	1	1	1	1
Income (loss) before provision for income taxes	(2)	(20)	(3)	(21)
Provision for income taxes	0	0	0	0
Net income (loss)	(2)%	(20)%	(3)%	(21)%

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Revenue

	Three Months Ended June 30, 2007 (in 000 s)	2006	Dollar Increase (Decrease)	Percent Increase (Decrease)	Six Months Ended June 30, 2007	2006	Dollar Increase (Decrease)	Percent Increase (Decrease)
Revenue:								
Service	$ 22,538	$ 20,519	$ 2,019	10 %	$ 43,837	$ 42,809	$ 1,028	2 %
Product and subscription	4,826	4,388	438	10 %	10,373	9,291	1,082	12 %
Total	$ 27,364	$ 24,907	$ 2,457	10 %	$ 54,210	$ 52,100	$ 2,110	4 %
Revenue (as % of total revenue):								
Service	82 %	82 %			81 %	82 %		
Product and subscription	18 %	18 %			19 %	18 %		
Total	100 %	100 %			100 %	100 %		

Service. Service revenue consists primarily of:

- card production on a price-per-card basis,
- software development 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.

Service revenue increased for the three-month period ended June 30, 2007 compared to the corresponding three-month period ended June 30, 2006 primarily due to increased service revenue from our Mexico operation, which experienced a production hiatus during the 2006 national elections, and higher production revenues in our Canada operations from the implementation of services to several provinces under our Atlantic Canada contract which was signed in 2006. Offsetting these increases were lower revenues due to a combination of price and volume mix from various states.

The increase in service revenue for the six-month period ended June 30, 2007 compared to the corresponding six-month period ended June 30, 2006 was due primarily to increased project work from the consortium of central banks, increased revenue following the hiatus in our Mexico plant. These increases were offset by lower production volumes from Haiti s voter identification project and lower revenue from Latvia, both of which were non-recurring in nature, and the negative impact of the change in certain states driver license renewal periods.

Product and subscription. Product revenue consists primarily of the sale of equipment and consumables related to identification card production systems and software licenses 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.

Product and subscription revenue increased for the three-month period ended June 30, 2007 compared to the corresponding three-month period ended June 30, 2006 primarily due to increased sales from the District of Columbia, Russia and Mozambique. These increases was offset by lower revenues from other international customers that occur from time to time.

The increase in product and subscription revenue between the six-month period ended June 30, 2007 and the corresponding six-month period ended June 30, 2006 was due primarily to additional payments from a cash basis customer and a net increase in non-recurring sales to various international customers.

Revenue by Geography

	Three Months Ended June 30, 2007 (in 000 s)	2006	Dollar Increase (Decrease)	Percent Increase (Decrease)	Six Months Ended June 30, 2007	2006	Dollar Increase (Decrease)	Percent Increase (Decrease)
Revenue by geography:								
Domestic	$ 21,219	$ 21,112	$ 107	1 %	$ 41,739	$ 41,307	$ 432	1 %
International	6,145	3,795	2,350	62 %	12,471	10,793	1,678	16 %
Total	$ 27,364	$ 24,907	$ 2,457	10 %	$ 54,210	$ 52,100	$ 2,110	4 %
Revenue (as % of total revenue):								
Domestic	78 %	85 %			77 %	79 %		
International	22 %	15 %			23 %	21 %		
Total	100 %	100 %			100 %	100 %		

The increase in domestic revenue for the three-month period ended June 30, 2007 as compared to the corresponding three-month period ended June 30, 2006 was due primarily to increased payments from a cash basis customer. The increase was offset by lower revenues from a combination of price and volume mix from various states.

The increase in domestic revenue for the six-month period ended June 30, 2007 as compared to the corresponding six-month period ended June 30, 2006 was due primarily to increased payments from a cash basis customer and increased project work from the consortium of central banks. These increases were offset by lower revenues from a combination of price and volume mix from various states.

The increase in international revenue for the three-month period ended June 30, 2007 as compared to the corresponding three-month period ended June 30, 2006 was due primarily to increased revenue from our operation in Mexico following a hiatus there during the 2006 national elections, increased sales of consumables to Russia, increased production revenues in Canada and increased product sales to Mozambique.

The increase in international revenue for the six-month period ended June 30, 2007 as compared to the corresponding six-month period ended June 30, 2006 was due primarily to increased revenue from our operation in Mexico following a hiatus there during the 2006 national elections and increased product sales to Ghana. These increases were offset by lower production volumes from Haiti s voter identification project and lower revenue from Latvia, both of which were non-recurring in nature.

Cost of Revenue

	Three Months Ended June 30, 2007	2006	Dollar Increase (Decrease)	Percent Increase (Decrease)	Six Months Ended June 30, 2007	2006	Dollar Increase (Decrease)	Percent Increase (Decrease)
	(in 000 s)							
Cost of Revenue:								
Service	$ 15,089	$ 15,002	$ 87	1 %	$ 29,804	$ 32,101	$ (2,297)	(7)%
Product and subscription	1,988	1,675	313	19 %	4,088	4,224	(136)	(3)%
Total	$ 17,077	$ 16,677	$ 400	2 %	$ 33,892	$ 36,325	$ (2,433)	(7)%
Cost of Revenue (as % of related revenue components):								
Service	67 %	73 %			68 %	75 %		
Product and subscription	41 %	38 %			39 %	45 %		

Service. Cost of service revenue primarily includes:

- costs of consumables used in delivering a service,
- compensation for software developers, quality assurance personnel, product managers, field operations personnel, and 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, 2007 compared to the corresponding three-month period ended June 30, 2006 primarily due to:

- increase in consumables inventory costs of $1.0 million related to increased revenues, offset by
- decreased employee compensation-related expenses of $0.9 million as part of the restructuring initiative.

Cost of service revenue decreased for the six-month period ended June 30, 2007 compared to the corresponding six-month period ended June 30, 2006 primarily due to:

- decreased employee compensation-related expenses of $1.5 million as part of the restructuring initiative,
- decreased contract and temporary labor of $0.5 million as part of the cost cutting initiative under which a number of contractors were converted to employees at lower average costs,
- decreased costs of approximately $1.1 million related to resource allocations (for example, in 2006 resources were allocated to projects that were of an operating expense nature and in 2007 resources were allocated to capital projects), offset by

- increased depreciation expense of $0.3 million related to programs completed in the later half of 2006 or implemented during the quarter, and

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- increased allocated infrastructure and centralized costs of $0.4 million primarily due to the redeployment of resources to program activities as part of our restructuring initiative during the prior year.

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 increased for the three-month period ended June 30, 2007 compared to the corresponding three-month period ended June 30, 2006 primarily due to higher material costs of $0.3 million relating to hardware sales to both domestic and international customers.

Cost of product and subscription revenue slightly decreased for the six-month period ended June 30, 2007 compared to the corresponding six-month period ended June 30, 2006 primarily due to lower material costs of $0.5 million related to consumable sales, offset by higher hardware costs.

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

Cost of Revenue Components

	Three Months Ended June 30, 2007 (in 000 s)	**2006**	**Dollar Increase (Decrease)**	**Percent Increase (Decrease)**	**Six Months Ended June 30, 2007**	**2006**	**Dollar Increase (Decrease)**	**Percent Increase (Decrease)**
Cost of revenue:								
Variable	$ 7,771	$ 6,454	$ 1,317	20 %	$ 15,382	$ 14,771	$ 611	4 %
Fixed field support and manufacturing	6,586	7,595	(1,009)	(13)%	13,025	16,338	(3,313)	(20)%
Program depreciation	2,720	2,628	92	4 %	5,485	5,216	269	5 %
Total	$ 17,077	$ 16,677	$ 400	2 %	$ 33,892	$ 36,325	$ (2,433)	(7)%
Cost of revenue (as % of total revenue):								
Variable	28 %	26 %			29 %	28 %		
Fixed field support and manufacturing	24 %	30 %			24 %	32 %		
Program depreciation	10 %	11 %			10 %	10 %		
Total	62 %	67 %			63 %	70 %		