DIGIMARC CORP
Form 10-Q
August 09, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

(Mark One)

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

For the quarterly period ended JUNE 30, 2006

OR

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

For the transition period from to

Commission File Number: 000-28317

DIGIMARC CORPORATION

(Exact name of registrant as specified in its charter)

Delaware	**94-3342784**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
9405 SW Gemini Drive, Beaverton, Oregon	**97008**
(Address of principal executive offices)	(Zip Code)

(503) 469-4800

(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o

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

Large accelerated filer o Accelerated filer x Non-accelerated filer o

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

As of July 31, 2006, there were 21,176,762 shares of the registrant s common stock, par value $0.001 per share, outstanding.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements.

DIGIMARC CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS
(DOLLARS IN THOUSANDS)
(UNAUDITED)

	June 30, 2006	December 31, 2005(1)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 17,698	$ 23,964
Short-term investments	1,001	739
Trade accounts receivable, net	6,895	9,469
Unbilled trade receivables	7,201	6,228
Inventory, net	6,349	7,451
Other current assets	2,596	2,828
Total current assets	41,740	50,679
Restricted cash	11,483	7,279
Property and equipment, net	61,568	64,108
Intangibles, net	16,144	17,164
Other assets, net	940	1,009
Total assets	$ 131,875	$ 140,239
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 6,877	$ 6,722
Accrued payroll and related costs	3,481	3,731
Deferred revenue	7,794	6,809
Other current liabilities	1,759	2,032
Total current liabilities	19,911	19,294
Other long-term liabilities	1,189	969
Total liabilities	21,100	20,263
Commitments and contingencies (Note 5)		
Stockholders equity:		
Common stock (21,176,762 and 20,808,994 shares issued and outstanding at June 30, 2006 and December 31, 2005, respectively)	22	21
Additional paid-in capital	209,657	209,337
Deferred stock compensation		(1,519)
Accumulated other comprehensive income	137	137
Accumulated deficit	(99,041)	(88,000)
Total stockholders equity	110,775	119,976
Total liabilities and stockholders equity	$ 131,875	$ 140,239

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

See Notes to Unaudited Condensed Consolidated Financial Statements.

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

	Three Months Ended June30, 2006	2005	Six Months Ended June 30, 2006	2005
Revenue:				
Service	$ 20,519	$ 21,616	$ 42,809	$ 41,212
Product and subscription	4,388	3,137	9,291	7,920
Total revenue	24,907	24,753	52,100	49,132
Cost of revenue:				
Service	15,002	15,471	32,101	29,195
Product and subscription	1,675	1,089	4,224	3,442
Total cost of revenue	16,677	16,560	36,325	32,637
Gross profit	8,230	8,193	15,775	16,495
Operating expenses:				
Sales and marketing	4,685	3,889	9,224	7,666
Research, development and engineering	2,994	3,428	6,230	6,336
General and administrative	4,172	5,521	9,382	11,018
Amortization of intangibles	550	1,339	1,123	2,150
Intellectual property	481	467	912	1,003
Restructuring charges, net	547		547	
Total operating expenses	13,429	14,644	27,418	28,173
Operating income (loss)	(5,199)	(6,451)	(11,643)	(11,678)
Other income (expense):				
Interest income	341	273	666	537
Interest expense	(28)	(58)	(44)	(120)
Other	(5)	82	43	64
Total other income, net	308	297	665	481
Income (loss) before provision for income taxes	(4,891)	(6,154)	(10,978)	(11,197)
Provision for income taxes	22	(63)	(63)	(140)
Net income (loss)	$ (4,869)	$ (6,217)	$ (11,041)	$ (11,337)
Net income (loss) per share basic	$ (0.24)	$ (0.30)	$ (0.54)	$ (0.55)
Net income (loss) per share diluted	$ (0.24)	$ (0.30)	$ (0.54)	$ (0.55)
Weighted average shares outstanding basic	20,627	20,468	20,617	20,461
Weighted average shares outstanding diluted	20,627	20,468	20,617	20,461

See Notes to Unaudited Condensed Consolidated Financial Statements.

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

	Six Months Ended June 30, 2006	June 30, 2005
Cash flows from operating activities:		
Net loss	$ (11,041)	$ (11,337)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	7,652	8,554
Stock-based compensation expense	1,576	202
Increase (decrease) in allowance for doubtful accounts	(164)	72
Other non-cash charges	(73)	(8)
Changes in operating assets and liabilities:		
Restricted cash	(4,204)	992
Trade and unbilled accounts receivable, net	1,765	(429)
Inventory, net	1,102	444
Other current assets	232	(1,179)
Other assets, net	69	132
Accounts payable	155	(3,981)
Accrued payroll and related costs	(250)	1,336
Deferred revenue	985	(34)
Other liabilities	(321)	324
Net cash provided by (used in) operating activities	(2,517)	(4,912)
Cash flows from investing activities:		
Purchase of property and equipment and capitalized labor costs	(3,407)	(8,959)
Purchase of Intangibles	(30)	(20)
Sale or maturity of short-term investments	62,713	91,538
Purchase of short-term investments	(62,975)	(74,845)
Net cash provided by (used in) investing activities	(3,699)	7,714
Cash flows from financing activities:		
Net proceeds from issuance of common stock	264	175
Principal payments under capital lease obligations	(314)	(234)
Net cash provided by (used in) financing activities	(50)	(59)
Net increase (decrease) in cash and cash equivalents	(6,266)	2,743
Cash and cash equivalents at beginning of period	23,964	18,489
Cash and cash equivalents at end of period	$ 17,698	$ 21,232
Supplemental disclosure of cash flow information:		
Cash paid for interest	$ 44	$ 120
Cash paid for income taxes	$ 111	$ 104
Summary of non-cash investing and financing activities:		
Equipment acquired or exchanged under capital lease obligations	$ 582	$ 51
Grant of restricted stock	$ 1,202	$ 2,025

See Notes to Unaudited Condensed Consolidated Financial Statements.

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

1. The Company, Basis of Presentation

Description of Business

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

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

As of June 30, 2006, the Company held rights in 271 issued U.S. patents and over 60 issued foreign patents on this technology and related technologies, applications, systems, and processes and had more than 500 U.S. and foreign applications pending.

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

The substantial majority of the Company s revenue is generated pursuant to long-term contracts with government agencies primarily U.S. state government agencies responsible for driver license issuance (State driver license issuers), a consortium of leading Central Banks and national governments of a number of foreign countries. These systems rely on our systems design, integration and materials science expertise, and proprietary technologies such as digital watermarking, to implement issuance systems and processes that improve the security of identity documents and banknotes.

The remainder of our revenue is generated primarily from patent and technology license fees paid by business partners providing media and rights management solutions to movie studios and music labels, television and radio broadcasters, creative professionals and other customers around the world. Private sector media and entertainment industry customers use secure media management solutions from the Company and its business partners to identify, track, manage and protect content as it is distributed and consumed either digitally or physically and to enable new consumer applications to improve access to networks and information from PCs and mobile devices.

Interim Financial Statements

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

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

These condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements included in the Company s Annual Report on Form 10-K for the year ended December 31, 2005, which was filed with the SEC on March 13, 2006. The results of operations for the interim periods presented in these condensed consolidated financial statements are not necessarily indicative of the results for the full year.

Use of Estimates

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

Through December 31, 2005 the Company depreciated program fixed assets that were specifically used to provide services under long term contracts over the shorter of the original contract term or estimated useful life. Starting January 1, 2006, the Company changed its policy for depreciating these assets to the shorter of the original contract term plus 2.75 years or estimated useful life. This change in estimate was supported by analysis completed by the Company during the first quarter of 2006 that showed that historically 95% of contracts were extended beyond the original contract term, that the average contract had at least two contract extensions during its life and that these extensions added on average 2.75 years to the length of the contracts original terms. Since contract-specific program assets are tracked on a contract basis, the findings that the contract life is routinely significantly longer than the original contract term and that these extensions are not generally accompanied by significant incremental capital investment indicates that the contract-related asset s useful life was longer than the original term of the contract. Given the findings of the analysis, Digimarc concluded that it was appropriate to change the estimated useful lives so that contract specific assets were being depreciated over the Company s estimate of the useful life of these assets. This change had the effect of reducing depreciation expense by $2,095 and $4,241 for the three- and six-month periods ended June 30, 2006, respectively. This reduction in depreciation increased basic and diluted earnings by $0.10 and $0.21 for the three- and six-month periods ended June 30, 2006, respectively, per share before taxes. Given that the depreciation expense attributed to contract-specific assets is part of cost of revenue, the decrease in depreciation expense will cause gross margins to increase by the amount of the reduction in depreciation expense.

Reclassifications

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

Specifically, certain costs were reclassified from general and administrative to cost of revenue, sales and marketing, research, development and engineering, intellectual property and amortization of intangibles as shown on the condensed consolidated statement of operations. The amortization of intangibles category includes amortization costs related to intangible assets, primarily customer relationship intangibles originally recorded in December 2001. The intellectual property category includes costs associated with documenting, applying for, and maintaining patents generated through the Company s research and development efforts. The infrastructure category includes rent, leasehold improvements amortization, insurance expense and infrastructure depreciation. The centralized cost category includes centralized departments that serve all operations such as our information technology department. The methods employed were based on headcount, square footage or a combination of both as appropriate.

Quarter ending March 31, 2005,	**Before**	**Intellectual Property**	**Infrastructure**	**Centralized Cost**	**After**
Cost of revenue service	$ 13,140	$	$ 140	$ 444	$ 13,724
Total cost of revenue	15,493		140	444	16,077
Gross profit	8,886		(140)	(444)	8,302
Sales and marketing	3,815	(311)	103	170	3,777
Research, development and engineering	2,483	(220)	233	412	2,908
General and administrative	7,004	(5)	(476)	(1,026)	5,497
Amortization of Intangibles	811				811
Intellectual Property		536			536
Total operating expenses	14,113		(140)	(444)	13,529

Quarter ending June 30, 2005,	**Before**	**Intellectual Property**	**Infrastructure**	**Centralized Cost**	**After**
Cost of revenue service	$ 14,878	$	$ 142	$ 451	$ 15,471
Total cost of revenue	15,967		142	451	16,560
Gross profit	8,786		(142)	(451)	8,193
Sales and marketing	3,898	(287)	105	173	3,889
Research, development and engineering	3,001	(220)	228	419	3,428
General and administrative	6,999	40	(475)	(1,043)	5,521
Amortization of Intangibles	1,339				1,339
Intellectual Property		467			467
Total operating expenses	15,237		(142)	(451)	14,644

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. For all periods presented, basic and diluted shares were the same. Shares are expressed in thousands.

Common stock equivalents related to stock options of 5,632 and 5,324 were excluded from diluted net loss per share calculations for the three- and six-month periods ended June 30, 2006, respectively, as their exercise price was higher than the average market price of the underlying common stock for the period and therefore their impact would be anti-dilutive. In addition, common stock equivalents related to stock options and restricted stock of 759 and 821 for the three- and six-month 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. The effect of 6,658 and 6,371 outstanding stock options for the three- and six-months periods ended June 30, 2005, 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 options of 407 and 351 for the three- and six-months periods ended June 30, 2005, 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 Securities and Exchange Commission issued Staff Accounting Bulletin No. 107 relating to application of SFAS 123(R). The Company has applied the provisions of SAB 107 in our 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 our 2006 fiscal year. In accordance with the modified prospective transition method, the Company s condensed consolidated financial statements for periods prior to the first quarter of fiscal 2006 have not been restated to reflect this change. Stock-based compensation recognized during the period 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 condensed consolidated financial statements for the first quarter of fiscal 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 our stock price as well as assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to the expected life of the award, our expected stock price volatility over the term of the award and actual and projected exercise behaviors. Although the fair value of stock-based awards is determined in accordance with SFAS 123(R) and SAB 107, the Black-Scholes option pricing model requires the input of highly subjective assumptions, and other reasonable assumptions could provide differing results.

Prior to January 1, 2006, the Company applied the recognition and measurement principles of Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees,* and related interpretations including Financial Accounting Standards Board (FASB) Interpretation No. 44, *Accounting for Certain Transactions involving Stock Compensation, an Interpretation of APB Opinion No. 25*, as allowed by FASB Statement No. 123, *Accounting for Stock-Based Compensation*. FASB Statement No. 123 and FASB Statement No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure, an amendment of FASB Statement No. 123*, established accounting and disclosure requirements using a fair-value-based method of accounting for stock-based employee compensation plans. Under APB Opinion No. 25, stock-based compensation expense is recognized for stock awards granted with an exercise price below fair market value on the date of grant.

Determining Fair Value Under SFAS 123(R)

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.*

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, 2006 and 2005 generally vest over four years and have contractual terms of ten years. Stock purchases under the Company s stock purchase plan have an expected life of six months to two years, which is equal to the offering period.

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.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model. There were 52,957 shares purchased under the Company s stock purchase plan during the three- and six- month periods ended June 30, 2006 and 32,491 shares purchased during the three- and six-month periods ended June 30, 2005. 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,**	
	2006	**2005**	**2006**	**2005**
Expected life (in years)	6.0	4.0	6.0	4.0
Expected volatility	53 %	50 %	53 %	50 %
Risk-free interest rate	4.7 %	4.5 %	4.7 %	4.5 %
Expected dividend yield	0 %	0 %	0 %	0 %
Expected forfeiture rate	14 %	20 %	14 %	20 %
Fair value	$ 3.89	$ 2.85	$ 3.89	$ 2.85

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-months ended June 30, 2006 which was incurred as follows (in thousands):

	Three Months Ended June 30, 2006	Six Months Ended June 30, 2006
Stock-based compensation:		
Cost of revenue	$ 84	$ 138
Sales and marketing	134	256
Research, development and engineering	76	190
General and administrative	488	992
Total stock-based compensation	$ 782	$ 1,576

At June 30, 2006 the Company had 1.6 million non-vested stock options that had a weighted average grant date price of $6.32. As of June 30, 2006, the Company had $6.1 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 1.72 years.

The following table presents the impact of the Company s adoption of SFAS 123(R) on selected line items from its condensed consolidated financial statements for the three- and six-month periods ended June 30, 2006 (in thousands, except per share amounts):

	Three Months Ended June 30, 2006		Six Months Ended June 30, 2006	
	As Reported Following FAS 123 (R	If Reported Following APB 25	As Reported Following FAS 123 (R)	If Reported Following APB 25
Condensed consolidated statement of operations:				
Operating income (loss)	$ (5,199)	$ (4,636)	$ (11,643)	$ (10,474)
Income (loss) before provision for income taxes	(4,891)	(4,328)	(10,978)	(9,809)
Net income (loss)	(4,869)	(4,306)	(11,041)	(9,872)
Net income (loss) per share				
Basic	(0.24)	(0.21)	(0.54)	(0.48)
Diluted	(0.24)	(0.21)	(0.54)	(0.48)

Stock Option Activity

As of June 30, 2006, under all of the Company s stock-based compensation plans, options to purchase an aggregate of 7.3 million shares were outstanding, and options to purchase an additional 3.6 million shares were authorized for future grants under the plans. The Company issues new shares for option exercises.

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

	Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life
Outstanding at December 31, 2005	7,368,636	$ 16.16	
Options granted	693,035	4.54	
Options exercised	(1,922)	2.42	
Options canceled	(823,248)	14.20	
Options expired			
Outstanding at March 31, 2006	7,236,501	$ 14.00	6.84 years
Exercisable at March 31, 2006	5,617,298	$ 16.24	6.23 years

	Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life
Outstanding at March 31, 2006	7,236,501	$ 14.00	
Options granted	277,825	6.83	
Options exercised	(3,857)	2.81	
Options canceled	(212,919)	11.07	
Options expired			
Outstanding at June 30, 2006	7,297,550	$ 13.82	6.80 years
Exercisable at June 30, 2006	5,706,024	$ 15.91	6.09 years

At December 31, 2005, a total of 6.3 million options were exercisable at a weighted-average exercise price of $16.16.

The following table summarizes information about stock options outstanding at June 30, 2006:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number Outstanding	Remaining Contractual Life (Years)	Weighted Average Price	Number Exercisable	Weighted Average Price
$ 0.50 - $ 6.15	1,414,558	8.46	$ 5.40	452,302	$ 4.24
$ 6.19 - $ 9.85	1,066,836	8.81	$ 7.58	437,566	$ 8.58
$10.29 - $12.25	760,612	7.48	$ 11.60	760,612	$ 11.60
$12.40 - $12.25	653,043	6.59	$ 12.83	653,043	$ 12.83
$13.38 - $14.13	797,200	4.67	$ 14.06	797,200	$ 14.06
$14.40 - $15.24	629,210	6.47	$ 15.10	629,210	$ 15.10
$15.25 - $17.00	830,297	6.38	$ 16.26	830,297	$ 16.26
$17.60 - $26.25	769,744	4.92	$ 20.99	769,744	$ 20.99
$27.50 - $35.13	121,050	3.86	$ 31.40	121,050	$ 31.40
$53.94 - $53.94	255,000	3.59	$ 53.94	255,000	$ 53.94
$ 0.50 - $53.94	7,297,550	6.80	$ 13.82	5,706,024	$ 15.91

Pro Forma Information Under SFAS 123 and APB 25

Prior to the fiscal year ending December 31, 2006, the Company accounted for stock-based compensation plans using the intrinsic value method prescribed in APB 25 and related interpretations. No stock-based compensation related to option grants or the employee stock purchase plan was reflected in net loss in the three- and six-months ended June 30, 2005, as all stock options granted under those plans had an exercise price equal to or greater than the market value of the underlying common stock on the date of grant. Had compensation cost for the plans been determined based on the fair value at the grant dates for awards under those plans consistent with the method of SFAS 123, the Company s net loss and basic and diluted net loss per share for the three- and six-month periods ended June 30, 2005 would have been changed to the pro forma amounts indicated below (in thousands, except for per share data):

	Three Months Ended June 30, 2005	Six Months Ended June 30, 2005
Net loss, as reported	$ (6,217)	$ (11,337)
Add: Stock-based compensation expense determined under the intrinsic value method	151	202
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards	(1,834)	(3,510)
Pro forma net loss	$ (7,900)	$ (14,645)
Earnings per share:		
Basic as reported	$ (0.30)	$ (0.55)
Diluted as reported	$ (0.30)	$ (0.55)
Basic pro forma	$ (0.39)	$ (0.72)
Diluted pro forma	$ (0.39)	$ (0.72)

On December 15, 2005, the Board of Directors of the Company approved the acceleration of vesting of the Company s outstanding stock options with option exercise prices equal to or greater than $9.00. The acceleration applied to all options outstanding as of December 31, 2005 under the Company s Restated 1999 Stock Incentive Plan and 2000 Non-Officer Employee Stock Incentive Plan, except for options held by members of the Company s Board of Directors. Options to purchase 422,248 shares of the Company s common stock, or 6% of the Company s total outstanding options, with a weighted average exercise price of $11.51 and varying remaining vesting schedules, were subject to this acceleration and became immediately vested and exercisable as of December 31, 2005. Of these 422,248 options, 120,972 options are held by the Company s executive officers.

On December 21, 2004, the Audit, Compensation and Corporate Governance Committees of the Board of Directors of the Company approved the acceleration of vesting of the Company s outstanding stock options with option exercise prices greater than $15.00. The acceleration applied to all options outstanding under the Company s Restated 1999 Stock Incentive Plan and 2000 Non-Officer Employee Stock Incentive Plan that would not have otherwise vested in full by June 30, 2005 in accordance with their terms. The effective date of the vesting acceleration was December 31, 2004. Options to purchase 310,057 shares of the Company s common stock, or 5% of the total number of options of the Company outstanding as of December 31, 2004 with remaining vesting schedules, were accelerated. Of these 310,057 options, approximately 50,000 options were held by the Company s executive officers. No additional compensation expense was recorded in the statement of operations as the options that were accelerated had an exercise price greater than the fair market value of the shares underlying the options on the date of the modification.

As a result of these accelerations, the Company reduced its exposure to the effects of SFAS 123(R).

4. Segment Information

The Company derives its revenue from a single reporting segment, secure identity and media management. Revenue is generated in this reporting 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 U.S. and in other countries through its sales personnel and its subsidiaries.

Revenue by geography is as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	**2005**	**2006**	**2005**
Domestic	$ 21,112	$ 20,108	$ 41,307	$ 40,069
International	3,795	4,645	10,793	9,063
Total	$ 24,907	$ 24,753	$ 52,100	$ 49,132

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. There was no single customer in the three- and six-month periods ended June 30, 2005 that accounted for more than 10% of total revenue. There was one customer that accounted for more than 10% of trade and unbilled accounts receivable, net at June 30, 2006. There was one customer who accounted for 11% of trade and unbilled accounts receivable, net at December 31, 2005.

5. Commitments and Contingencies

Beginning in September 2004, three purported class action lawsuits were commenced against the Company and certain of its current and former directors and officers by or on behalf of persons claiming to have purchased or otherwise acquired the Company s securities during the period from April 17, 2002 to July 28, 2004. These lawsuits were filed in the United States District Court for the District of Oregon and were consolidated into one action for all purposes on December 16, 2004. On May 16, 2005, plaintiffs filed an amended complaint. The complaint asserted claims under the federal securities laws, specifically Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, relating to the Company s announcement that it had discovered errors in its accounting for software development costs and project capitalization and other project cost capitalization accounting practices, and that it likely would be required to restate its previously reported financial statements for full fiscal year 2003 and the first two quarters of 2004. Specifically, the complaint alleged that the Company issued false and misleading financial statements and created a misperception regarding the profitability of the Company in order to inflate the value of Digimarc stock, which permitted insider sales of personal holdings at inflated values, and that the Company maintained insufficient accounting controls, which created an environment where improper accounting could be used to manipulate financial results. The complaint sought unspecified damages. On November 30, 2005, the Court granted the Company s motion to dismiss the amended complaint on the grounds that plaintiffs had failed to allege facts sufficient to support their allegation that the defendants knowingly or recklessly acted in violation of the securities laws. Plaintiffs filed a second amended complaint on January 17, 2006. On February 14, 2006, the Company filed a motion to dismiss the second amended complaint on the grounds that plaintiffs still fail to allege facts sufficient to support their allegation that the defendants knowingly or recklessly acted in violation of the securities laws. On August 4, 2006, the Court granted this motion and dismissed the lawsuit with prejudice. Plaintiffs have thirty days to appeal this decision to the U.S. Court of Appeals for the Ninth Circuit. Due to the inherent uncertainties of litigation, the Company cannot accurately predict the ultimate 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, as well as the second derivative action described in the immediately following paragraph. 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. This motion currently is pending. 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.

A separate derivative action, involving substantially the same claims, was filed on or about April 6, 2005 in the Circuit Court of the State of Oregon for the County of Washington. On March 31, 2006 the individual defendants filed a motion to dismiss the lawsuit based on the recommendation of the Board committee. Plaintiffs subsequently stipulated to a dismissal of the lawsuit and, on May 5, 2006, Judge Gardner signed a stipulated motion and order of dismissal, dismissing the lawsuit with prejudice.

Beginning in May 2001, a number of substantially identical class action complaints alleging violations of the federal securities laws were filed in the United States District Court for the Southern District of New York naming approximately 300 companies, including the Company, 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 provide, among other things, a release of the Company and of the individual defendants for the conduct alleged in the amended complaint to be wrongful. The Company would agree to undertake other responsibilities under the partial settlement, including agreeing to assign away, not assert, or release certain potential claims the Company may have against its underwriters. Any direct financial impact of the proposed settlement (other than defense costs incurred and expensed prior to May 31, 2003) is expected to be borne by the Company s insurers. The court granted the preliminary approval motion on February 15, 2005, subject to certain modifications. On August 31, 2005, the court issued a preliminary order further approving the modifications to the settlement and certifying the settlement classes. The court also appointed the Notice Administrator for the settlement and ordered that notice of the settlement be distributed to all settlement class members beginning on November 15, 2005 and completed by January 15, 2006. The settlement fairness hearing was held on April 26, 2006, but the court has not yet rendered its decision. If the court determines that the settlement is fair to the class members, the settlement will be approved. There can be no assurance that this proposed settlement will be approved and implemented in its current form, or at all. Due to the inherent uncertainties of litigation and because the settlement approval process is at a preliminary stage, the Company cannot accurately predict the ultimate outcome of the matter.

The Company from time to time experiences delays in identification system implementation, timely acceptance for identification systems programs, concerns regarding identification system program performance, and other contractual disputes. Customers have asserted, and may in the future assert, compensatory or liquidated damages, 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. From time to time, customers have given notice of their intention to assert claims for liquidated damages. 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 its 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.

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

The Company is subject from time to time to other legal proceedings and claims arising in the ordinary course of business. Although the ultimate outcome of these matters cannot be determined, management believes that, as of June 30, 2006, 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 Company. No accrual has been recorded because the amounts are not probable or reasonably estimatable in accordance with SFAS No. 5, *Accounting for Contingencies*.

6. Recent Accounting Pronouncements

In March 2006, the FASB issued SFAS No. 156, *Accounting for Servicing of Financial Assets, an amendment of SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. The statement changes the way entities account for servicing assets and obligations associated with financial assets acquired or disposed of. SFAS No. 156 is effective for the first fiscal year beginning after September 15, 2006. The Company does not expect the adoption of this standard to have a material effect on the Company s financial statements.

In July 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, which defines the threshold for recognizing the benefits of tax return positions in the financial statements as more-likely-than-not to be sustained by the taxing authority. Interpretation No. 48 applies to all tax positions accounted for under SFAS No. 109, *Accounting for Income Taxes*. Interpretation No. 48 is effective as of the beginning of the first fiscal year beginning after December 15, 2006. Upon adoption, we will adjust our financial statements to reflect only those tax positions that are more-likely-than-not to be sustained as of the adoption date. Any adjustment will be recorded directly to our beginning retained earnings balance in the period of adoption and reported as a change in accounting principle. We are currently analyzing the effects of adopting Interpretation No. 48.

7. Revenue Recognition

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 earned which has not been invoiced is classified as unbilled trade receivables in the consolidated balance sheets. Revenue related to an enhancement of or upgrade to an existing system is deferred and recognized over the remaining life of the contract.

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.

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. Revenue earned which has not been invoiced is classified as unbilled trade receivables in the consolidated balance sheets.

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.

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 over the term of the service period.

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

The Company also generates revenue from 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.

AICPA SOP No. 98-9 requires that revenue be recognized using the residual method in circumstances when vendor specific objective evidence 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.

Certain customer arrangements encompass multiple deliverables, such as hardware sales, consumables sales, maintenance fees, and software development fees. The Company accounts for these arrangements in accordance with Emerging Issues Task Force 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 our purposes, fair value is generally defined as the price at which a customer could purchase each of the elements independently from other vendors or as the price that the Company has sold the element separately to another customer. Applicable revenue recognition criteria is considered separately for each separate unit of accounting. Management applies judgment to ensure appropriate application of EITF Issue No. 00-21, including value allocation among multipledeliverables, determination of whether undelivered elements are essential to the functionality of delivered elements and timing of revenue recognition, among others.

8. 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, 2006	**December 31, 2005**
Equipment and deferred contract costs	$ 778	$ 899
Consumable materials	5,571	6,552
Inventory, net	$ 6,349	$ 7,451

The reserve for slow moving and obsolete items was $220 and $240 at June 30, 2006 and December 31, 2005, respectively. While we do not currently expect to be able to sell or otherwise use the reserved inventory we have on hand based upon our forecast and backlog, it is possible that a customer or customers will decide in the future to purchase a portion of the reserved inventory.

9. Software Development Costs

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

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

10. Related Party Transactions

During the three- and six-month periods ended June 30, 2006, the Company recognized revenue of $100 and $225, respectively, from a holder of common stock. In addition the Company recognized revenue of $113 and $255 for the three- and six-month periods ended June 30, 2005, respectively, from this stockholder. Net accounts receivable from this stockholder was $20 at June 30, 2006 and $231 at December 31, 2005.

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 under the caption Risk Factors in this Form 10-Q and the audited consolidated financial statements and related notes included in our Annual Report on Form 10-K for the year ended December 31, 2005 filed on March 13, 2006, and other reports and filings made with the SEC.

Overview

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

The Company issues more than 60 million identification documents (IDs) annually and is the leading supplier of government-issued citizen IDs in the United States, producing more than two-thirds of all driver licenses issued in the U.S.

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 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.

Digital watermarking is a strategic component of nearly all of our product offerings. We provide solutions based on this technology directly and through our licensees. Digital watermarking has already proven to be a powerful differentiator in banknote security, giving rise to a long-term relationship with leading Central Banks and many leading companies in the IT industry. We are working to develop a similar success in secure identity management systems. We anticipate that more than one in three driver licenses issued in the U.S. in 2006 will carry digital watermarks as a means to provide cross-jurisdictional machine authentication.In addition, Digimarc and its licensees have successfully propagated digital watermarking in music, movies, television and radio broadcasts, images and printed materials. Digital watermarks have been used in these applications to provide improved media rights and asset management, reduced piracy and counterfeiting losses, improve marketing programs, and more efficient and effective distribution of valuable media content.

The majority of our revenue is derived from supplying infrastructure to government agencies pursuant to long-term contracts, primarily State driver license issuers, a consortium of leading Central Banks and national governments of various foreign countries. The industry model for the U.S. driver license market is characterized by long-term contracts awarded through competitive bids to prime contractors who take full responsibility for delivery and maintenance of driver license issuance systems. 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. Our licensing business is built upon our extensive patent portfolio, which contains 267 issued U.S. patents as of June 30, 2006. We expect that patent licensing will continue to contribute most of our revenues from non-government customers for the foreseeable future.

Markets

Government

We believe that the U.S. driver license market will continue to grow due to broadening use of the driver license as a secure credential beyond its traditional role as evidence of competence to drive a motor vehicle; technological innovation; desire among issuers to improve security and efficiency; and new governmental regulations such as the REAL ID Act. We anticipate that these regulations will result in more opportunities for States to expand their existing driver license systems using Federal dollars. However, funding under the REAL ID Act, as well as guidance on future regulations that will more specifically define the requirements for compliance, have not been provided as quickly as we anticipated. We cannot predict the full extent to which we will benefit from funding under the REAL ID Act until the Department of Homeland Security provides such guidance. These future regulations may impose certain requirements, such as specific card architectures or security features, and may condition funding upon compliance with such requirements. In addition, the conditions for availability of grant money from the Department of Homeland Security and the Department of Transportation for projects relating to compliance with the REAL ID Act, commercial driver license systems, and protection of the Homeland may cause some changes in the procurement model, but we cannot predict the likelihood or outcome of those changes at this time.

We believe that many aspects of our driver license issuance solutions have value in other forms of credentials and secure personal identification systems. As the global market for secure personal identification solutions develops, we believe that our position as the largest supplier of government-issued citizen IDs in the U.S. and Mexico and our extensive investments in research and development provide a good foundation for participation in the global market for government programs in establishing the identities of citizens and issuing associated credentials.

Media & Entertainment

Our technology is used in various products and solutions affecting a variety of media objects, from movies and music, to banknotes and secure credentials. Each media object enabled by our technology creates the potential for several applications, such as counterfeiting and piracy deterrence, media identification and management, authentication, monitoring, or linking to networks and enhanced services in support of mobile commerce. We believe the market for digital watermarking applications is in the early stages of development and that existing solutions represent only a small portion of the potential market for our products, services, and technologies. However, we cannot, as of the date of this report, provide reliable estimates of the size of these markets or predict the extent to which these markets will provide opportunities for revenue growth.

Products and Services

Financial Document Security

We have a multi-year contract with an international consortium of Central Banks in which we have developed, deployed, and are supporting and continuing to enhance a system to deter digital counterfeiting of currency using personal computers and digital reprographics. Work on the system began in 1997. Details of the system are confidential for security reasons.

Secure ID Solutions

As the leading provider of government-issued secure IDs in North America, our systems produce more than 60 million driver licenses and other secure personal IDs per year. Two-thirds of the U.S. States and many foreign governments, including Russia, Latvia, Mexico, and Canada, use Digimarc secure ID solutions to issue credentials to citizens. 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. Our North American driver license issuance systems vary from jurisdiction to jurisdiction. These systems are typically provided pursuant to long-term (normally five or more years) contracts. The systems provided include the hardware, software, consumable supplies (such as ribbons, blank or preprinted card materials, and laminates), and on-going support necessary for a turnkey solution. They typically involve custom 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 assets associated with the system and are responsible for maintaining the system over the contractual period. A digital driver license issuance system typically captures images (photo and signature) and demographic information, validates applicant identity, produces the actual driver license or ID (either at the point of service or at a central production facility operated by us), provides or delivers the finished driver license or other ID to the individual licensee, stores the images and associated data in a database, and communicates with the issuer s other systems for completion of processing of the driver license applicants.

We are working on broadening our security offerings to provide more integrated identity verification and fraud detection capabilities within the issuance workflow of our customers. Many aspects of our solutions anticipate both the mandate of the REAL ID Act and the emerging consensus on best practices consistent with our product and service strategy. In 2005, we introduced the Digimarc Identity Validation Suite (IDVS) to validate identity documents and verify the biometric and demographic data presented to establish an applicant s identity. As identity credentials become more secure and difficult to counterfeit, counterfeiters turn to producing false breeder documents to fuel attempts to fraudulently obtain valid secure credentials. Thus, the process of validating identity is becoming central to secure ID issuance as document quality improves, ensuring that only valid applicants receive genuine IDs. This market development is underscored by the focus of the REAL ID Act on identity validation. IDVS is our most strategic product offering in 2006, serving a growing demand by our customers for effective multi-factor identification of applicants.

In the second quarter of 2006, we introduced the next generation of three Digimarc secure enrollment products the Digimarc Camera Tower, Digimarc Capture Software, and Digimarc Image Server to digitally capture and manage the industry s highest quality portraits, clear signatures, and reliable fingerprints. Together, these products securely capture, store and serve up the biometric images needed by driver license and other government ID issuers for card production, renewals, fraud investigation, and more. Additionally, knowledge testing, validation of documents and verification of applicant identity are keys to the secure intake and enrollment process, and a critical step toward ensuring that driver licenses are only issued to legitimate applicants.

Media and Entertainment

We license our technology and patents and otherwise foster development of the market for digital watermarking-based solutions for commercial as well as governmental uses. These licenses primarily involve use of our technology and patents in the media and entertainment area. Commercial customers use secure media solutions from our business partners and us to identify, track, manage and protect content as it is distributed and consumed either digitally or physically and to enable new consumer applications to access networks and information from PCs and mobile devices. Many movie studios, record labels, broadcasters, creative professionals and other customers rely on digital watermarking as a cost-effective means to:

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

Our business partners include Activated Content Corporation, AquaMobile, Cinea, Inc., a subsidiary of Dolby Laboratories, Inc., GCS Research LLC, MediaGrid, Nielsen Media Research, Inc., Royal Philips, Signum Technologies Limited, Thomson Multimedia, S.A., Verance Corporation, Verimatrix, Inc. and VCP (an affiliate of VEIL Interactive Technologies).

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, 2005 and in our Quarterly Report on Form 10-Q for the quarter ended March 31, 2006.

Recent Developments

In our report on Form 10-Q for the quarter ending March 31, 2006, we disclosed certain developments concerning our protest of a notice of intent to award a contract issued by the Commonwealth of Virginia Department of Motor Vehicles (DMV) for the issuance of driver licenses. On April 5, 2006, DMV issued a notice of intent to award a contract to Canadian Bank Note Secure Technologies, Inc. (CBN) for a new driver license issuance system pursuant to RFP 154:5-060. On April 17, 2006, Digimarc filed a protest of this award, based in part on certain alleged irregularities in the evaluation process and the assertion that the CBN proposal did not represent the best value for the Commonwealth and its citizens. On April 27, 2006, DMV issued a response, in which it rescinded the Notice of Intent to Award. The DMV response stated that Digimarc s protest raises issues that DMV believes warrant further consideration and evaluation and that, [i]n addition, DMV has determined that certain details pertaining to the agreement with the proposed contractor were still being addressed when the earlier notice was posted. On June 1, 2006, DMV cancelled the RFP and informed bidders that DMV is working to issue a new RFP in the near future.

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 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. If our estimates of projected future cash flows were too high by 10% or less, we believe there would be no material impact on the reported value of intangible assets on our Consolidated Balance Sheet. 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. If our estimate of uncollectible accounts were too low by 10% or less, we believe there would be no material impact on the reported value of accounts receivable on our consolidated balance sheets.

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: On January 1, 2006, we adopted SFAS 123(R), 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. Under SFAS 123(R), we use the Black-Scholes option pricing model as our method of valuation for stock-based awards. Our determination of the fair value of stock-based awards on the date of grant using an option pricing model is affected by our stock price as well as assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to the expected life of the award, our expected stock price, volatility over the term of the award and actual and projected exercise behaviors. Although the fair value of stock-based awards is determined in accordance with SFAS 123(R), the Black-Scholes option pricing model requires the input of highly subjective assumptions, and other reasonable assumptions could provide differing results.

Results of Operations

The following table presents our condensed consolidated statements of operations data for the periods indicated as a percentage of total revenue.

	Three Months Ended June 30, 2006	Three Months Ended June 30, 2005	Six Months Ended June 30, 2006	Six Months Ended June 30, 2005
Revenue:				
Service	82 %	87 %	82 %	84 %
Product and subscription	18	13	18	16
Total revenue	100	100	100	100
Cost of revenue:				
Service	60	63	62	59
Product and subscription	7	4	8	7
Total cost of revenue	67	67	70	66
Gross profit	33	33	30	34
Operating expenses:				
Sales and marketing	19	16	17	16
Research, development and engineering	12	14	12	13
General and administrative	17	22	18	23
Amortization of intangibles	2	5	2	4
Intellectual property	2	2	2	2
Restructuring charges, net	2	0	1	0
Total operating expenses	54	59	52	58
Operating income (loss)	(21)	(26)	(22)	(24)
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	(20)	(25)	(21)	(23)
Provision for income taxes	0	0	0	0
Net income (loss)	(20)%	(25)%	(21)%	(23)%

Revenue

	Three Months Ended June 30, 2006	Three Months Ended June 30, 2005	Dollar Increase (Decrease)	Percent Increase (Decrease)	Six Months Ended June 30, 2006	Six Months Ended June 30, 2005	Dollar Increase (Decrease)	Percent Increase (Decrease)
Revenue:								
Service	$ 20,519	$ 21,616	$ (1,097)	(5)%	$ 42,809	$ 41,212	$ 1,597	4 %
Product and subscription	4,388	3,137	1,251	40 %	9,291	7,920	1,371	17 %
Total	$ 24,907	$ 24,753	$ 154	1 %	$ 52,100	$ 49,132	$ 2,968	6 %
Revenue (as % of total revenue):								
Service	82 %	87 %			82 %	84 %		
Product and subscription	18 %	13 %			18 %	16 %		
Total	100 %	100 %			100 %	100 %		

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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 is an umbrella category consisting of both service revenue and contract-based service revenue. The distinction between these two subcategories is that service revenue is generated from long-term identification and driver license production contracts, while contract-based service revenue is generated from other long-term, time-and-materials service contracts.

Service revenue decreased for the three-month period ended June 30, 2006 compared to the corresponding three-month period ended June 30, 2005 primarily due to decreased card issuance revenue from the Mexico program that resulted from a several month hiatus related to national elections. The increase in revenue for the six-month period ended June 30, 2006 compared to the corresponding six-month period ended June 30, 2005 resulted primarily from increased production for certain programs including Florida, Alabama, Haiti and Latvia, offset by decreased revenue from the Mexico program.

In addition, we have observed seasonality in our service revenues, with larger revenues in the second and third quarter of the year, and generally lower revenues in the first and fourth quarters. The fourth quarter is usually the seasonally lowest quarter each year. We expect our service revenue results in the third quarter of 2006 to be consistent with this pattern of seasonality.

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

Product and subscription revenue increased for the three-month period ended June 30, 2006 compared to the corresponding three-month period ended June 30, 2005 primarily due to several programs, including Ghana, Russia and Florida. The increase in revenue between the six-month period ended June 30, 2006 and the corresponding six month period ended June 30, 2005 resulted primarily from a new international program with Yemen, which was offset by decreased domestic revenue due to lower product sales to certain domestic customers in 2006.

Backlog. Based on projected driver license 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, 2006 will generate more than $220 million in revenue during the contractual terms of such contracts, currently up to seven years. We expect approximately $40 million of this amount to be recognized as revenue during the remainder of 2006. This amount includes production volumes reasonably expected to be achieved under currently effective contracts, government orders that are firm but not yet funded, and government contracts awarded but not yet signed.

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,
- Periods following low bid activity,
- Contracts with shorter contractual periods replacing contracts with longer contractual periods, and

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• 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. For example, the three-month period ended June 30, 2006 had a low level of bid awards, and as a result we have consumed backlog during the quarter without large replenishments from competitive bid wins. Over the next year or so, 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 example is the variable revenue model. Two of our recent domestic driver license issuance system sales were not our characteristic price-per-card model, but instead included 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 can be 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 recognition may change.

	Three Months Ended June 30, 2006	**2005**	**Dollar Increase (Decrease)**	**Percent Increase (Decrease)**	**Six Months Ended June 30, 2006**	**2005**	**Dollar Increase (Decrease)**	**Percent Increase (Decrease)**
Revenue by geography:								
Domestic	$ 21,112	$ 20,108	$ 1,004	5 %	$ 41,307	$ 40,069	$ 1,238	3 %
International	3,795	4,645	(850)	(18)%	10,793	9,063	1,730	19 %
Total	$ 24,907	$ 24,753	$ 154	1 %	$ 52,100	$ 49,132	$ 2,968	6 %
Revenue (as % of total revenue):								
Domestic	85 %	81 %			79 %	82 %		
International	15 %	19 %			21 %	18 %		
Total	100 %	100 %			100 %	100 %		

The increase in domestic revenue for the three-month period ended June 30, 2006 as compared to the corresponding three-month period ended June 30, 2005 resulted primarily from increased revenue from certain programs such as Florida and Alabama that were either delivered or achieved full production in early 2006. The increase in revenue for the six-month period ended June 30, 2006 as compared to the corresponding six-month period ended June 30, 2005 was due primarily to increased revenue from the Florida and Alabama programs offset by lower production revenues in certain States that occur from time to time. The decrease in international revenue for the three-month period ended June 30, 2006 compared to the corresponding three-month period ended June 30, 2005 was due primarily to decreased revenue from the second quarter hiatus in our Mexico plant due to national elections. The increase in international revenue for the six-month period ended June 30, 2006 as compared to the corresponding six-month period ended June 30, 2005 was due primarily to increased revenue from Yemen, Haiti, and Latvia programs that were either delivered or achieved full production in early 2006, offset by the Mexico program.

In non-U.S. markets, where we provide driver license, national identification, and voter identification systems, services, and components in partnership with local card producers, security printers, system integrators, and others, we may serve as prime contractor or sub-contractor, depending on the circumstances. As a sub-contractor, we are responsible for delivering hardware, software, or consumables to the prime contractor; and, as a prime contractor, we are responsible for integrating the components of the system to the customer s specifications.

International sales have typically taken the form of an outright sale of equipment and/or consumables to non-U.S. government agencies or their prime contractors. These sales often can be large, carry relatively low margins and may cause variations in quarterly revenue and gross profit trends. Despite the relatively low margins, we enter into such contracts from time to time to maintain market presence and build customer and partner relationships, as such programs 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. We believe that international growth opportunities exist for us, and we expect to continue to invest in personnel and resources to support our potential revenue growth outside of the U.S.

Cost of Revenue

	Three Months Ended June 30, 2006	2005	Dollar Increase (Decrease)	Percent Increase (Decrease)	Six Months Ended June 30, 2006	2005	Dollar Increase (Decrease)	Percent Increase (Decrease)
Cost of Revenue:								
Service	$ 15,002	$ 15,471	$ (469)	(3)%	$ 32,101	$ 29,195	$ 2,906	10 %
Product and subscription	1,675	1,089	586	54 %	4,224	3,442	782	23 %
Total	$ 16,677	$ 16,560	$ 117	1 %	$ 36,325	$ 32,637	$ 3,688	11 %
Cost of Revenue (as % of related revenue components):								
Service	73 %	72 %			75 %	71 %		
Product and subscription	38 %	35 %			45 %	43 %		

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, business development personnel and outside contractors, depreciation charges for machinery, equipment and capitalized software, deployment costs used specifically for service delivery, provisions for obsolete and excess inventories, travel costs directly attributable to service and development contracts, and charges for infrastructure and centralized costs.

Cost of service revenue decreased for the three-month period ended June 30, 2006 compared to the corresponding three-month period ended June 30, 2005 primarily due to:

- decreased program costs related to cost reduction initiatives of $0.6 million,
- decreased employee compensation-related expenses of $0.2 million as part of a restructuring initiative, offset by
- increased allocated infrastructure and centralized costs of $0.3 million primarily due to system upgrades and enhancements in our information technology department.

Cost of service revenue increased for the six-month period ended June 30, 2006 compared to the corresponding six-month period ended June 30, 2005 primarily due to the increased support cost of $3.2 million. During the first two quarters of the fiscal year the Company allocated additional resources to fixing and improving existing programs and experienced delays in initiation of certain capital projects. As a result, support costs increased and fewer expenditures were capitalized to the balance sheet

Product and subscription. Cost of product and subscription revenue primarily includes compensation for operations personnel, costs of consumables sold to third parties, costs of machinery sold to third parties, and 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, 2006 compared to the corresponding three-month period ended June 30, 2005 primarily due to increased domestic and international material costs of $0.6 million related to hardware and consumable sales.

Cost of product and subscription revenue increased for the six-month period ended June 30, 2006 compared to the corresponding six-month period ended June 30, 2005 primarily due to increased international material costs of $1.6 million, offset by lower domestic material costs of $0.6 million related to hardware and consumable sales.

The costs included in our cost of revenue are comprised of three categories as described below:

	Three Months Ended June 30,		**Dollar Increase (Decrease)**	**Percent Increase (Decrease)**	**Six Months Ended June 30,**		**Dollar Increase (Decrease)**	**Percent Increase (Decrease)**
	2006	**2005**			**2006**	**2005**		
Cost of revenue:								
Variable	$ 6,454	$ 6,850	$ (396)	(6)%	$ 14,771	$ 14,131	$ 640	5 %
Fixed field support and manufacturing	7,595	6,524	1,071	16 %	16,338	12,537	3,801	30 %
Program depreciation	2,628	3,186	(558)	(18)%	5,216	5,969	(753)	(13)%
Total	$ 16,677	$ 16,560	$ 117	1 %	$ 36,325	$ 32,637	$ 3,688	11 %
Cost of revenue (as % of total revenue):								
Variable	26 %	28 %			28 %	29 %		
Fixed field support and manufacturing	30 %	26 %			32 %	25 %		
Program depreciation	11 %	13 %			10 %	12 %		
Total	67 %	67 %			70 %	66 %		

Variable costs include the price of materials and labor to produce an identification card, direct costs of hardware and software delivered and other costs that are variable in nature. The changes in variable costs as a percentage are primarily due to a sales mix that included lower margin sales of hardware and consumable products that occur from time to time, as well as continued pricing improvement with vendors and improved yields during the manufacturing process.

Fixed field support and manufacturing includes field operations, field support, manufacturing, and supply chain costs. These costs are considered fixed with respect to supporting current contracts. As new contracts are entered into and delivered, the overall level of fixed costs increases. The increase in fixed costs are primarily due to newer contracts requiring additional headcount, as well as travel costs to support them. During the first two quarters of the fiscal year, we focused on fixing and improving certain existing programs and as a result fewer expenditures were capitalized to the balance sheet. As a result of these actions, fixed support costs increased.

Program depreciation primarily consists of amortization and depreciation of costs incurred during the delivery process, where such costs are capitalized and then amortized or depreciated over the useful lives of the assets to which the costs relate. Program depreciation decreased in relation to the other components of cost of revenue primarily due to the change in the estimated useful lives of program-related fixed assets. Through December 31, 2005, we depreciated program fixed assets that were specifically used to provide services under long term contracts over the shorter of the original contract term or estimated useful life. Starting January 1, 2006, we changed our policy for depreciating these assets to the shorter of the original contract term plus 2.75 years or estimated useful life. This change in estimate was supported by analysis 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 findings that the contract life is routinely significantly longer than the original contract term and that these extensions are not generally accompanied by significant incremental capital investment indicates that the contract-related assets useful life was longer than the original term of the contract. Given the findings of the analysis, we concluded that it was appropriate to change the estimated useful lives so that contract specific assets were being depreciated over our most accurate estimate. The following table shows the effect of this policy of reducing depreciation expense in the first two quarters of 2006, as well as the expected effect in the future periods specified:

	Q1 2006 (in 000 S)	Q2 2006	Q3 2006	Q4 2006	2006	2007
Previous estimated depreciation	$ 4,540	$ 4,464	$ 4,177	$ 4,199	$ 17,380	$ 16,067
Updated estimated depreciation	2,394	2,369	2,315	2,298	9,376	9,787
Reduction in depreciation expense	$ 2,146	$ 2,095	$ 1,862	$ 1,901	$ 8,004	$ 6,280

The change in estimating the useful lives of program-related fixed assets had the effect of reducing depreciation expense by $2,095 and $4,241 for the three- and six-month periods ended June 30, 2006, respectively. This reduction in depreciation increased basic and diluted earnings per share by $0.10 and $0.21 for the three- and six-month periods ended June 30, 2006, respectively. Given that the depreciation expense attributed to contract-specific assets is included in cost of revenue, the decrease in depreciation expense will cause gross margins to increase by the amount of the reduction in depreciation expense.

The primary factor offsetting the reduction in program depreciation was higher than average costs to deploy certain new programs where we provided a complete system replacement using advanced technologies. These programs have recently been completed and are now in production. These installations were particularly challenging for us, representing a more expanded scope than that of our historical system deliveries. We were successful in delivering these programs, but at higher costs than have been customary. In another case, we bid a program aggressively as part of a broader market development strategy that we believe will yield good long-term performance. The fixed costs for these systems, which include amortization and depreciation of costs capitalized during the delivery process, as well as field service and operational costs to manage and maintain them, are higher than average and, thus, reduce reported margins. We anticipate that we will be able to improve profit margins in these accounts over time and earn a better return on investment over the life of the account relationship.

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 as a percentage of revenue in the second and third quarters when our revenues are higher and decreasing margins as a percentage of revenue in the first and fourth quarters when our issuance revenues are typically lower, while having a neutral effect on a yearly basis.

Gross Profit

	Three Months Ended June 30, 2006	2005	Dollar Increase (Decrease)	Percent Increase (Decrease)	Six Months Ended June 30, 2006	2005	Dollar Increase (Decrease)	Percent Increase (Decrease)
Gross Profit:								
Service	$ 5,517	$ 6,145	$ (628)	(10)%	$ 10,708	$ 12,017	$ (1,309)	(11)%
Product and subscription	2,713	2,048	665	32 %	5,067	4,478	589	13 %
Total	$ 8,230	$ 8,193	$ 37	<1 %	$ 15,775	$ 16,495	$ (720)	(4)%
Gross Profit (as % of related revenue components):								
Service	27 %	28 %			25 %	29 %		
Product and subscription	62 %	65 %			55 %	57 %		
Total	33 %	33 %			30 %	34 %		

Overall gross profit as a percentage of revenue was 33% and 30%, respectively, for the three- and six-month periods ended June 30, 2006, compared to 33% and 34% for the three- and six-month periods ended June 30, 2005. The decrease in the six-month period ended June 30, 2006 as compared to the six-month period ended June 30, 2005 was primarily due to the increased costs described under the Cost of Revenue section.

Operating Expenses

Sales and marketing

	Three Months Ended June 30, 2006	2005	Dollar Increase (Decrease)	Percent Increase (Decrease)	Six Months Ended June 30, 2006	2005	Dollar Increase (Decrease)	Percent Increase (Decrease)
Sales and marketing	$ 4,685	$ 3,889	$ 796	21 %	$ 9,224	$ 7,666	$ 1,558	20 %
Variable (as % of total revenue)	19 %	16 %			17 %	16 %		

Sales and marketing expenses consist primarily of compensation, benefits and related costs of sales and marketing employees, product managers and sales engineers, as well as recruiting, travel, market research, costs associated with marketing programs, such as trade shows, public relations and new product launches, and charges for infrastructure and centralized costs.

The increase in sales and marketing expense for the three-month period ended June 30, 2006, as compared to the corresponding three-month period ended June 30, 2005, resulted primarily from:

- increased costs related to tradeshows, advertising, consulting fees and event sponsorhip of $0.4 million, and

- increased employee compensation-related expenses of $0.2 million, consisting of salaries, benefits, recruiting costs, and incentive plan compensation, due to increased personnel in marketing and governmental activities, and higher benefit program costs.

The increase in sales and marketing expense for the six-month period ended June 30, 2006, as compared to the corresponding six-month period ended June 30, 2005, resulted primarily from:

- increased costs related to tradeshows, advertising, consulting fees and event sponsorhip of $0.4 million,

- increased employee compensation-related expenses of $0.3 million, consisting of salaries, benefits, recruiting costs, and incentive plan compensation, due to increased personnel in marketing and governmental activities, and higher benefit program costs, and

- increased stock option expense of $0.3 million.

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Research, development and engineering

	Three Months Ended June 30, 2006	2005	Dollar Increase (Decrease)	Percent Increase (Decrease)	Six Months Ended June 30, 2006	2005	Dollar Increase (Decrease)	Percent Increase (Decrease)
Research, development and engineering	$ 2,994	$ 3,428	$ (434)	(13)%	$ 6,230	$ 6,336	$ (106)	(2)%
Research, development and engineering (as % of total revenue)	12 %	14 %			12 %	13 %		

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

The decrease for the three-month period ended June 30, 2006, as compared to the corresponding three-month period ended June 30, 2005, resulted primarily from:

- decreased employee compensation-related expenses of $0.3 million as part of a restructuring initiative.

The decrease for the six-month period ended June 30, 2006, as compared to the corresponding six-month period ended June 30, 2005, resulted primarily from:

- decreased employee compensation-related expenses of $0.3 million as part of a restructuring initiative, offset by

- increased stock option expense of $0.2 million.

General and administrative

	Three Months Ended June 30, 2006	2005	Dollar Increase (Decrease)	Percent Increase (Decrease)	Six Months Ended June 30, 2006	2005	Dollar Increase (Decrease)	Percent Increase (Decrease)
General and administrative	$ 4,172	$ 5,521	$ (1,349)	(24)%	$ 9,382	$ 11,018	$ (1,636)	(15)%
General and administrative (as % of total revenue)	17 %	22 %			18 %	23 %		

General and administrative expenses consist primarily of compensation, benefits and related costs of executive, finance and administrative personnel, human resources and other professional fees, and charges for infrastructure and centralized costs.

The decrease for the three-month period ended June 30, 2006, as compared to the corresponding three-month period ended June 30, 2005, resulted primarily from:

- decreased professional and audit fees of $1.1 million related to our audit and review, Sarbanes-Oxley audit, compliance and remediation efforts in 2005,

- decreased other administration costs of $0.3 million related to cost cutting initiatives, offset by

- increased stock option expense of $0.3 million.

The decrease for the six-month period ended June 30, 2006, as compared to the corresponding six-month period ended June 30, 2005, resulted primarily from:

- decreased professional and audit fees of $1.6 million related to our audit and review, Sarbanes-Oxley audit, compliance and remediation efforts in 2005,

- decreased other administration costs of $0.5 million related to cost cutting initiatives, offset by

- increased stock option expense of $0.8 million.

Amortization of intangible assets

	Three Months Ended June 30, 2006	2005	Dollar Increase (Decrease)	Percent Increase (Decrease)	Six Months Ended June 30, 2006	2005	Dollar Increase (Decrease)	Percent Increase (Decrease)
Amortization of intangibles	$ 550	$ 1,339	$ (789)	(59)%	$ 1,123	$ 2,150	$ (1,027)	(48)%
Amortization of intangibles (as % of total revenue)	2 %	5 %			2 %	4 %		

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

The decrease for the three- and six-month periods ended June 30, 2006 compared to the corresponding three- and six-month periods ended June 30, 2005 resulted primarily from extended amortization periods from contract extensions on several domestic customers and the increased amortization in 2005 related to a domestic customer who awarded their contract to a competitor. The intangible asset related to this customer was fully amortized by the fourth quarter of 2005.

Intellectual property

	Three Months Ended June 30, 2006	2005	Dollar Increase (Decrease)	Percent Increase (Decrease)	Six Months Ended June 30, 2006	2005	Dollar Increase (Decrease)	Percent Increase (Decrease)
Intellectual property	$ 481	$ 467	$ 14	3 %	$ 912	$ 1,003	$ (91)	(9)%
Intellectual property (as % of total revenue)	2 %	2 %			2 %	2 %		

Intellectual property costs primarily consist of employee-related expenses, such as salaries, benefits, recruiting costs, and incentive plans, as well as costs associated with documenting, applying for, and maintaining patents.

The slight increase for the three-month period ended June 30, 2006, as compared to the corresponding three-month period ended June 30, 2005, resulted primarily from a decrease of $0.1 million related to a reduction in headcount, which was offset by an increase of $0.1 million in consulting fees paid to third-party agents and government fees related to patent and other intellectual property work

The decrease for the six-month period ended June 30, 2006, as compared to the corresponding six-month period ended June 30, 2005, resulted primarily from a decrease of $0.1 million related to a reduction in headcount.

Restructuring charges, net.

	Three Months Ended June 30, 2006
Cost of revenue	$ 159
Sales and marketing	93
Research, development and engineering	248
General and administrative	47
Total	$ 547

During the second quarter, we initiated productivity improvement initiatives and significantly reduced fixed costs in order to facilitate our effort to achieve profitability. The reduction in fixed costs included reduction of our workforce by nearly 20% since the beginning of 2006. The restructuring charge for the three-month period ended June 30, 2006 totaled $547, primarily due to employee severance and related costs. These restructuring charges were allocated out of the departments as noted above.

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 Securities and Exchange Commission issued Staff Accounting Bulletin No. 107 relating to application of SFAS 123(R). The Company has applied the provisions of SAB 107 in our 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 our 2006 fiscal year. In accordance with the modified prospective transition method, the Company s condensed consolidated financial statements for periods prior to the first quarter of fiscal 2006 have not been restated to reflect this change. Stock-based compensation recognized during the period 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 condensed consolidated financial statements for the first quarter of fiscal 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 our stock price as well as assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to the expected life of the award, our expected stock price volatility over the term of the award and actual and projected exercise behaviors. Although the fair value of stock-based awards is determined in accordance with SFAS 123(R) and SAB 107, the Black-Scholes option pricing model requires the input of highly subjective assumptions, and other reasonable assumptions could provide differing results.

Prior to January 1, 2006, the Company applied the recognition and measurement principles of Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees,* and related interpretations including Financial Accounting Standards Board (FASB) Interpretation No. 44, *Accounting for Certain Transactions involving Stock Compensation, an Interpretation of APB Opinion No. 25*, as allowed by FASB Statement No. 123, *Accounting for Stock-Based Compensation*. FASB Statement No. 123 and FASB Statement No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure, an amendment of FASB Statement No. 123*, established accounting and disclosure requirements using a fair-value-based method of accounting for stock-based employee compensation plans. Under APB Opinion No. 25, stock-based compensation expense is recognized for stock awards granted with an exercise price below fair market value on the date of grant.

The expense was recorded in the respective statement of operations expense categories for the employees to which it applies, as set forth in the table below.

	Three Months Ended June 30,		**Six Months Ended June 30,**	
	2006	**2005**	**2006**	**2005**
Cost of revenue	$ 84	$	$ 138	$
Sales and marketing	134		256	
Research, development and engineering	76		190	
General and administrative	488	152	992	203
Total	$ 782	$ 152	$ 1,576	$ 203

We anticipate an additional $6.1 million in stock-based compensation through fiscal 2010 for awards outstanding as of June 30, 2006. Additional impact resulting from adoption of this statement on our financial position and results of operations will be determined by stock-based awards granted in future periods and the assumptions on which the value of those stock-based awards is based. Our tax accounting may also be impacted by actual exercise behavior and the relative market prices at exercise.

On December 15, 2005, the Board of Directors of the Company approved the acceleration of vesting of the Company s outstanding stock options with option exercise prices equal to or greater than $9.00. The acceleration applied to all options outstanding as of December 31, 2005 under the Company s Restated 1999 Stock Incentive Plan and 2000 Non-Officer Employee Stock Incentive Plan, except for options held by members of the Company s Board of Directors. Options to purchase 422,248 shares of the Company s common stock, or 6% of the Company s total outstanding options, with a weighted average exercise price of $11.51 and varying remaining vesting schedules, were subject to this acceleration and became immediately vested and exercisable as of December 31, 2005. Of these 422,248 options, 120,972 options are held by the Company s executive officers.

On December 21, 2004, the Audit, Compensation and Corporate Governance Committees of the Board of Directors of the Company approved the acceleration of vesting of the Company s outstanding stock options with option exercise prices greater than $15.00. The acceleration applied to all options outstanding under the Company s Restated 1999 Stock Incentive Plan and 2000 Non-Officer Employee Stock Incentive Plan that would not have otherwise vested in full by June 30, 2005 in accordance with their terms. The effective date of the vesting acceleration was December 31, 2004. Options to purchase 310,057 shares of the Company s common stock, or 5% of the total number of options of the Company outstanding as of December 31, 2004 with remaining vesting schedules, were accelerated. Of these 310,057 options, approximately 50,000 options were held by the Company s executive officers. No additional compensation expense was recorded in the statement of operations as the options that were accelerated had an exercise price greater than the fair market value of the shares underlying the options on the date of the modification.

As a result of these accelerations, the Company reduced its exposure to the effects of SFAS 123(R).

Total other income, net. Total other income, net consists primarily of interest received and paid. Total other income, net was $0.3 and $0.7 million for the three- and six-month periods ended June 30, 2006, respectively, compared to $0.3 and $0.5 million for the three- and six-month periods ended June 30, 2005. The increase resulted from higher interest earned on lower cash and investment balances, which was partially offset by higher interest expense related to capitalized leases.

Provision for Income Taxes. The provision for income taxes reflects expected tax expense from profitability in foreign jurisdictions. The tax expense for the three-month period ended June 30, 2006 reflects a negative adjustment of $135,000 related to a reduction in taxes ultimately incurred in foreign jurisdictions for the year ended December 31, 2005, as well as expected to be incurred for the quarter ended March 31, 2006. These adjustments are due in part to a study undertaken by the Company to better define and document the functions performed and risks undertaken in certain foreign jurisdictions and apply proper economic analyses to compensate each of our foreign subsidiaries accordingly. Due to the uncertainty of realization of the Company s NOL and other deferred tax assets, including those generated in the current period, we have recorded a full valuation allowance against our net deferred tax assets at June 30, 2006. We will continue to evaluate the realizability of our net deferred tax assets in future periods and may recognize income tax benefits in future earnings if we determine the realization of these assets is more likely than not.

Liquidity and Capital Resources

As of June 30, 2006, we had cash and cash equivalents, restricted cash, and short-term investments of $30.2 million, representing a decrease of approximately $1.8 million from $32.0 million at December 31, 2005. The decrease primarily resulted from the increase in restricted cash due to a large number of performance bond renewals on various government contracts and investments in new program implementations and the purchase of fixed assets. As of June 30, 2006, $11.5 million of cash and cash equivalents is restricted as a result of the requirements of performance bonds that we are obligated to maintain in connection with some of our long-term contracts in our personal identification systems business. Working capital at June 30, 2006 was $21.8 million, compared to working capital of $31.4 million at December 31, 2005. The decrease in working capital resulted primarily from investments made in new programs and infrastructure assets.

The $2.5 million of cash used in operations for the six-months ended June 30, 2006 resulted from a net loss of $11.0 million, partially offset by non cash items related to depreciation and amortization of $7.7 million and stock-based compensation expense of $1.6 million, and a decrease in trade and unbilled accounts receivable, net of $1.8 million and inventory of $1.1 million. Negatively affecting cash provided by operations was an increase in restricted cash of $4.2 million. The $4.9 million of cash used in operations for the six months ended June 30, 2005 resulted from a net loss of $11.3 million, offset by non cash items related to depreciation and amortization of $8.6 million and an increase in accrued payroll and related costs of $1.3 million. Items negatively affecting cash used in operations were a decrease in accounts payable of $4.0 million and an increase in other current assets of $1.2 million.

The $3.7 million of cash used in investing activities for the six-month period ended June 30, 2006 primarily related to $0.3 million in net purchase of short-term investments and $3.4 million for the purchase of property and equipment, including capitalization of labor costs of $1.1 million. The $7.7 million of cash provided by investing activities for the six-months ended June 30, 2005 primarily related to $16.7 million in net sale or maturity of short-term investments partially offset by $9.0 million for the purchase of property and equipment, including capitalization of labor costs.

The $0.1 million of cash used in financing activities for the six-month periods ended June 30, 2006 resulted primarily from the principal payments on capital leases, partially offset by the proceeds from the issuance of stock. The $0.1 million of cash used in financing activities for the six-month period ended

June 30, 2005 resulted primarily from the principal payments on capital leases, partially offset by the proceeds from the issuance of stock.

Our significant commitments consist of obligations under non-cancelable operating leases, which totaled $7.9 million as of June 30, 2006, and are payable in monthly installments through August 2011. Our obligations under non-cancelable capital leases, which totaled $0.9 million as of June 30, 2006, are payable in monthly installments through June 2011.

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

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

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

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

In order to take advantage of opportunities, we may find it necessary to obtain additional equity financing, debt financing, or credit facilities, although we do not believe at this time that our long-term working capital and capital expenditures will be of such a nature that we would be required to take steps presently to remedy any such potential deficiency. If it were necessary to obtain additional financings or credit facilities, we may not be able to do so, or if these funds are available, they may not be available on satisfactory terms.

Off-Balance Sheet Arrangements

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

Recent Accounting Pronouncements

In March 2006, the FASB issued SFAS No. 156, *Accounting for Servicing of Financial Assets, an amendment of SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. The statement changes the way entities account for servicing assets and obligations associated with financial assets acquired or disposed of. SFAS No. 156 is effective for the first fiscal year beginning after September 15, 2006. The Company does not expect the adoption of this standard to have a material effect on the Company s financial statements.

In July 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, which defines the threshold for recognizing the benefits of tax return positions in the financial statements as more-likely-than-not to be sustained by the taxing authority. Interpretation No. 48 applies to all tax positions accounted for under SFAS No. 109, *Accounting for Income Taxes*. Interpretation No. 48 is effective as of the beginning of the first fiscal year beginning after December 15, 2006. Upon adoption, we will adjust our financial statements to reflect only those tax positions that are more-likely-than-not to be sustained as of the adoption date. Any adjustment will be recorded directly to our beginning retained earnings balance in the period of adoption and reported as a change in accounting principle. We are currently analyzing the effects of adopting Interpretation No. 48.

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

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

- trends and expectations in revenue growth, including, but not limited to, statements regarding the temporary nature of the decrease in ID systems bid activity and the expected increase of such activity in the future, statements regarding anticipated growth in U.S. driver license revenues due to broadening use of the driver license as a secure credential, statements regarding opportunities to facilitate efforts of state government agencies to comply with the REAL ID Act;

- the success of new products, such as IDVS;

- our future level of investment in our business, including investment in development of products and technology, acquisition of new customers and development of new market opportunities;

- our ability to improve margins;

- anticipated expenses, costs, margins and investment activities in the foreseeable future;

- anticipated revenue to be generated from current contracts, patent and license technology fees and as a result of new programs;

- the investments required to complete certain driver license programs and our ability to recoup those expenses under the relevant contract;

- our profitability in future periods;

- the development and growth of the market for digital watermarking technology;

- momentum in the recognition of the benefits offered by digital watermarking and in the adoption of digital watermarking;

- business opportunities that could require that we seek additional financing;

- opportunities for increased participation in the global market for ID systems;

- the size and growth of our markets, including the U.S. driver license market;

- the existence of international growth opportunities and our future investment in such opportunities;

- the source of a majority of our future revenue;
- our expected short-term and long-term liquidity positions;

- our ability to fund our capital needs through cash flow from operations;
- our use of cash in upcoming quarters;
- anticipated levels of backlog in future periods;
- anticipated extensions of the term of our contract with the central banks; and
- the likelihood or outcome of legal proceedings and claims and their effect on our business.

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

Factors Affecting Forward Looking Statements

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

Given our history of losses, we cannot guarantee sustained profitability, particularly if we were to lose large contracts.

Except for the year 2003, we have incurred significant net losses from inception. Our accumulated deficit as of June 30, 2006 was $99.0 million. In order to attain sustained profitability, we will need to generate higher revenue than we have in prior years while controlling expenditures. Achieving profitability will depend upon a variety of factors, including the impact of new financial accounting mandates requiring us to expense stock options, as well as expenses related to litigation and other proceedings that have arisen as a result of our prior year restatement. In addition, we evaluate our strategy and market opportunities on an ongoing basis and will adjust our approach to market conditions that prevail from time to time. Accordingly, in the short term we may focus more on growing our revenue and taking advantage of market opportunities than an immediate return to profitability. Finally, various adverse developments including the loss of large contracts or cost overruns on our existing contracts could have a negative impact on our revenue or our margins. Accordingly, increases in our expenses may not be offset by revenue increases and as a result we may not be able to regain and/or sustain profitability.

The loss of any large contract may result in loss of revenue and potential acceleration of amortization expense or impairment of intangible assets.

Contracts between government agencies and Digimarc have varying duration, generally five or more years in length. Some contracts we enter into contain cancellation clauses. In addition, after a contract period expires, generally the government agency can re-open the contract for competitive bidding. If we were to lose a contract due to cancellation or in a competitive bidding situation, then, in addition to the loss of revenue and margin on a prospective basis, we could also incur accelerated amortization expense or impairment of intangible assets related to the customer, which could adversely affect our financial results.

We have not experienced the early termination of any driver license issuance contracts and are not aware of any early terminations of such contracts of our competitors.

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

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

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

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

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

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

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

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

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

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

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

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

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

New developments are expected to continue, and we cannot assure you that discoveries by others, including current and potential competitors, will not render our services and products noncompetitive. Moreover, because of rapid technological changes, we may be required to expend greater amounts of time and money than currently anticipated to develop new products and services, which in turn may necessitate us to require greater revenue streams on such products and services to cover developmental costs. Many of the companies that currently compete with us for some of our business, as well as other companies with whom we may compete in the future, are larger and national or international in scope and may have greater technical, financial, marketing, and political resources than we do. These resources could enable these companies to initiate severe price cuts or take other measures in an effort to gain market share or otherwise impede our progress. We cannot assure you that we will be able to compete successfully against current or future participants in our market or against alternative technologies, nor can we assure you that the competitive pressures we face will not decrease our revenue and profits in the future.

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

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

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

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

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

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

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

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

- continue to develop our technical expertise; and

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

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

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

In the fourth quarter of 2005 and the first half of 2006, we made significant reductions in our workforce as part of our efforts to reach quarterly profitability in the second half of 2006 or early in 2007. These reductions did not impede our ability to meet demand because they were accompanied by improvements in our internal business processes and coincided with a period of relatively low bid activity with respect to development and deployment of new systems. We believe that this decrease in bid activity is temporary and that the U.S. driver license market will demonstrate increased demand in future periods. Our current reduced staffing levels could affect our ability to respond to increased demand for our services. In addition, to meet any increased demand and take advantage of new business opportunities in the future, we may need to increase our workforce through additional employees or contract labor, which would increase our costs. If we experience such an increase in costs, we may not succeed in achieving or sustaining profitability.

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

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

- delays in project implementation;

- failure to achieve add-on sales to existing customers;

- governmental regulation of credentials and issuance policies;

- private sector usage trends for driver licenses and other credentials;

- level of commodity vs. proprietary components applicable to customer system specifications;

- whether contracts have been extended or renewed; and the amount of capital expenditure associated with such extension or renewal;

- price competition in competitive bids, contract renewals and contract extensions;

- variations in costs of materials and manufacturing;

- varying levels of efficiency of our workforce in delivering, implementing, and servicing contracts;

- seasonality of issuance volumes;

- sales mix related to card issuance revenues compared to product sales;

- sales mix related to domestic sales compared to international sales;

- sales mix related to adoption of new products compared to sales of current products;

- strategic decisions on new business;

- depreciation and amortization of capitalized project costs related to new or upgraded programs; and

- variability in the extent to which we are able to allocate personnel expenses to capital projects and thereby amortize such costs over the life of the relevant contract, rather than expensing such costs in the quarter in which they are incurred.

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

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

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

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

Our business and strategy rely, in part, on deployment of our digital watermark reader technology by third-party software developers and original equipment manufacturers. For example, one form of our digital watermark reader is commonly deployed in image editing applications (offered by vendors including Adobe, Corel and Ulead) to permit users of these products to read watermarks embedded in imagery, and

thereby discern the identities of image owners. Another form of our digital watermark reader is used in our anti-counterfeiting product offerings. We anticipate entering into additional agreements with third-party vendors to create, promote and service products that incorporate, embed, integrate or bundle our technologies. If third parties who include such technologies in their products cease to do so, or we fail to obtain other partners that will incorporate, embed, integrate or bundle such technologies, or these partners are unsuccessful in their efforts, our efforts to expand deployment of our technologies would be adversely affected and, consequently, our ability to increase revenues would be adversely affected and we may suffer other adverse effects to our business. In addition, if our technologies do not perform according to market expectations, our future sales would suffer as customers seek other providers.

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

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

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

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

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

As international customers have accounted for approximately 15% of our total revenue during the quarter ended June 30, 2006, the loss of these customers or the failure to find new customers may result in a decline in our international revenue, which could lower our profitability and slow our growth.

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

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

If we are affected by these risks, our sales of products and services to customers outside the U.S. could be reduced significantly. In addition, if foreign customers, in particular foreign government authorities, terminate or delay the implementation of our products and services, we may have limited recourse against them to recover any potential losses.

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

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

Our contracts for driver license and other identification issuance systems and related products typically include terms relating to, time-based performance, development and delivery schedules customer acceptance and testing, and other performance milestones. Such provisions are common in large scale government contracts at the state and federal levels. Because procedures often require compliance over extended periods of time, they give rise to an increased risk that we may fail to meet timing or other delivery requirements and milestones pursuant to the terms of such contracts. If we failed to meet such requirements or milestones, customers may assert against us compensatory or liquidated damages, breach of contract, or other claims. Consequently, our failure to meet contractual milestones or other performance requirements as promised could result in our having to incur increased costs, lower margins, or compensatory obligations, in addition to other losses, such as harm to our reputation. Such unexpected increases in costs to meet our contractual obligations or any other requirements necessary to address claims and damages with regard to our customer contracts could have a material adverse effect on our business and financial results. We anticipate that future contracts will continue to have such provisions unless and until industry practices change.

A significant portion of our business depends on a limited number of large, public-sector contracts, which are generally subject to termination for convenience, as determined by the subject agency, or for lack of budgetary appropriation provided for the subject agency. Some government contracts also may be one-time events, such as in the case of some personal identification systems in non-U.S. markets involving voter registration programs. In such cases, we may generate substantial revenue that may not be subject to future renewal. Moreover, government contracts result from purchasing decisions made by public sector agencies that may be subject to political influence, unusual procurement procedures, strict legal requirements, budget changes and cutbacks during economic downturns, variations in appropriations cycles, and protests of contract awards. Additionally, some governmental authorities require performance bonds that we are obligated to maintain during the life of the contract. Often, the terms of these bonds require that we maintain large restricted cash reserves as a guarantee, reducing our ability to use these funds for our other business purposes. Even with the availability of such cash reserve guarantees, we may not be able to obtain such performance bond underwriting at a favorable rate or at all. Our failure to be able to provide such performance bonds may preclude our ability to bid on new government contracts or maintain our existing contracts for their full terms. The size, nature and purpose of, and the risks and uncertainties associated with, public sector contracts can potentially cause our quarterly results to fluctuate and anticipated revenue to decrease significantly.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

We have invested significant time and resources in product development activities for new secure identification markets, including designing and developing numerous enhancements to our driver license systems and improving our cards ability to withstand intrusions or alterations without detection. At present, our new products include Digimarc Camera Tower, Digimarc Capture Software, Digimarc Image Server, Digimarc ID Validation Suite (IDVS) and Digimarc IDMarc. If we do not experience a timely, positive reaction from issuing authorities to our new offerings, our projected revenues, margins and earnings may be negatively impacted.

Recent and ongoing leadership, staffing and organizational changes may result in disruptions and inefficiencies in our business during transition periods, may require process changes in our business, and will likely cause additional costs to our business before benefits from such changes may be realized.

During the second quarter of 2004, we made significant changes in our management and staff as a result of a detailed review of our business processes. Many of these changes were initiated following the hiring of our new Chief Financial Officer in June 2004 and other senior managers, and in conjunction with the continuing implementation of our new accounting and material requirements planning systems and work on Sarbanes-Oxley compliance. In 2005, we made certain organizational changes designed to better consolidate the secure ID systems and digital watermarking groups into a single business unit and thereby improve our business execution and operational efficiencies. In addition, we appointed a new President of Government Programs and made considerable changes to the management team that reports to him. While we anticipate that these changes in leadership and staffing will improve operations, there is a risk that these changes may disrupt the operations of our business and, consequently, may result in some short-term inefficiencies as personnel complete their transitions and new leaders implement their new plans and procedures. We also expect that these changes may require further modifications of our finance and business processes and will likely cause additional costs to our business in the short term before any benefits from such changes, if any, may be realized.

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

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

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

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

We currently are engaged in litigation relating to the initial public offering of our securities, in addition to the class actions filed against us in connection with our previously announced accounting errors. Such litigation is expensive and lengthy. These matters are discussed in greater detail in Part II, Item 1 (Legal Proceedings) of this Quarterly Report on Form 10-Q and in Note 5 (Commitments and Contingencies) of the Notes to Consolidated Financial Statements included in this Quarterly Report on Form 10-Q. We have incurred significant costs relating to these matters, and expect that we will continue to do so. Due to the inherent uncertainties of such litigation, the ultimate cost and outcome cannot be predicted.

If a judgment were to be entered against the Company and our director and officer liability insurance was inadequate or unavailable, the obligation to pay the judgment may materially harm our business and financial condition.

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

We may be required to invest significant additional time and resources to comply with the requirements of Section 404 of the Sarbanes-Oxley Act of 2002, which may increase our operating expenses and reduce our profitability in the near future.

In 2004, we discovered certain material weaknesses in our internal controls and procedures and since then have deployed significant resources to design and implement new and enhanced controls and procedures. As we monitor the regulatory requirements in the future, we may discover additional problems that require further modifications to our controls, review processes and financial management, which could result in our company experiencing additional costs and expenses that may reduce our profitability in the near future.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

The market risk disclosures as set forth in Item 7A of our Annual Report on Form 10-K for the year ended December 31, 2005 have not changed materially.

Item 4. Controls and Procedures.

Evaluation of Disclosure Controls and Procedures

The SEC defines the term disclosure controls and procedures to mean a company s controls and other procedures that are designed to ensure that information required to be disclosed in the reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported, within the time periods specified in the Commissions rules and forms. While our disclosure controls and procedures are designed to provide reasonable assurance of achieving their objectives, the design of any system of controls is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions, regardless of how remote. Our management, with the participation of our principal executive officer and principal financial officer, carried out a separate evaluation of the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934) as of June 30, 2006, which included an evaluation of disclosure controls and procedures applicable to the period covered by the filing of this periodic report. Based on the evaluation of the effectiveness of our disclosure controls and procedures by our management as of June 30, 2006, our principal executive officer and principal financial officer have concluded that our disclosure controls and procedures were effective to ensure that information required to be disclosed by us in the reports that we file or submit under the Securities Exchange Act of 1934 is accumulated and communicated to our management, including our principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

Changes in Internal Controls

Our management, with the participation of our principal executive officer and principal financial officer, conducted an evaluation of our internal controls over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934) to determine whether any changes occurred during the period covered by this report. Based on that evaluation, our principal executive officer and principal financial officer concluded that there has been no change in internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting for the period covered by this report.

PART II. OTHER INFORMATION.

Item 1. Legal Proceedings.

Beginning in September 2004, three purported class action lawsuits were commenced against the Company and certain of its current and former directors and officers by or on behalf of persons claiming to have purchased or otherwise acquired the Company s securities during the period from April 17, 2002 to July 28, 2004. These lawsuits were filed in the United States District Court for the District of Oregon and were consolidated into one action for all purposes on December 16, 2004. On May 16, 2005, plaintiffs filed an amended complaint. The complaint asserted claims under the federal securities laws, specifically Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, relating to the Company s announcement that it had discovered errors in its accounting for software development costs and project capitalization and other project cost capitalization accounting practices, and that it likely would be required to restate its previously reported financial statements for full fiscal year 2003 and the first two quarters of 2004. Specifically, the complaint alleged that the Company issued false and misleading financial statements and created a misperception regarding the profitability of the Company in order to inflate the value of Digimarc stock, which permitted insider sales of personal holdings at inflated values, and that the Company maintained insufficient accounting controls, which created an environment where improper accounting could be used to manipulate financial results. The complaint sought unspecified damages. On November 30, 2005, the Court granted the Company s motion to dismiss the amended complaint on the grounds that plaintiffs had failed to allege facts sufficient to support their allegation that the defendants knowingly or recklessly acted in violation of the securities laws. Plaintiffs filed a second amended complaint on January 17, 2006. On February 14, 2006, the Company filed a motion to dismiss the second amended complaint on the grounds that plaintiffs still fail to allege facts sufficient to support their allegation that the defendants knowingly or recklessly acted in violation of the securities laws. On August 4, 2006, the Court granted this motion and dismissed the lawsuit with prejudice. Plaintiffs have thirty days to appeal this decision to the U.S. Court of Appeals for the Ninth Circuit. Due to the inherent uncertainties of litigation, the Company cannot accurately predict the ultimate 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, as well as the second derivative action described in the immediately following paragraph. 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. This motion currently is pending. 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.

A separate derivative action, involving substantially the same claims, was filed on or about April 6, 2005 in the Circuit Court of the State of Oregon for the County of Washington. On March 31, 2006 the individual defendants filed a motion to dismiss the lawsuit based on the recommendation of the Board committee. Plaintiffs subsequently stipulated to a dismissal of the lawsuit and, on May 5, 2006, Judge Gardner signed a stipulated motion and order of dismissal, dismissing the lawsuit with prejudice.

Beginning in May 2001, a number of substantially identical class action complaints alleging violations of the federal securities laws were filed in the United States District Court for the Southern District of New York naming approximately 300 companies, including the Company, 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 provide, among other things, a release of the Company and of the individual defendants for the conduct alleged in the amended complaint to be wrongful. The Company would agree to undertake other responsibilities under the partial settlement, including agreeing to assign away, not assert, or release certain potential claims the Company may have against its underwriters. Any direct financial impact of the proposed settlement (other than defense costs incurred and expensed prior to May 31, 2003) is expected to be borne by the Company s insurers. The court granted the preliminary approval motion on February 15, 2005, subject to certain modifications. On August 31, 2005, the court issued a preliminary order further approving the modifications to the settlement and certifying the settlement classes. The court also appointed the Notice Administrator for the settlement and ordered that notice of the settlement be distributed to all settlement class members beginning on November 15, 2005 and completed by January 15, 2006. The settlement fairness hearing was held on April 26, 2006, but the court has not yet rendered its decision. If the court determines that the settlement is fair to the class members, the settlement will be approved. There can be no assurance that this proposed settlement will be approved and implemented in its current form, or at all. Due to the inherent uncertainties of litigation and because the settlement approval process is at a preliminary stage, the Company cannot accurately predict the ultimate outcome of the matter.

We are subject, from time to time, to other legal proceedings and claims arising in the ordinary course of business. Although the ultimate outcome of these other matters cannot be determined, management believes that, as of June 30, 2006, the final disposition of these proceedings will not have a material adverse effect on our consolidated financial position, results of operations, or liquidity.

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

We held our annual meeting of stockholders on May 2, 2006. Two proposals were voted on by our stockholders.

Proposal 1: Election of Three Class I Directors

William J. Miller, Jim Roth and Lloyd Buzz Waterhouse were elected as Class I directors for a term of 3 years. The voting for each director was as follows:

	For	Withheld
William J. Miller	18,876,882	628,561
Jim Roth	18,769,273	736,170
Lloyd Buzz Waterhouse	19,045,908	459,535

The Company s Class II and III directors did not stand for reelection at the annual meeting. The terms of the Company s Class II directors, Philip J. Monego, Sr., Peter W. Smith and Bernard Whitney, will continue until the 2007 annual meeting of stockholders. The terms of the Company s Class III directors, Bruce Davis, Brian J. Grossi and James T. Richardson will continue until the 2008 annual meeting of stockholders.

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

Grant Thornton was ratified as our independent certified public accountants for the fiscal year ending December 31, 2006 with 19,277,114 votes in favor, 217,860 votes against and 10,469 abstentions.

Item 6. Exhibits.

See attached exhibit index.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

	DIGIMARC CORPORATION
Date: August 9, 2006	By: /s/ MICHAEL MCCONNELL
	Michael McConnell
	Chief Financial Officer and Treasurer
	(Duly Authorized Officer
	and Principal Financial Officer)

EXHIBIT INDEX

Exhibit Number	**Document**
3.1	Second Amended and Restated Certificate of Incorporation of the Registrant, as amended (incorporated by reference to Exhibit 3.1 of Exhibits to the Registrant s Annual Report on Form 10-K, as filed with the Securities and Exchange Commission on March 13, 2006)
3.2	Amended and Restated Bylaws of the Registrant (incorporated by reference to Exhibit 3.3 of Exhibits to Registrant s Quarterly Report on Form 10-Q, as filed with the Securities and Exchange Commission on August 9, 2005)
10.1	Summary of Non-employee Director compensation Arrangements (incorporated by reference to Registrant s Current Report on Form 8-K, as filed with the Securities and Exchange Commission on May 9, 2006)
31.1	Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer
31.2	Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer
32.1	Section 1350 Certification of Chief Executive Officer
32.2	Section 1350 Certification of Chief Financial Officer