DIGIMARC CORP
Form 10-K
February 29, 2008

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

ý **Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the fiscal year ended December 31, 2007

OR

o **Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the transition period from to

Commission File Number 000-28317

DIGIMARC CORPORATION

(Exact name of registrant as specified in its charter)

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

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

(503) 469-4800
(Registrant's telephone number, including area code)
Securities registered pursuant to Section 12(b) of the Act:

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

Securities registered pursuant to Section 12(g) of the Act: **NONE**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No ý

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No ý

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer.

Large accelerated filer o Accelerated filer ý Non-accelerated filer o

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

The aggregate market value of common stock, par value $0.001 per share, held by non-affiliates of the registrant, based on the closing price for the common stock on The Nasdaq Global Market on the last business day of the registrant's most recently completed fiscal second quarter (June 30, 2007), was approximately $208 million. Shares of common stock beneficially held by each officer and director have been excluded from this computation in that such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for any other purposes.

As of January 31, 2008, there were 22,041,002 shares of the registrant's common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's proxy statement pursuant to Regulation 14A (the "Proxy Statement") for its 2008 annual meeting of stockholders are incorporated by reference into Items 10, 11, 12, 13 and 14 of Part III of this Annual Report on Form 10-K. The registrant intends to file the Proxy Statement not later than 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K.

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PART I

The following discussion of Digimarc's business contains forward-looking statements relating to future events or the future financial performance of Digimarc. 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 Annual Report on Form 10-K in Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations, under the caption "Safe Harbor Statement under the Private Securities Litigation Reform Act of 1995."

Although we believe that the expectations reflected in our forward-looking statements are reasonable, we do not give any assurances that these expectations will prove to be correct. These statements by their nature involve substantial risks and uncertainties that could significantly affect expected results. Actual future results could differ materially from those described in our forward-looking statements, and we do not intend to update or revise any forward-looking statements as a result of new information, future events or otherwise. We urge you to carefully review and consider the various disclosures we have made that attempt to advise interested parties of the factors which affect our business, including the disclosures made in Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations, under the caption "Factors Affecting Forward Looking Statements" in this Annual Report on Form 10-K, the audited consolidated financial statements and related notes included in this Annual Report on Form 10-K, and other reports and filings made with the SEC.

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 Annual Report on Form 10-K.

This Annual Report on Form 10-K includes trademarks and registered trademarks of Digimarc Corporation.

ITEM 1: BUSINESS

Overview

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

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

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

We issue more than 60 million identification documents ("IDs") annually and are the leading supplier of government-issued citizen IDs in North America, including supplying systems that produce more than two-thirds of all driver licenses issued in the United States. We are also a pioneer and leading owner of intellectual property in a signal processing technology innovation known as "digital watermarking" which allows imperceptible digital information to be embedded in all forms of digitally designed, produced or distributed media content, including personal identification documents, financial instruments, photographs, movies, music, television, and product packages. The embedded data within various types of media content can be detected and read by software or hardware detectors in personal computers and other digital devices.

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

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

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

Our media identification and management revenue is generated through commercial and government applications of our digital watermarking and related media identification and management technologies, primarily from patent and technology license fees paid by business partners and our contracts with a consortium of Central Banks and with The Nielsen Company. Our licensing program, which is a core part of our media identification and management business, is built upon our extensive patent portfolio, which contains 360 issued U.S. patents, and numerous foreign patents, as of December 31, 2007. Private sector media and entertainment industry customers use secure media identification and management solutions from our business partners and us to identify, track, manage and protect content as it is distributed and consumed either digitally or physically and to enable new consumer applications to improve access to networks and information from personal computers and mobile devices. We expect that patent and technology licensing will continue to contribute most of our revenues from non-government customers for the foreseeable future.

Financial information about geographic areas is incorporated by reference to Note 4 of our consolidated financial statements.

History

Digimarc was incorporated in 1995. We were founded to commercialize a signal processing innovation known as "digital watermarking." Digital watermarking is a technology that allows our customers to infuse digital data into any media content that is digitally processed at some point during its lifecycle. The technology can be applied to printed materials, video, audio, and images. The inclusion of this digital data enables a wide range of improvements in security and media management, and new business models for distribution and consumption of media content. We use digital watermarking as a differentiator in nearly all of our product offerings to increase value to our customers.

Banknote counterfeit deterrence was the first commercially successful use of digital watermarking. Digimarc, in cooperation with an international consortium of Central Banks, developed a system to deter the use of digital technologies in the unauthorized reproduction of banknotes. More recently, innovations based on our digital watermarking technology and experience have been leveraged to create new products to deter counterfeiting and tampering of driver licenses and other government-issued secure credentials. In parallel, Digimarc's business partners, under patent or technology license from Digimarc, are delivering digital watermarking solutions to track and monitor the distribution of music, images, television and movies to consumers.

Following the events of September 11, 2001, we realized that our expertise in security printing and digital imaging technologies and systems placed us in a position to address both the digital threats to identity management credentials and the environment and concerns of the issuers of these credentials. In late 2001, we acquired the Large Government Programs business unit of Polaroid Corporation ("Polaroid"). The primary focus of this business is the production of driver licenses and other IDs issued by government agencies. The acquired assets included all relevant software, hardware, services, materials science and distribution assets of Polaroid's government-issued photo identification business.

In this strategic acquisition, we saw a unique opportunity to assist in efforts to deter identity theft and fraud and thereby enhance transportation safety and Homeland Security through the combination of a new layer of security using our digital watermarking technology and Polaroid's expertise in secure ID solutions. Based on Polaroid's history with secured ID issuance systems, the resulting business has over 50 years of experience in the delivery and operation of secure ID issuance systems, has produced more than 2 billion issued IDs, and has guided customers through numerous major upgrades and technology migrations in ID security. We are the leader in deploying new solutions to meet driver license security and related service challenges. This includes being first to:

- produce driver licenses with digital portraits,
- deploy facial recognition and State-wide fingerprint matching in 1995 and 1996,
- introduce market leading security features, including digital watermarking, Kinegrams, and secure card materials,
- produce driver licenses in secure, networked central issuance factories,
- offer driver license renewal by Internet,
- offer comprehensive and modular secure driver license solutions to address recently enacted Federal legislation, such as the Federal legislation passed in May 2005 known as the REAL ID Act (the "REAL ID Act"). The Real ID Act imposes certain Federal requirements for State-issued driver licenses. These requirements are intended to increase the security of driver licenses, require validation of applicants prior to issuance, and mandate certain changes in business processes relating to security and the sharing and storage of data, and
- offer an Enhanced Driver License (EDL) solution in response to a recently enacted Federal law called the Western Hemisphere Travel Initiative, which imposes new security requirements on North American land and sea border crossings. We supplied production of the first high security licenses in a pilot program in Washington State.

With increasing interest in issues surrounding Homeland Security, prevention of identity theft and fraud, traffic safety, copyright and intellectual property protection and establishment of new business models for digital distribution and use of media content, Digimarc has evolved from a technology-driven early stage company to an important supplier of critical infrastructure to government agencies and a strategic business partner to solution providers supporting the media and entertainment industry.

Customers and Business Partners

Our ID systems revenue is derived from long-term contracts with government ID issuers, primarily State driver license issuers and governments of various foreign countries and provinces.

Our media identification and management revenue is generated through commercial and government applications of our digital watermarking, including a long-term contract with a consortium

of Central Banks. Our contract with the Central Bank consortium is in its tenth year in 2008. The contract is in the final year of a 5-year extension and provides for two additional 3-year extensions. The Central Bank consortium has agreed to the first 3-year extension. Other digital watermarking-related revenue is generated primarily from patent and technology license fees paid by business partners providing media identification and management solutions to movie studios and music labels, television broadcasters, creative professionals and other customers around the world. Patent and technology licensing is expected to continue to contribute most of the revenues from non-government customers for the foreseeable future.

We must comply with and are affected by laws and regulations relating to the award, administration and performance of government contracts. Government contract laws and regulations affect how we do business with our customers and, in some instances, impose added costs on our business.

In some instances, these laws and regulations impose terms or rights that are more favorable to the government than those typically available to commercial parties in negotiated transactions. For example, the government agency may terminate any of our contracts and, in general, subcontracts, at its convenience, as well as for default based on performance. Upon termination for convenience of a fixed-price type contract, we normally are entitled to receive the purchase price for delivered items, reimbursement for allowable costs for work-in-process and an allowance for profit on the contract or adjustment for loss if completion of performance would have resulted in a loss. Upon termination for convenience of a cost reimbursement contract, we normally are entitled to reimbursement of allowable costs plus a portion of the fee.

In addition, our government contracts typically span one or more base years and multiple option years. The government agency generally has the right to not exercise option periods and may not exercise an option period if the agency is not satisfied with our performance on the contract.

Products and Services

We provide secure ID solutions to government agencies and media identification and management solutions to commercial entities and government customers.

Secure ID Systems

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

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

Our strategy regarding the anticipated opportunities relating to the REAL ID Act is to provide solutions that address the requirements of the REAL ID Act: identity verification; document scanning and archiving; individual background checking; data and image sharing; and migration to and production of REAL ID Act compliant driver license documents. These solutions are available to customers as upgrades or complete issuance systems. Digimarc is currently offering the States program management assistance to safely migrate to REAL ID Act compliance.

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

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

Media Identification and Management

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

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

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

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

Technology and Intellectual Property

We use intellectual property ("IP") to differentiate its products and technologies, mitigate infringement risk, and develop opportunities for licensing. Licensing of our digital watermarking and related technologies is supported by a broad patent portfolio covering a wide range of methods, applications, and system architectures.

Most of our patents relate to various methods for embedding digital information in video, audio, and images, whether the content is rendered in analog or digital formats. The digital information is generally embedded by making subtle modifications to the fundamental elements of the content itself, generally at a signal processing level. The changes necessary to embed this information are so subtle that they are generally not noticeable by people during normal use. Because the message is carried by the content itself, it is file-format independent. The message generally survives most normal compression, edits, rotation, scaling, re-sampling, file-format transformations, copying, scanning and printing. Our media identification and management patent portfolio includes not only digital watermarking but innovations in pattern recognition (sometimes referred to as "fingerprinting") and digital rights management (DRM) applications.

To protect our significant efforts in creating these technologies, we have implemented an extensive intellectual property protection program that relies on a combination of patent, copyright, trademark and trade secret laws, and nondisclosure agreements and other contracts. As a result, we believe we have one of the world's most extensive patent portfolios in the field of digital watermarking, with 360 U.S. and over 80 foreign issued patents and more than 500 U.S. and foreign patent applications on file as of December 31, 2007 in the areas of digital watermarking, secure identity management and related technologies. Separately, we own registered trademarks in both the U.S. and other countries and have applied for other trademarks. We continue to develop and broaden our portfolio of patented technologies, including digital watermarking and related applications and systems, and other technologies related to secure ID systems. For ID systems-related technologies, the focus of patent development has been in the areas of imaging and printing systems, card architecture and materials, and security features. Some patents relate to future product offerings or related technologies like smart cards, laser engraving and alternative card systems.

Although we devote significant resources to developing and protecting our technologies, and periodically evaluate potential competitors of our technologies for infringement of our intellectual property rights, these infringements may nonetheless go undetected or may arise in the future. We expect that infringement claims may increase as companies become more concerned with protecting their content from electronic copying.

Markets

Identification

We believe that the U.S. driver license market will continue to grow as a result of (i) broadening use of the driver license as a secure credential beyond its traditional role as evidence of competence to drive a motor vehicle; (ii) technological innovation; (iii) desire among issuers to improve security and efficiency; and (iv) new governmental regulations such as the REAL ID Act. We anticipate that these regulations may result in substantial system upgrades by our customers. Final rules under the REAL ID Act were published on January 11, 2008. According to a February 8, 2008 report published by CNET Networks, Inc., 30 States have stated they intend to comply with REAL ID or have applied for and already received extensions. Five States, representing 5% of the U.S. population, have passed anti-REAL ID laws; and 15 States believe they will possibly comply.

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 leading supplier of government-issued citizen IDs in North America and our extensive investments in research and development provide a good foundation for participation in the global market for government programs establishing the identities of citizens and issuing associated credentials.

An example of such a potential opportunity is in the market for smart cards. The Western Hemisphere Travel Initiative requires that all U.S. citizens returning from outside the U.S. present either a passport, a new border PASS Card or EDL, approved by the Department of Homeland Security. The Federal government is requiring a Radio-frequency identification (RFID) chip in each PASS Card or EDL. In other applications, the Federal government has been advancing worker identification using smart cards. In response to these moves, in 2006 we announced a smart card option for our secure driver license solution. We began production of the first high security licenses in a pilot program in Washington State. Interest in these new high tech licenses is spreading. The US Secretary of Homeland Security is strongly encouraging Canadian provincial governments to consider producing such licenses, which could be used in lieu of a passport at the border. In parallel, a growing number of U.S. States, including Arizona, New York, Texas, and Vermont, have expressed interest in producing an EDL. In addition, we will continue to look for opportunities to participate in smart card ID programs in Europe and other parts of the world where smart cards are more widely used.

Media Identification and Management

Digital watermarking and related technologies are used in various media identification and management products and solutions supporting 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 management,
- authentication and monitoring,
- linking to networks and providing access to information,
- and enhanced services in support of mobile commerce.

We believe the market for such 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.

Competition

Digimarc competes for government business with system integrators, biometrics suppliers, security printers, card manufacturers, and smart card and other security technology suppliers, including companies like L-1 Identity Solutions, Inc. (formerly Viisage Technology, Inc.) (biometrics), Unisys Corporation (system integration) and De La Rue plc (security printer). Each of these companies is a supplier to U.S. driver license issuers. As U.S. driver licenses gain utility as general credentials and the Federal government is demanding higher security and a certain amount of standardization, competition may increase. For instance, certain aspects of the REAL ID Act may expedite an existing trend toward central issuance of driver licenses. Although we are proficient at central issuance, the possible acceleration of this trend could draw new competition from classic security printers such as Canadian Banknote Company, Limited and Giesecke & Devrient GmbH.

The possibility of including smart card technologies in driver licenses is generating a great deal of public debate. The smart card industry is generally driven by European chip manufacturers such as Infineon Technologies AG and Gemalto NV. While successful in bank cards, mobile phone SIMs and phone cards, smart cards have only recently begun to gain distribution as government-issued credentials. The U.S. government is a strong advocate. Federal identity standards are embracing smart cards for the military, transportation workers, and government employees and contractors, and new "ePassports" will carry a portrait in an on-book chip. Despite considerable investment by the Federal government, we believe no States have attempted or even piloted smart card driver licenses, except for the EDL card we recently deployed in Washington State. We understand that in recent years, at least two States have expressly considered and rejected smart card driver licenses. Emerging border control and Federal traveler programs are considering smart card concepts, but have not gained traction and face privacy issues. We anticipate we will be prepared to support requirements from customers for smart card technology if, and when, such requirements arise.

We are seeing increased interest in the U.S. ID market from large systems integrators such as Electronic Data Systems Corporation, IBM Global Services, Accenture, and Bearing Point, as well as other ID and security suppliers such as Canadian Banknote and DataCard Corporation. Smaller application providers are also emerging as point-product competition, including Saber and Archon. In 2007, we implemented our first EDL pilot approved by the Department of Homeland Security in the State of Washington for land and sea border crossing. While to date there are no other known companies offering complete EDL solutions, we anticipate the primary competition for the EDL will be the PASS Card, which General Dynamics Corporation is contracted to provide.

Internationally, we supply credentialing systems, components or supplies to numerous foreign governments, including four Canadian provinces, Latvia, Mexico, Ghana and Russia. Competition in international markets, like in the U.S., comes from security printers, card producers, biometric companies and systems integrators, such as Sagem Telecommunications, S.A., De La Rue plc, Gemalto NV, Fujitsu Siemens Computers, Wincor Nixdorf International GmbH, Unisys Corporation, and Hewlett Packard Company.

In media identification and management, our business partners and we generally compete with application-specific alternative technologies for the security budget of the producers and distributors of the media objects. These alternatives include technologies and solutions based on encryption or on pattern recognition. We anticipate that our competitive position within certain markets may be affected by factors such as reluctance to adopt new technologies and, positively or negatively, by changes in government regulations.

Seasonality

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

Backlog

Backlog as of December 31, 2007 was approximately $225 million. We expect more than $90 million of this amount to be recognized as revenue during 2008. 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. Backlog as of December 31, 2006 was approximately $250 million.

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

Employees

At December 31, 2007, we had 424 full-time employees, including 60 in sales, marketing, technical support and customer support; 89 in research, development and engineering; 84 in finance, administration, information technology and legal; and 191 in field operations, manufacturing and supply chain. We also had 38 contract workers, primarily utilized in our international manufacturing operations at December 31, 2007. Our future success will depend, in part, on our ability to continue to attract, retain and motivate highly qualified technical and management personnel, for whom competition is intense. Our employees are not covered by any collective bargaining agreement, and we have never experienced a work stoppage. We believe that our relations with our employees are good.

Available Information

We make available through our website at *www.digimarc.com* our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and amendments to these and other reports filed or furnished by us pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 as soon as reasonably practicable after we file such materials with the Securities and Exchange Commission.

ITEM 1A: RISK FACTORS

Certain risk factors that may affect our business, financial condition, results of operation and cash flows, or that may cause our actual results to vary from the forward-looking statements contained in this Annual Report on Form 10-K are set forth in Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations, under the caption "Factors Affecting Forward Looking Statements," in this Annual Report on Form 10-K.

ITEM 1B: UNRESOLVED STAFF COMMENTS

None.

ITEM 2: PROPERTIES

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

	Square Feet	Expires
Beaverton, Oregon	46,000	August 2011
Burlington, Massachusetts	60,000	October 2010
Fort Wayne, Indiana	48,000	January 2010

We also lease sales and support offices in multiple locations throughout the United States and internationally.

ITEM 3: LEGAL PROCEEDINGS

Beginning in September 2004, three purported class action lawsuits were filed in the U.S. District Court for the District of Oregon against us and certain of our current and former directors and officers on behalf of purchasers of our securities during the period April 17, 2002 to July 28, 2004. These lawsuits were later consolidated into one action for all purposes. The amended complaint, which sought unspecified damages, asserted claims under the federal securities laws relating to the restatement of our financial statements for 2003 and the first two quarters of 2004 and alleged that we issued false and misleading financial statements and issued misleading public statements about our operations and prospects. On August 4, 2006, the court granted our motion to dismiss the lawsuit with prejudice and entered judgment in our favor. Plaintiffs have filed a notice of appeal in the Ninth Circuit Court of Appeals. The appeal was stayed pending the recent U.S. Supreme Court's determination in another case of issues relating to the Private Securities Litigation Reform Act, and briefing is scheduled to be completed by the end of the year. We anticipate oral argument and a decision in 2008. However, due to the inherent uncertainties of litigation, we cannot accurately predict the ultimate timing or outcome of the matter.

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

Beginning in May 2001, a number of substantially identical class action complaints alleging violations of the federal securities laws were filed in the United States District Court for the Southern District of New York naming approximately 300 companies, including Digimarc, certain of its officers and directors, and certain underwriters of our 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 our initial public offering violated securities laws by failing to disclose certain alleged compensation arrangements (such as undisclosed commissions or stock stabilization practices) in our initial public offering registration statement and by engaging in manipulative practices to artificially inflate the price of our stock in the after-market subsequent to our initial public offering. Certain of its officers and directors and we 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, other defendants in the consolidated cases and we 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 us. The claims against us under Section 10(b), however, were dismissed. In June 2003, a committee of our board of directors conditionally approved a proposed partial settlement with the plaintiffs in this matter. In June 2004, an agreement of settlement was submitted to the court for preliminary approval. The settlement would have provided, among other things, a release of us and of the individual defendants for the alleged wrongful conduct in the amended complaint in exchange for a guarantee from our insurers regarding recovery from the underwriter defendants and other consideration from us regarding our underwriters, including agreeing to assign away, not assert, or release certain potential claims we may have against its underwriters. The plaintiffs have continued to litigate against the underwriter defendants. The district court directed that the litigation proceed within a number of "focus cases" rather than in all of the 310 cases that have been consolidated. Our case is not one of these focus cases. On October 13, 2004, the district court certified the focus cases as class actions. The underwriter defendants appealed that ruling, and on December 5, 2006, the Court of Appeals for the Second Circuit reversed the district court's class certification decision. On April 6, 2007, the Second Circuit denied plaintiffs' petition for rehearing. In light of the Second Circuit opinion, we have informed the district court that this settlement cannot be approved because the defined settlement class, like the litigation class, cannot be certified. We cannot predict whether we will be able to renegotiate a settlement that complies with the Second Circuit's mandate. Due to the inherent uncertainties of litigation, we cannot accurately predict the ultimate outcome of the matter.

On October 10, 2007, a Digimarc shareholder filed a lawsuit in the United States District Court for the Western District of Washington against several companies that acted as lead underwriters on our initial public offering. The complaint, which also named us as a nominal defendant but did not assert any claims against us, asserted claims against the underwriters under Section 16(b) of the Securities Exchange Act of 1934 for recovery of alleged short-swing profits on trades of our stock.

ITEM 4: SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None.

PART II

ITEM 5: MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Our common stock is traded on The Nasdaq Global Market under the symbol "DMRC." The closing price of our common stock on The Nasdaq Global Market was $8.26 as of January 31, 2008. The following table lists the high and low sales prices of our common stock for the periods indicated, as reported by The Nasdaq Global Market.

	Year Ended December 31,			
	2007		2006	
	High	Low	High	Low
First quarter	$ 12.43	$ 8.09	$ 8.00	$ 5.85
Second quarter	$ 11.05	$ 8.90	$ 7.76	$ 5.85
Third quarter	$ 11.60	$ 8.05	$ 8.45	$ 5.56
Fourth quarter	$ 9.60	$ 8.21	$ 9.75	$ 7.51

At February 25, 2008, we had 487 stockholders of record of our common stock, as shown in the records of our transfer agent.

We have never declared or paid cash dividends on our capital stock and we do not anticipate paying any cash dividends in the foreseeable future. We currently intend to retain future earnings, if any, to finance the future growth of our business.

The following table sets forth information regarding purchases of our equity securities during the quarter ended December 31, 2007, all of which were shares subject to restricted stock awards that we purchased to cover applicable tax withholding obligations when these awards vested.

Period	(a) Total number of shares (or units) purchased	(b) Average price paid per share (or unit)	(c) Total number of shares (or units) purchased as part of publicly announced plans or programs	(d) Maximum number (or approximate dollar value) of shares (or units) that may yet be purchased under the plans or programs
Month 1 October 1, 2007 to October 31, 2007	3,175	$ 8.95		
Month 2 November 1, 2007 to November 30, 2007				
Month 3 December 1, 2007 to December 31, 2007	21,272	$ 8.82		
Total	24,447	$ 8.84		

Information regarding securities authorized for issuance under equity compensation plans is included in Part III, Item 12 of this Form 10-K.

STOCK PERFORMANCE GRAPH

The following graph compares the performance of our common stock with the performance of (i) the Nasdaq U.S. Index and (ii) a peer group selected by us. The comparison assumes $100 was invested on December 31, 2002 in our common stock at the closing price on such date and in each of the other two indices at the closing price on such date and assumes reinvestment of any dividends. We believe that the companies in the peer group are more comparable to us in terms of line-of-business, market capitalization, revenues, and number of employees and, therefore, comprise a more appropriate peer group for purposes of comparing stock performance. The comparisons in the graph are based on historical data and are not indicative of, nor intended to forecast, future performance of our common stock.

Comparison of Cumulative Five Year Total Return

Indexed Data

Company Name / Index	Base Period 2002	Years Ending December 31, 2003	2004	2005	2006	2007
Digimarc Corporation	**100**	$ 117.28	$ 82.19	$ 52.03	$ 77.51	$ 77.78
Nasdaq U.S. Index	**100**	150.36	163.00	166.58	183.68	201.91
Peer Group	**100**	160.33	187.81	145.79	137.99	127.54

Companies included in the peer group index of the stock performance graph are as follows:

ACTIVIDENTITY CORP
ALADDIN KNOWLEDGE SYS LTD
AMERICAN BK NT HOLOGRAPHICS
COGENT INC
DTS INC
DYNAMICS RESEARCH CORP
ENTRUST INC
L-1 IDENTITY SOLUTIONS INC
LASERCARD CORP
MACROVISION CORP
MEDIALINK WORLDWIDE INC
NCI INC
NIC INC
RAE SYSTEMS INC
SCM MICROSYSTEMS INC
TYLER TECHNOLOGIES INC
VERINT SYSTEMS INC

(1) The peer group does not include two companies, CompuDyne and Safenet, from our 2006 peer group since they were acquired in 2007.

ITEM 6: SELECTED FINANCIAL DATA

The selected financial data set forth below should be read in conjunction with the consolidated financial statements and the notes to the consolidated financial statements and "Management's Discussion and Analysis of Financial Condition and Results of Operations," which are included elsewhere in this report. The consolidated statement of operations and balance sheet data as of and for each of the five years in the period ended December 31, 2007, are derived from our audited consolidated financial statements.

	Year Ended December 31,				
	2007	2006	2005	2004	2003
	(in 000'S, except per share data)				
Consolidated Statement of Operations Data:					
Revenue	$ 109,764	$ 104,247	$ 101,053	$ 92,947	$ 85,591
Net income (loss)	$ (445)	$ (11,740)	$ (23,097)	$ (9,022)	$ 175
Net income (loss) per share basic	$ (0.02)	$ (0.57)	$ (1.13)	$ (0.44)	$ 0.01
Net income (loss) per share diluted	$ (0.02)	$ (0.57)	$ (1.13)	$ (0.44)	$ 0.01
Weighted average shares basic	20,982	20,649	20,485	20,326	18,572
Weighted average shares diluted	20,982	20,649	20,485	20,326	19,351

	Year Ended December 31,				
	2007	2006	2005	2004	2003
	(in 000'S)				
Consolidated Balance Sheet Data:					
Total assets	$ 142,023	$ 134,631	$ 140,239	$ 163,287	$ 161,153
Long-term obligations, net of current portion	8,462	6,230	3,009	3,104	2,006

ITEM 7: 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 Item 7, under the caption "Safe Harbor Statement under the Private Securities Litigation Reform Act of 1995."

Although we believe that the expectations reflected in our forward-looking statements are reasonable, we do not give any assurances that these expectations will prove to be correct. These statements by their nature involve substantial risks and uncertainties that could significantly affect expected results. Actual future results could differ materially from those described in our forward-looking statements, and we do not intend to update or revise any forward-looking statements as a result of new information, future events or otherwise. We urge you to carefully review and consider the various disclosures we have made that attempt to advise interested parties of the factors which affect our business, including the disclosures made under the caption "Factors Affecting Forward Looking Statements" in this Item 7, the audited consolidated financial statements and related notes included in this Annual Report on Form 10-K, and other reports and filings made with the SEC.

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 Annual Report on Form 10-K.

Overview

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

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

Our media identification and management revenue is generated through commercial applications of our digital watermarking and related technologies, primarily from patent and technology license fees paid by business partners, and a contract with a consortium of Central Banks.

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

Depreciation. Starting January 1, 2006, we changed our policy for depreciating fixed assets that were specifically used to provide services under long-term contracts to the shorter of the original contract term plus 2.75 years or estimated useful life. Through December 31, 2005, we depreciated these assets over the shorter of the original contract term or estimated useful life. This change in estimate was supported by an analysis we completed during the first quarter of 2006 which showed that historically 95% of contracts were extended beyond the original contract term, that the average contract had at least two contract extensions during its life and that these extensions added an average of 2.75 years to the length of the contracts' original terms.

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

Backlog. Based on projected government-issued credential production volumes and other commitments we have for the periods under contract with our respective customers, we anticipate our current contracts as of December 31, 2007 will generate approximately $225 million in revenue during the contractual terms of such contracts, currently up to seven years. We expect more than $90 million of this amount to be recognized as revenue during 2008. 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. Backlog as of December 31, 2006 was approximately $250 million. The decrease in backlog reflects factors noted below.

Some factors that lead to increased backlog are:

- Competitive bid wins,
- Renewals with current customers,
- Add-on sales to current customers, and
- Contracts with longer contractual periods replacing contracts with shorter contractual periods.

Some factors that lead to decreased backlog are:

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

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

Over the next year or so, we anticipate several states to request bids or negotiate extensions on their driver license issuance system programs. This period of expected high bid and potential extension activity could lead to additional backlog if we are successful with our bids. Another example is our variable revenue model. From time to time we have sales to our customers that are not characteristic of our 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 is no assurance that our backlog will result in actual revenue in any particular period, because the orders, awards and contracts included in our backlog may be subject to modification, cancellation or suspension. We may not realize revenue on certain contracts, orders or awards included in our backlog or the timing of such recognition may change.

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

Critical Accounting Policies and Estimates

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

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

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

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

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

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

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

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

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

Results of Operations

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

	Year Ended December 31,		
	2007	2006	2005
Revenue:			
Service	82%	82%	84%
Product and subscription	18	18	16
Total revenue	100	100	100
Cost of revenue:			
Service	55	58	61
Product and subscription	7	8	7
Total cost of revenue	62	66	68
Gross profit	38	34	32
Operating expenses:			
Sales and marketing	15	15	16
Research, development and engineering	6	10	13
General and administrative	14	16	21
Amortization of intangibles	2	2	4
Intellectual property	2	2	2
Restructuring charges		1	
Total operating expenses	39	46	56
Operating income (loss)	(1)	(12)	(24)
Other income (expense), net	1	1	1
Income (loss) before provision for income taxes		(11)	(23)
Provision for income taxes			
Net income (loss)	%	(11)%	(23)%

Our total revenue for the year ended December 31, 2007 was $109.8 million, or 5% higher as compared to $104.2 million for the prior year. We reported a substantially reduced loss for the year of $(0.4) million, an improvement of $11.3 million from 2006. We believe this dramatic improvement in earnings, driven both by increased revenue and reduced expenses, is the result of realizing the financial leverage caused by the restructuring efforts begun in 2005 and carried through 2006.

Years Ended December 31, 2007 and 2006

Revenue

	Year Ended December 31, 2007	Year Ended December 31, 2006	Dollar Increase (Decrease)	Percent Increase (Decrease)
	(in 000'S)			
Revenue:				
Service	$ 89,623	$ 85,681	$ 3,942	5%
Product and subscription	20,141	18,566	1,575	8%
Total	$ 109,764	$ 104,247	$ 5,517	5%
Revenue (as % of total revenue):				
Service	82%	82%		
Product and subscription	18%	18%		
Total	100%	100%		

Service. Service revenue consists primarily of:

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

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

The increase in service revenue was due primarily to increased revenue from our Mexican operations following a production hiatus associated with the 2006 national elections in that country and the commencement of services to additional provinces under our Atlantic Canada contract. These increases were offset by lower production volumes from Haiti's one-time voter identification project completed in the first quarter of fiscal year 2006, lower revenue from Latvia as a result of a non-recurring transaction in 2006, and lower revenues from various states from a combination of price and volume mix.

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

The increase in product and subscription revenue was due primarily to a net increase in variable sales, add-ons and upgrades, to various domestic and international customers and additional payments from certain cash basis customers where billings were made in the prior year but collected in 2007. Offsetting these increases was lower revenue from the United Kingdom contract that ended in the second quarter of 2007.

Revenue by Geography

	Year Ended December 31, 2007	2006	Dollar Increase (Decrease)	Percent Increase (Decrease)
	(in 000'S)			
Revenue by geography:				
Domestic	$ 87,610	$ 83,161	$ 4,449	5%
International	22,154	21,086	1,068	5%
Total	$ 109,764	$ 104,247	$ 5,517	5%
Revenue (as % of total revenue):				
Domestic	80%	80%		
International	20%	20%		
Total	100%	100%		

The increase in domestic revenue was due primarily to variable sales and additional cash payments as discussed above, offset by lower revenues from a combination of price and volume mix from various states.

The increase in international revenue was due primarily to increased revenue from Mexico and Canada as discussed above. These increases were offset by lower revenue from the United Kingdom contract, lower production volumes as a result of Haiti's one-time voter identification project, which ended in fiscal year 2006, and lower revenue from Latvia due to a non-recurring transaction in fiscal year 2006.

Revenue by Source

	Year Ended December 31, 2007	2006	Dollar Increase (Decrease)	Percent Increase (Decrease)
	(in 000'S)			
Revenue by source:				
Media identification and management	$ 13,211	$ 11,071	$ 2,140	19%
Identification	96,553	93,176	3,377	4%
Total	$ 109,764	$ 104,247	$ 5,517	5%
Revenue (as % of total revenue):				
Media identification and management	12%	11%		
Identification	88%	89%		
Total	100%	100%		

The increase in media identification and management revenue was due primarily to additional license revenues from our cash based customers where billings were made in 2006 and collected in 2007 and higher service revenue from our Central Bank and Nielsen contracts.

The increase in identification revenue was due primarily to service and product sales to various domestic and international customers as discussed above.

Cost of Revenue

	Year Ended December 31, 2007	2006	Dollar Increase (Decrease)	Percent Increase (Decrease)
	(in 000'S)			
Cost of Revenue:				
Service	$ 59,941	$ 60,817	$ (876)	(1)%
Product and subscription	8,087	7,952	135	2%
Total	$ 68,028	$ 68,769	$ (741)	(1)%
Cost of Revenue (as % of related revenue components):				
Service	67%	71%		
Product and subscription	40%	43%		

Service. Cost of service revenue primarily includes:

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

The decrease in cost of service revenue was due primarily to the following:

- decreased employee compensation-related expenses for salaries, benefits, recruiting costs and incentive plans aggregating $1.9 million as part of the restructuring initiative,
- decreased accrued benefits of $0.5 million due to no corporate incentive bonus earned or accrued across all cost areas in 2007, offset by

increased depreciation expense of $1.1 million related to programs completed in the second half of 2006 or in fiscal year 2007, and

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

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

The increase in cost of product and subscription revenue was due primarily to the following:

increased product costs to domestic and international customers related to increased sales, partially offset by

decreased product costs as a result of the end of the United Kingdom contract that ended in the second quarter of 2007.

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

	Year Ended December 31, 2007	Year Ended December 31, 2006	Dollar Increase (Decrease)	Percent Increase (Decrease)
	(in 000'S)			
Cost of revenue:				
Variable	$ 31,281	$ 29,145	$ 2,136	7%
Fixed field support and manufacturing	25,044	28,972	(3,928)	(14)%
Program depreciation	11,703	10,652	1,051	10%
Total	$ 68,028	$ 68,769	$ (741)	(1)%
Cost of revenue (as % of total revenue):				
Variable	28%	28%		
Fixed field support and manufacturing	23%	28%		
Program depreciation	11%	10%		
Total	62%	66%		

Variable. Variable costs include:

price of materials to produce an identification card,

direct costs of hardware and software, and related labor, delivered to customers, and

other costs that are variable in nature.

While the variable cost as a percentage of revenue remained the same, the increase in variable costs is primarily due to increased costs associated with increased variable sales as discussed above and somewhat offset by improved margins related to higher yields in the manufacturing process.

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

field operations and support costs,

manufacturing costs,

supply chain costs, and

charges for infrastructure and centralized costs.

The decrease in support costs was primarily due to costs associated with our focus on improving certain programs in early 2006 that resulted in fewer expenditures capitalized to the balance sheet and temporarily increased fixed support expenses, as discussed in cost of service revenue above, excluding program depreciation. After improving the efficiencies in these programs, our fixed costs returned to more normal levels, and reflected various significant cost reductions and operating efficiencies that were initiated over the prior two years, thus gaining financial leverage.

Program depreciation. Program depreciation primarily consists of amortization and depreciation of costs incurred during the delivery process, where such costs are capitalized and then amortized or