IDEXX LABORATORIES INC /DE
Form 10-Q
October 28, 2015

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2015

OR

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

For the transition period from _______________ to _______________.

COMMISSION FILE NUMBER: 000-19271

IDEXX LABORATORIES, INC.

(Exact name of registrant as specified in its charter)

DELAWARE	01-0393723
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)

ONE IDEXX DRIVE, WESTBROOK, MAINE	04092
(Address of principal executive offices)	(ZIP Code)

207-556-0300
(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 No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

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

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date. The number of shares outstanding of the registrant's Common Stock, $0.10 par value per share, was 90,963,542 on October 19, 2015.

IDEXX LABORATORIES, INC.

Quarterly Report on Form 10-Q

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PART I— FINANCIAL INFORMATION

Item 1. Financial Statements.

IDEXX LABORATORIES, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands, except per share amounts)

(Unaudited)

	September 30, 2015	December 31, 2014
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 141,150	$ 322,536
Marketable securities	208,399	-
Accounts receivable, net of reserves of $5,186 in 2015 and $4,306 in 2014	190,904	152,380
Inventories	192,405	160,342
Deferred income tax assets	36,767	37,689
Other current assets	63,771	86,451
Total current assets	833,396	759,398
Long-Term Assets:		
Property and equipment, net	320,337	303,587
Goodwill	180,392	184,450
Intangible assets, net	58,650	65,122
Other long-term assets	84,435	71,654
Total long-term assets	643,814	624,813
TOTAL ASSETS	$ 1,477,210	$ 1,384,211
LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)		
Current Liabilities:		
Accounts payable	$ 53,614	$ 44,743
Accrued liabilities	203,738	195,351
Line of credit	542,500	549,000
Current portion of deferred revenue	24,914	31,812
Total current liabilities	824,766	820,906
Long-Term Liabilities:		
Deferred income tax liabilities	36,571	41,688
Long-term debt	599,556	350,000

Long-term deferred revenue, net of current portion	25,460	21,665
Other long-term liabilities	29,660	32,363
Total long-term liabilities	691,247	445,716
Total liabilities	1,516,013	1,266,622
Commitments and Contingencies (Note 15)		
Stockholders' Equity (Deficit):		
Common stock, $0.10 par value: Authorized: 120,000 shares; Issued: 102,126 and 101,947 shares in 2015 and 2014, respectively; Outstanding: 91,200 and 47,373 shares in 2015 and 2014, respectively	10,213	10,195
Additional paid-in capital	931,808	888,293
Deferred stock units: Outstanding: 240 and 235 units in 2015 and 2014, respectively	5,387	5,066
Retained earnings	274,005	1,675,299
Accumulated other comprehensive loss	(37,493)	(8,071)
Treasury stock, at cost: 10,926 and 54,574 shares in 2015 and 2014, respectively	(1,222,812)	(2,453,266)
Total IDEXX Laboratories, Inc. stockholders' equity (deficit)	(38,892)	117,516
Noncontrolling interest	89	73
Total stockholders' equity (deficit)	(38,803)	117,589
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)	$ 1,477,210	$ 1,384,211

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

IDEXX LABORATORIES, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share amounts)

(Unaudited)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2015	2014	2015	2014
Revenue:				
Product revenue	$ 246,750	$ 233,666	$ 730,063	$ 690,573
Service revenue	159,637	149,857	472,144	443,275
Total revenue	406,387	383,523	1,202,207	1,133,848
Cost of Revenue:				
Cost of product revenue	92,185	84,784	266,758	249,782
Cost of service revenue	89,928	85,403	262,874	250,115
Total cost of revenue	182,113	170,187	529,632	499,897
Gross profit	224,274	213,336	672,575	633,951
Expenses:				
Sales and marketing	73,107	70,602	223,460	206,470
General and administrative	46,198	45,698	133,717	128,633
Research and development	24,862	24,847	74,185	73,394
Impairment charge	8,212	-	8,212	-
Income from operations	71,895	72,189	233,001	225,454
Interest expense	(7,750)	(4,294)	(21,313)	(10,033)
Interest income	684	313	1,668	1,272
Income before provision for income taxes	64,829	68,208	213,356	216,693
Provision for income taxes	20,600	16,045	65,611	60,693
Net income	44,229	52,163	147,745	156,000
Less: Net income attributable to noncontrolling interest	6	21	16	55
Net income attributable to IDEXX Laboratories, Inc. stockholders	$ 44,223	$ 52,142	$ 147,729	$ 155,945
Earnings per Share:				
Basic	$ 0.48	$ 0.52	$ 1.59	$ 1.53
Diluted	$ 0.48	$ 0.52	$ 1.57	$ 1.51
Weighted Average Shares Outstanding:				
Basic	91,944	99,489	93,194	101,642

Diluted	92,897	100,800	94,262	103,045

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

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IDEXX LABORATORIES, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(in thousands)

(Unaudited)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2015	2014	2015	2014
Net income	$ 44,229	52,163	147,745	156,000
Other comprehensive income, net of tax:				
Foreign currency translation adjustments	(13,859)	(19,003)	(26,793)	(15,524)
Unrealized gain (loss) on net investment hedge	(396)	-	340	-
Unrealized loss on investments, net of tax benefit of ($60) and ($29) in 2015 and ($23) and ($19) in 2014	(88)	(37)	(81)	(32)
Unrealized gain (loss) on derivative instruments:				
Unrealized gain, net of tax expense of $1,030 and $2,882 in 2015 and $2,809 and $1,796 in 2014	2,495	6,204	6,793	4,027
Less: reclassification adjustment for gains included in net income, net of tax benefit (expense) of ($1,374) and ($4,079) in 2015 and ($67) and $24 in 2014	(3,369)	(205)	(9,681)	(103)
Unrealized gain (loss) on derivative instruments	(874)	5,999	(2,888)	3,924
Other comprehensive loss, net of tax	(15,217)	(13,041)	(29,422)	(11,632)
Comprehensive income	29,012	39,122	118,323	144,368
Less: comprehensive income attributable to noncontrolling interest	6	21	16	55
Comprehensive income attributable to IDEXX Laboratories, Inc.	$ 29,006	$ 39,101	$ 118,307	$ 144,313

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

IDEXX LABORATORIES, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(Unaudited)

	For the Nine Months Ended September 30, 2015	2014
Cash Flows from Operating Activities:		
Net income	$ 147,745	$ 156,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	51,227	43,610
Amortization on marketable securities, net	967	-
Impairment charge	8,212	-
Provision for uncollectible accounts	1,808	1,678
Benefit of deferred income taxes	(4,649)	(6,729)
Share-based compensation expense	14,760	13,463
Other	(305)	(79)
Tax benefit from share-based compensation arrangements	(10,044)	(9,581)
Changes in assets and liabilities:		
Accounts receivable	(51,024)	(8,464)
Inventories	(27,238)	(12,638)
Other assets	41,041	(3,375)
Accounts payable	(2,841)	6,876
Accrued liabilities	(24,503)	16,216

Deferred revenue	(2,688)	11,566
Net cash provided by operating activities	142,468	208,543
Cash Flows from Investing Activities:		
Purchases of property and equipment	(67,517)	(42,504)
Purchase of marketable securities	(231,387)	-
Proceeds from the sale and maturities of marketable securities	24,711	-
Proceeds from sale of equity investment	-	5,400
Acquisitions of a business, net of cash acquired	(8,200)	(7,516)
Acquisitions of intangible assets	-	(175)
Net cash used by investing activities	(282,393)	(44,795)
Cash Flows from Financing Activities:		
(Repayments) borrowings on revolving credit facilities, net	(6,500)	98,000
Debt issue costs	(199)	(1,357)
Issuance of long term debt	250,097	200,000
Payment of notes payable	-	(1,394)
Repurchases of common stock	(309,057)	(468,968)
Proceeds from exercises of stock options and employee stock purchase plans	19,221	18,361
Tax benefit from share-based compensation arrangements	10,044	9,581
Net cash used by financing activities	(36,394)	(145,777)
Net effect of changes in exchange rates on cash	(5,067)	(4,294)
Net (decrease) increase in cash and cash equivalents	(181,386)	13,677
	322,536	279,058

Cash and cash equivalents at beginning of period				
Cash and cash equivalents at end of period	$	141,150	$	292,735

The accompanying notes are an integral part of these condensed consolidated financial statements.
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IDEXX LABORATORIES, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

NOTE 1. BASIS OF PRESENTATION AND PRINCIPLES OF CONSOLIDATION

The accompanying condensed consolidated financial statements of IDEXX Laboratories, Inc. and its subsidiaries have been prepared in accordance with accounting principles generally accepted in the United States of America (“U.S. GAAP”) for interim financial information and with the requirements of Regulation S-X, Rule 10-01 for financial statements required to be filed as a part of this Quarterly Report on Form 10-Q. Unless the context requires otherwise, references in this Quarterly Report on Form 10-Q to "IDEXX," the "Company," "we," "our" or "us" refer to IDEXX Laboratories, Inc. and its subsidiaries.

The accompanying condensed consolidated financial statements include the accounts of IDEXX Laboratories, Inc. and our wholly-owned and majority-owned subsidiaries. We do not have any variable interest entities for which we are the primary beneficiary. All intercompany transactions and balances have been eliminated in consolidation.

The accompanying condensed consolidated financial statements reflect, in the opinion of our management, all adjustments necessary for a fair statement of our financial position and results of operations. All such adjustments are of a recurring nature. The consolidated balance sheet data at December 31, 2014 was derived from audited financial statements, but does not include all disclosures required by U.S. GAAP. The results of operations for the three and nine months ended September 30, 2015 are not necessarily indicative of the results to be expected for the full year or any future period. These condensed consolidated financial statements should be read in conjunction with this Quarterly Report on Form 10-Q for the quarter ended September 30, 2015 and our Annual Report on Form 10-K for the year ended December 31, 2014 (the “2014 Annual Report”) filed with the U.S. Securities and Exchange Commission (“SEC”).

Stock Split

On May 6, 2015, we announced a two-for-one split of our outstanding shares of common stock which was effected through a stock dividend that was paid through the issuance of treasury shares. The stock split entitled each stockholder of record at the close of business on May 18, 2015 to receive one additional share of common stock for each outstanding share of common stock held. The additional shares of our common stock paid pursuant to the stock split were distributed by the Company's transfer agent on June 15, 2015. All share and per share amounts in the condensed consolidated balance sheets, condensed consolidated statement of operations and notes to the condensed consolidated financial statements retroactively reflect the effect of the stock split unless otherwise noted.

Reclassifications

Certain prior year amounts have been reclassified to conform with the current year presentation. Such reclassifications had no material impact on previously reported results of operations, financial position or cash flows.

Note 2. ACCOUNTING POLICIES

The significant accounting policies used in preparation of these condensed consolidated financial statements for the three and nine months ended September 30, 2015 are consistent with those discussed in Note 2 to the consolidated financial statements in our 2014 Annual Report, except for our significant accounting policies related to marketable securities.

During the nine months ended September 30, 2015, we purchased marketable debt securities, which are classified as available-for-sale and carried at fair value in the accompanying condensed consolidated balance sheets on a trade date basis. We have classified our investments with maturities beyond one year as short-term, based on their highly liquid nature and because such marketable securities represent the investment of cash that is available for current operations. Unrealized holding gains and losses are deferred within accumulated other comprehensive income ("AOCI"), net of applicable taxes, except for when an impairment is determined to be other-than-temporary or the security is divested prior to maturity. Within the accompanying condensed consolidated statements of operations, interest earned and amortization of premiums or discounts on marketable securities are included in interest income, realized gains and losses on the sale of our marketable securities are included in other income.

We perform ongoing reviews to evaluate whether an unrealized loss on an investment represents an other-than-temporary impairment. An unrealized loss exists when the fair value of an investment is less than its amortized cost. When determining whether an impairment is other-than-temporary, we consider the duration and extent to which the fair value of the investment has been below its cost, the financial condition and near-term prospects of the issuer as expressed by the security's credit rating and rating outlook, and whether a credit event has occurred, including the failure of the issuer to make scheduled interest or principal payments. Should we intend to sell or determine that we would more likely than not be required to sell the security before the expected recovery of the amortized cost basis, we would consider the loss to be other-than-temporary and charge income in the period such determination is made. For debt securities that we have no intent to sell and for which we believe that it is more likely than not that we will not be required to sell prior to recovery, only the credit loss component of the impairment is charged to income, while any remaining loss remains recognized in AOCI. The credit loss component is identified as the difference between the present value of expected cash flows expected to be collected and the amortized cost of the investment.

New Accounting Pronouncements Not Yet Adopted

In May 2014, the Financial Accounting Standards Board ("FASB") issued an amendment which will replace most of the existing revenue recognition guidance within U.S. GAAP. The core principle of this guidance is that an entity should recognize revenue for the transfer of goods or services to customers in an amount that it expects to be entitled to receive for those goods or services. In doing so, companies will be required to make certain judgments and estimates, including identifying contract performance obligations, estimating the amount of variable consideration to include in the transaction price and allocating the transaction price among separate performance obligations. Additionally, the amendment requires disclosure about the nature, amount, timing and uncertainty of revenue and cash flows arising from customer contracts, significant judgments reached in the application of the guidance and assets recognized from the costs to obtain or fulfill a contract. In July 2015, the FASB voted to defer the effective date of the amendment to apply to public business entities for annual and interim periods ending after December 15, 2017. The amendment allows for two methods of adoption: a full retrospective method or a modified retrospective approach with the cumulative effect recognized at the date of initial application. We are in the process of determining the method of adoption and the impact of this amendment on our consolidated financial statements.

In August 2014, the FASB issued an amendment that requires management to assess an entity's ability to continue as a going concern by incorporating and expanding upon certain principles that are currently in U.S. auditing standards. The amendments in this update provide guidance about management's responsibility to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern for one year after the date that the financial statements are issued and to provide related footnote disclosures. In doing so, the amendments should reduce diversity in the timing and content of footnote disclosures. The amendments in this update apply to all entities and are effective for the annual period ending after December 15, 2016, and for annual periods and interim periods thereafter. Early application is permitted. This amendment is not expected to have a material impact on our financial statements.

In February 2015, the FASB issued amendments which change the analysis that a reporting entity must perform to determine whether it should consolidate certain types of legal entities, placing more emphasis on risk of loss when determining a controlling financial interest. The amendments in this update apply to all entities and are effective for the annual period ending after December 15, 2016, and for annual periods and interim periods thereafter. Early application is permitted. This amendment is not expected to have a material impact on our financial statements.

In April 2015, the FASB issued amendments that require that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. Under current guidance, our debt issuance costs are reflected as a deferred charge, within other current assets, net and other long-term assets, net on our condensed consolidated balance sheets. This update is effective for the annual reporting periods beginning after December 15, 2015. This amendment is not expected to have a material impact on our financial statements.

In April 2015, the FASB issued amendments that provide guidance to customers about whether a cloud computing arrangement includes a software license. If a cloud computing arrangement includes a software license, then the customer should account for the software license element of the arrangement consistent with the acquisition of other software licenses. If a cloud computing arrangement does not include a software license, the customer should account for the arrangement as a service contract. The new guidance does not change the accounting for a customer's accounting for service contracts. The standard update is effective for fiscal years beginning after December 15, 2015 and interim periods within those years. Early adoption is permitted. The standard allows for adoption retrospectively or prospectively to all arrangements entered into or materially modified after the effective date. The amendment is not expected to have a material impact on our financial statements.

In May 2015, the FASB issued amendments which remove the requirement to categorize within the fair value hierarchy all investments for which fair value is measured using the net asset value as a practical expedient for fair value. Removing investments measured using the practical expedient from the fair value hierarchy is intended to eliminate the diversity in practice that currently exists with respect to the categorization of these investments. The new guidance requires reporting entities to continue to disclose information on investments for which fair value is measured at net asset value (or its equivalent) as a practical expedient to help users understand the nature and risks of the investments and whether the investments, if sold, are probable of being sold at amounts different from net asset value. A reporting entity should apply the amendments retrospectively to all periods presented. This update is effective for public business entities during fiscal years beginning after December 15, 2015. Early adoption is permitted. This amendment is not expected to have a material impact on our financial statements.

In July 2015, the FASB issued amendments which simplify the existing guidance which requires entities to subsequently measure inventory at the lower of cost or market value. Under the amendments, an entity should measure inventory valued using a first-in, first-out or average cost method at the lower of cost and net realizable value, which is defined as the estimated selling price in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation. This update is effective for public business entities during fiscal years beginning after December 15, 2016. Early adoption is permitted. This amendment is not expected to have a material impact on our financial statements.

In September 2015, the FASB issued amendments which eliminate the requirement for an acquirer in a business combination to retrospectively account for measurement-period adjustments. Under the amendments, an entity is required to record measurement-period adjustments during the period in which the amounts are determined, including changes in depreciation, amortization and any other income effects as if the accounting had been completed at the acquisition date. This update is effective for public business entities during fiscal years beginning after December 15, 2015. Early adoption is permitted. This amendment is not expected to have a material impact on our financial statements.

NOTE 3.ACQUISITIONS

We believe that our acquisitions enhance our existing businesses by either expanding our geographic range or customer base.

During the nine months ended September 30, 2015, we paid an aggregate of $7.5 million in cash and recorded contingent consideration of $3.2 million to acquire two reference laboratory diagnostic and consulting businesses, each accounted for as a separate business combination. As part of these business acquisitions, we recognized $5.2 million in customer list amortizable intangible assets, $5.0 million in goodwill, $1.1 million in working capital, $0.3 million in fixed assets and a deferred tax liability of $0.9 million. The customer lists were each assigned useful lives of 15 years. Goodwill is calculated as the consideration in excess of net assets recognized and represents the future economic benefits arising from other assets acquired that could not be individually identified and separately recognized. The goodwill recorded from these business acquisitions is not deductible for income tax purposes. All assets acquired in connection with these business acquisitions were assigned to our CAG segment. The results of operations of these acquired businesses have been included since the acquisition date. Pro forma information has not been presented for these business acquisitions because such information is not material to the financial statements.

NOTE 4. SHARE-BASED COMPENSATION

The fair value of options, restricted stock units, deferred stock units and employee stock purchase rights awarded during the three and nine months ended September 30, 2015 totaled $0.6 million and $24.4 million, respectively, as compared to $1.0 million and $23.8 million for the three and nine months ended September 30, 2014, respectively. The total unrecognized compensation expense, net of estimated forfeitures, for unvested share-based compensation awards outstanding at September 30, 2015 was $42.7 million, which will be recognized over a weighted average period of approximately 1.8 years.

We determine the assumptions used in the valuation of option awards as of the date of grant. Differences in the expected stock price volatility, expected term or risk-free interest rate may necessitate distinct valuation assumptions at each grant date. As such, we may use different assumptions for options granted throughout the year. Option awards are granted with an exercise price equal to the closing market price of our common stock at the date of grant. We have never paid any cash dividends on our common stock, and we have no intention to pay such a dividend at this time; therefore, we assume that no dividends will be paid over the expected terms of option awards. The weighted averages of the valuation assumptions used to determine the fair value of each option award on the date of grant and the weighted average estimated fair values were as follows:

%

27

%

Total

100

%

100

%

Service. Service revenue consists primarily of revenue derived from the sale of software development and consulting services. The majority of service revenue arrangements are structured as time and materials consulting agreements. Most of our service revenue is derived from contracts with the Central Banks and government agency contractors. The agreements range from several months to several years in length, and our longer term contracts are subject to work plans that are reviewed and agreed upon at least annually. These contracts generally provide for billing hours worked at predetermined rates and, to a lesser extent, reimbursement for third party costs and services. Increases or decreases in the services provided under these contracts are generally subject to both volume and price changes. The volume of work is generally negotiated at least annually and can be modified as the customer’s needs change. We also have provisions in our longer term contracts that allow for specific hourly rate increases on an annual basis to account for cost of living variables. Contracts with government agency contractors are generally shorter term in nature, less linear in billings and less predictable than our longer term contracts because the contracts with government agency contractors are subject to government budgets and funding.

The decrease in service revenue was primarily due to lower volume of program work with the Central Banks. The volume of program work can vary year to year depending on the program roadmap governed by the Central Banks.

Subscription. Subscription revenue includes revenue derived from the sale of Digimarc Discover, Digimarc Barcode and Digimarc Guardian products and services, and is generally recurring in nature, paid in advance and recognized over the term of the subscription.

The increase in subscription revenue was due to higher Digimarc Discover and Digimarc Barcode revenue, partially offset by lower Digimarc Guardian revenue. Digimarc Discover and Digimarc Barcode revenue increased due to contracts with new customers during the year and escalating annual fees from existing customers. Digimarc Guardian revenue declined largely due to one customer contract termination during the year.

License. License revenue originates primarily from licensing our intellectual property where we receive license fees and/or royalties as our income stream.

The decrease in license revenue was primarily due to the impact of the $3.5 million upfront license fee we realized in the third quarter of 2017 and $0.9 million of royalties realized in the first nine months of 2017 from the licensee. In exchange for the upfront license fee, we waived any future royalty obligations from this licensee in one of the licensed fields of use.

Revenue by geography

	Year Ended December 31, 2018	Year Ended December 31, 2017	Dollar Increase (Decrease)	Percent Increase (Decrease)
Revenue by geography:				
Domestic	$ 5,573	$ 5,116	$ 457	9 %
International	15,619	20,097	(4,478)	(22)%
Total	$ 21,192	$ 25,213	$ (4,021)	(16)%
Revenue (as % of total revenue):				
Domestic	26 %	20 %		
International	74 %	80 %		
Total	100 %	100 %		

The increase in domestic revenue was primarily due to higher Digimarc Discover and Digimarc Barcode revenue, partially offset by lower Digimarc Guardian revenue from domestic customers.

The decrease in international revenue was primarily due to lower license revenue reflecting the impact of the $3.5 million upfront license fee realized in the third quarter of 2017 and $0.9 million of royalties realized in the first nine months of 2017 from the licensee.

Cost of revenue

Service. Cost of service revenue primarily includes costs that are allocated from research, development and engineering, sales and marketing and intellectual property that relate directly to performing services under our customer contracts and direct costs of program delivery. Costs include:

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

Subscription. Cost of subscription revenue primarily includes:

- compensation, benefits, incentive compensation in the form of stock-based compensation and related costs of operations personnel;
- cost of outside contractors that provide operational support;
- amortization of existing technology acquired in the acquisition of Attributor Corporation; and
- Internet service provider connectivity charges and image search data fees to support the services offered to our subscription customers.

License. Cost of license revenue primarily includes:

- amortization of capitalized patent costs; and
- amortization of patent maintenance fees.

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Gross profit

	Year Ended December 31, 2018	Year Ended December 31, 2017	Dollar Increase (Decrease)	Percent Increase (Decrease)
Gross Profit:				
Service	$ 6,852	$ 7,144	$ (292)	(4)%
Subscription	4,134	3,255	879	27 %
License	1,780	6,256	(4,476)	(72)%
Total	$ 12,766	$ 16,655	$ (3,889)	(23)%
Gross Profit (as % of related revenue components):				
Service	54 %	55 %		
Subscription	68 %	59 %		
License	75 %	93 %		
Total	60 %	66 %		

The decrease in total gross profit was primarily due to lower license revenue.

The decrease in service gross profit as a percentage of service revenue was insignificant.

The increase in subscription gross profit as a percentage of subscription revenue was primarily due to higher subscription revenue and completion of amortization of our acquired intangible assets.

The decrease in license gross profit as a percentage of license revenue was primarily due to lower license revenue.

Operating expenses

We allocate certain costs of research, development and engineering, sales and marketing, and intellectual property to cost of revenue when they relate directly to our customer contracts. We record all remaining, or “residual,” costs as sales and marketing, research, development and engineering, general and administrative, and intellectual property expenses.

Sales and marketing

	Year Ended December 31, 2018	Year Ended December 31, 2017	Dollar Increase (Decrease)	Percent Increase (Decrease)
Sales and marketing	$ 19,140	$ 16,636	$ 2,504	15 %
Sales and marketing	90 %	66 %		

(as % of total revenue)

Sales and marketing expenses consist primarily of:

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

The increase in sales and marketing expenses was due primarily to:

- increased headcount and compensation-related expenses of $2.2 million;
- increased charges for infrastructure and centralized costs of $0.5 million due to increased costs and headcount; partially offset by
- decreased recruiting costs of $0.3 million.

Research, development and engineering

	Year Ended December 31, 2018	Year Ended December 31, 2017	Dollar Increase (Decrease)	Percent Increase (Decrease)
Research, development and engineering	$ 15,971	$ 15,435	$ 536	3 %
Research, development and engineering (as % of total revenue)	75 %	61 %		

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

- Fundamental Research:
- investigation of new digital watermarking algorithms to increase robustness and/or computational efficiency;
- research of mobile device usage models and imaging sub-systems in camera-phones;
- industry conference participation and authorship of papers for industry journals;
- survey and study of human and computer interaction models with a focus on mobile devices and modeling of intent;
- development of new intellectual property, including documentation of claims and production of supporting diagrams and materials;
- research in multi-spectral analyses, machine learning, machine readable indicia and other content identification technologies;
- development of metadata ranking algorithms for matching Internet file content against reference database; and
- investigation of substrates, printing techniques, and printing technology relating to consumer packaged goods and thermal labels.
- Platform Development:
- tuning and optimization of implementation models to improve resistance to non-malicious attacks and routine transformations, such as JPEG, cropping and printing;
- mobile platform creation to leverage device-specific capabilities (e.g., instruction sets and Graphics Processing Units);
- mobile platform optimization involving usage of multiple sensors simultaneously;
- embedded systems platform creation and tuning for barcode scanners, thermal label printers, and machine vision environments;
- tuning big data analytics transformation and metrics aggregation engine;
- tuning data-driven Internet crawling infrastructure with policy-driven feedback loop; and
- assembly of master book publishing catalog based on aggregation and reconciliation of multiple public data sources.

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- Product Development:
- delivery and enhancement of Digimarc Barcode for an expanding list of applications, including packaging for consumer packaged goods, thermal labels for fresh foods, and machine vision applications for manufacturing and recycling;
- improvements to the Digimarc Barcode Manager to provide campaign management and routing services for the Digimarc Discover platform;
- maintenance of the web-hosted image enhancement service in support of Digimarc Discover platform;
- development and optimization of production level image enhancement tools and quality control services;
- iterative development and release of the Digimarc Discover application for the iOS and Android platforms; and
- development of real-time analytics portal to support anti-piracy services for the publishing industry.

Research, development and engineering expenses consist primarily of:

- compensation, benefits, incentive compensation in the form of stock-based compensation and related costs of software and hardware developers and quality assurance personnel;
- charges for infrastructure and centralized costs of facilities and information technology;
- payments to outside contractors; and
- the purchase of materials and services for product development.

The increase in research, development and engineering expenses was due primarily to:

- increased headcount and compensation-related expenses of $0.5 million; and
- increased charges for infrastructure and centralized costs of $0.2 million due to increased costs and headcount; partially offset by
- decreased recruiting costs of $0.1 million.

General and administrative

	Year Ended December 31, 2018	Year Ended December 31, 2017	Dollar Increase (Decrease)	Percent Increase (Decrease)
General and administrative	$ 9,897	$ 9,680	$ 217	2 %
General and administrative (as % of total revenue)	47 %	38 %		

We incur general and administrative costs in the functional areas of finance, legal, human resources, executive and board of directors. Costs for facilities and information technology are also managed as part of the general and administrative processes and are allocated to this area as well as each of the areas in cost of revenue, sales and marketing, research, development and engineering and intellectual property.

General and administrative expenses consist primarily of:

- compensation, benefits and incentive compensation in the form of stock-based compensation and related costs of general and administrative personnel;
- third party and professional fees associated with legal, accounting and human resources functions;
- costs associated with being a public company; and

- charges for infrastructure and centralized costs of facilities and information technology.

The increase in general and administrative expenses was due primarily to:

- increased compensation-related expenses of $1.0 million;
- increased depreciation and amortization expenses of $0.3 million; partially offset by
- decreased charges for infrastructure and centralized costs of $0.7 million, which were allocated to sales and marking and research, development and engineering due to increased headcount in those areas; and
- decreased professional fees of $0.3 million.

Intellectual property

	Year Ended December 31, 2018	Year Ended December 31, 2017	Dollar Increase (Decrease)	Percent Increase (Decrease)
Intellectual property	$ 1,282	$ 1,469	$ (187)	(13)%
Intellectual property (as % of total revenue)	6 %	6 %		

We incur intellectual property expenses that arise primarily from costs associated with documenting, applying for, and maintaining domestic and international patents and trademarks.

Gross expenditures for intellectual property costs, before reflecting the effect of capitalized patent costs, primarily consist of:

- compensation, benefits and incentive compensation in the form of stock-based compensation and related costs of attorneys and legal assistants;
- third party costs, including filing and governmental regulatory fees and fees for outside legal counsel and translation costs, each incurred in the patent process;
- charges to write off previously capitalized patent costs for patent assets we abandon; and
- charges for infrastructure and centralized costs of facilities and information technology.

Intellectual property expenses can vary from period to period based on the level of capitalized patent activity.

The decrease in intellectual property expenses was primarily due to lower write-offs of abandoned patent costs of $0.2 million.

Stock-based compensation

	Year Ended December 31, 2018	Year Ended December 31, 2017	Dollar Increase (Decrease)	Percent Increase (Decrease)

Cost of revenue	$ 613	$ 663	$ (50)	(8)%
Sales and marketing	1,649	1,440	209	15%
Research, development and engineering	1,361	1,359	2	0%
General and administrative	3,386	2,974	412	14%
Intellectual property	289	321	(32)	(10)%
Total	$ 7,298	$ 6,757	$ 541	8%

The increase in stock-based compensation expense was due primarily to increased headcount and the timing and amount of stock awards.

We anticipate incurring an additional $14,055 in stock-based compensation expense through December 31, 2022 for awards outstanding as of December 31, 2018.

Other income, net

	Year Ended December 31, 2018	Year Ended December 31, 2017	Dollar Increase (Decrease)	Percent Increase (Decrease)
Other income, net	$ 1,057	$ 588	$ 469	80 %
Other income, net (as % of total revenue)	5 %	2 %		

The increase in other income, net was primarily due to higher interest income as a result of higher interest rates on cash and investments, partially offset by a lower level of cash and investments.

Provision for income taxes

The provision for income taxes reflects current taxes, deferred taxes and withholding taxes in certain foreign jurisdictions.

For the year ended December 31, 2018, our effective tax rate was 0%, reflecting a full valuation allowance recorded against our deferred tax assets. The valuation allowance against deferred tax assets as of December 31, 2018 was $42.3 million, an increase of $10.0 million from $32.3 million as of December 31, 2017. We continually assess the applicability of a valuation allowance against our deferred tax assets. Based upon the positive and negative evidence available as of December 31, 2018, and largely due to the cumulative loss incurred by us over the preceding three years, which is considered a significant piece of negative evidence when assessing the realizability of deferred tax assets, a full valuation allowance is recorded against our deferred tax assets. We will not record tax benefits on any future losses until it is determined that those tax benefits will be realized. All future reversals of the valuation allowance would result in a tax benefit in the period recognized.

For the year ended December 31, 2017, our effective tax rate was 1%, reflecting the recognition of alternative minimum tax ("AMT") credit carryforwards and a full valuation allowance recorded against our deferred tax assets. The valuation allowance against deferred tax assets as of December 31, 2017 was $32.3 million, an increase of $7.4 million from $24.9 million as of December 31, 2016.

The U.S. enacted tax reform legislation on December 22, 2017 commonly known as the Tax Cuts and Jobs Act ("the Act"), resulting in significant modifications to existing U.S. tax law. Accounting for the income tax effects of the Act has been completed and included in our financial statements as of December 31, 2017. As a result of the Act, we recorded a one-time tax provision and corresponding reduction to valuation allowance of $10.5 million, which consisted primarily of the remeasurement of deferred tax assets and liabilities from a tax rate of 35% to a tax rate of 21%. The future impact of the Act is not expected to have a material effect on our financial results and cash flows in the foreseeable future because we have a full valuation allowance recorded against our deferred tax assets.

Liquidity and Capital Resources

	December 31, 2018	December 31, 2017
Working capital	$ 45,326	$ 71,275
Current ratio (1)	11.5:1	15.1:1
Cash, cash equivalents and short-term marketable securities	$ 43,656	$ 67,738
Long-term marketable securities	$ —	$ —
Total cash, cash equivalents and marketable securities	$ 43,656	$ 67,738

(1) The current (liquidity) ratio is calculated by dividing total current assets by total current liabilities.

The $24.1 million decrease in cash, cash equivalents and marketable securities at December 31, 2018 from December 31, 2017 resulted primarily from:

- cash used in operations,
- purchases of common stock related to tax withholding in connection with the vesting of restricted stock, and
- purchases of property and equipment and capitalized patent costs; partially offset by
- proceeds from stock option exercises.

Financial instruments that potentially subject us to concentrations of credit risk consist primarily of cash and cash equivalents, marketable securities, and trade accounts receivable. We place our cash and cash equivalents with major banks and financial institutions and at times deposits may exceed insured limits. Marketable securities include commercial paper and corporate notes. Our investment policy requires our portfolio to be invested to ensure that the greater of $3 million or 7% of the invested funds will be available within 30 days' notice.

Other than cash used for operating needs, which may include short-term marketable securities, our investment policy limits our credit exposure to any one financial institution or type of financial instrument by limiting the maximum of 5% of our cash and cash equivalents and marketable securities or $1 million, whichever is greater, to be invested in any one issuer except for the U.S. government, U.S. federal agencies and U.S. backed securities, which have no limits, at the time of purchase. Our investment policy also limits our credit exposure by limiting to a maximum of 40% of our cash and cash equivalents and marketable securities, or $15 million, whichever is greater, to be invested in any one industry category, (e.g., financial or energy industries), at the time of purchase. As a result, we believe our credit risk associated with cash and investments to be minimal. A decline in the market value of any security below cost that is deemed to be other-than-temporary results in a reduction in carrying amount to fair value. To determine whether an impairment is other-than-temporary, we consider whether we have the ability and intent to hold the investment until a market price recovery and evidence indicating that the cost of the investment is recoverable outweighs evidence to the contrary. There have been no other-than-temporary impairments identified or recorded by us in the years ended December 31, 2018 and 2017.

Cash flows from operating activities

The components of operating cash flows were:

	Year Ended December 31, 2018	Year Ended December 31, 2017	Dollar Increase (Decrease)	Percent Increase (Decrease)
Net loss	$ (32,506)	$ (25,771)	$ (6,735)	(26)%
Non-cash items	9,441	9,183	258	3%
Changes in operating assets and liabilities	1,855	(1,023)	2,878	281%
Net cash used in operating activities	$ (21,210)	$ (17,611)	$ (3,599)	(20)%

Cash flows used in operating activities in 2018 compared to 2017 increased by $3.6 million, primarily as a result of a higher net loss, partially offset by changes in operating assets and liabilities. The higher net loss was primarily as a result of lower license revenue and higher operating expenses. The changes in operating assets and liabilities were primarily due to increased collections of accounts receivable reflecting the impact of the $3.5 million upfront license fee realized in 2017.

Cash flows from investing activities

Cash flows provided by investing activities in 2018 compared to 2017 decreased by $10.5 million, from $19.0 million to $8.5 million, primarily as a result of lower net maturities of marketable securities.

Cash flows from financing activities

Cash flows from financing activities in 2018 compared to 2017 decreased by $28.6 million, from $27.8 million provided to $0.8 million used, primarily as a result of the sale of common stock in connection with our registered direct offerings in 2017.

Future cash expectations

We believe that our current cash, cash equivalents, and short-term marketable securities balances will satisfy our projected working capital and capital expenditure requirements for at least the next 12 months. We have a $100 million shelf registration statement in place, of which $17.8 million and $12.0 million were allocated for sales of our common stock in connection with our registered direct offerings in June 2017 and November 2017, respectively. This shelf registration statement has $70.2 million remaining for future issuance and expires in June 2020. We may use similar or other financing means to raise working capital in the future, if necessary, to support continued investment in our growth initiatives. We may also raise capital in the future to fund acquisitions and/or investments in complementary businesses, technologies or product lines. If it becomes necessary to obtain additional financing, we may not be able to do so, or if these funds are available, they may not be available on satisfactory terms.

Contractual Obligations

We are party to operating leases in Beaverton, Oregon and San Mateo, California.

In July 2015, we entered into an amendment with the landlord of our corporate offices in Beaverton, Oregon to extend the lease term through March 2024 for rent payments totaling $5.5 million, payable in monthly installments.

In February 2015, we entered into a new facilities lease agreement in San Mateo, California with a lease term through March 2020 for rent payments totaling $1.0 million, payable in monthly installments.

Off-Balance Sheet Arrangements

Other than the leases noted below, 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 is material to investors.

We are party to operating leases for our facilities in Beaverton, Oregon and San Mateo, California. In July 2015, we entered into an amendment with the landlord of our corporate offices in Beaverton, Oregon to extend the lease term through March 2024, with remaining rent payments totaling $4.2 million, payable in monthly installments. In February 2015, we entered into a new facilities lease agreement in San Mateo, California with a lease term through March 2020, with remaining rent payments totaling $0.3 million, payable in monthly installments.

Forward-Looking Statements

This Annual Report on Form 10-K includes “forward-looking statements” within the meaning of Section 21E of the Securities Exchange Act of 1934 and Section 27A of the Securities Act of 1933. Words such as “may,” “might,” “plan,” “should,” “could,” “expect,” “anticipate,” “intend,” “believe,” “project,” “forecast,” “estimate,” “continue,” and variations of s similar expressions are intended to identify such forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These forward-looking statements, or other statements made by us, are made based on our expectations and beliefs concerning future events impacting us, and are subject to uncertainties and factors (including those specified below), which are difficult to predict and, in many instances, are beyond our control. As a result, our actual results could differ materially from those expressed in or implied by any such forward-looking statements, and investors are cautioned not to place undue reliance on such statements. We believe that the following factors, among others (including those described in Item 1A. “Risk Factors”), could affect our future performance and the liquidity and value of our securities and cause our actual results to differ materially from those expressed or implied by forward-looking statements made by us. Forward-looking statements include but are not limited to statements relating to:

- concentration of revenue with few customers comprising a large majority of the revenue;
- revenue trends and expectations, including our belief that international revenue could represent a growing percentage of total revenue in the future;
- anticipated successful advocacy of our technology by our channel partners;
- our belief regarding the global deployment of our products;
- our future level of investment in our business, including investment in research, development and engineering of products and technology, development of our intellectual property, sales growth initiatives and development of new market opportunities;
- anticipated expenses, costs, margins, provision for income taxes and investment activities in the foreseeable future;
- our assumptions and expectations related to stock awards;
- our belief that we have one of the world’s most extensive patent portfolios in digital watermarking and related fields;
- anticipated effect of our adoption of accounting pronouncements and the Tax Cuts and Jobs Act;
- our beliefs regarding our critical accounting policies;
- anticipated revenue to be generated from current contracts, renewals, and as a result of new programs;
- our estimates, judgements and assumptions related to impairment testing;
- variability of contracted arrangements;
- business opportunities that could require that we seek additional financing and our ability to do so;
- the size and growth of our markets and our assumptions and beliefs related to those markets;
- the existence of international growth opportunities and our future investment in such opportunities;
- the sources of our future revenue;
- our expected short-term and long-term liquidity positions;
- our capital expenditure and working capital requirements and our ability to fund our capital expenditure and working capital needs through cash flow from operations or financing;
- the effect of computerized trading on our stock price;
- capital market conditions, our expectations regarding credit risk exposure, interest rate volatility and other limitations on the availability of capital, which could have an impact on our cost of capital and our ability to access the capital markets;
- our use of cash, cash equivalents and marketable securities in upcoming quarters;
- the adoption of our technology and success of our products, including Digimarc Discover, Digimarc Barcode and Digimarc Guardian;
- our ability to innovate and enhance our competitive differentiation;

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- our beliefs related to our existing facilities;
- protection, development and monetization of our intellectual property portfolio;
- our beliefs related to our relationship with our employees;
- our beliefs regarding cybersecurity incidents;
- our beliefs related to certain provisions in our bylaws and articles of incorporation;
- our beliefs related to legal proceedings and claims arising in the ordinary course of business; and
- other risks detailed in our filings with the Securities and Exchange Commission, including the risk factors set forth in Item 1A. “Risk Factors.”

We believe that the factors specified above and the risk factors contained in Item 1A, “Risk Factors,” among others, could affect our future performance and the liquidity and value of our securities and cause our actual results to differ materially from those expressed or implied by forward-looking statements made by us or on our behalf. Investors should understand that it is not possible to predict or identify all risk factors and that there may be other factors that may cause our actual results to differ materially from the forward-looking statements. All forward-looking statements made by us or by persons acting on our behalf apply only as of the date of this Annual Report. We do not undertake any obligation to publicly update or revise any forward-looking statements to reflect future events, information or circumstances that arise after the date of the filing of this Annual Report on Form 10-K.

ITEM 8: FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Our Consolidated Financial Statements and the accompanying Notes that are filed as part of this Annual Report are listed under Part III, Item 15, Exhibits and Financial Statement Schedules and are set forth beginning on page F-1 immediately following the signature page of this Form 10-K.

ITEM 9: CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None

ITEM 9A: CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

Our management, under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer, have carried out an 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 the end of the period covered by this Form 10-K. These disclosure controls and procedures are designed to ensure that information required to be disclosed by us in reports that we file or submit under the Securities Exchange Act of 1934 is (i) recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms, and (ii) accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

Based on our evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures, as of the end of the period covered by this Form 10-K, were effective.

Management’s Report on Internal Control Over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934. Our internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with U.S. GAAP.

Because of inherent limitations, any control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Management is committed to continue monitoring our internal controls over financial reporting and will modify or implement additional controls and procedures that may be required to ensure the ongoing integrity of our consolidated financial statements.

With the participation of our Chief Executive Officer and Chief Financial Officer, management conducted an evaluation of the effectiveness of internal control over financial reporting based on the framework established in Internal Control—Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission, (COSO). Based on this evaluation, management has concluded that internal control over financial reporting was effective as of the end of the period covered by this Form 10-K based on those criteria.

Changes in Internal Control Over Financial Reporting

There was no change in our internal control over financial reporting that occurred during the quarter ended December 31, 2018, that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Our independent auditors have issued an audit report on the effectiveness of our internal control over financial reporting as of December 31, 2018, which is included herein.

Report of Independent Registered Public Accounting Firm

To the Shareholders and Board of Directors

Digimarc Corporation:

Opinion on Internal Control Over Financial Reporting

We have audited Digimarc Corporation and subsidiaries' (the "Company") internal control over financial reporting as of December 31, 2018, based on criteria established in Internal Control—Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission. In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2018, based on criteria established in Internal Control – Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) ("PCAOB"), the consolidated balance sheets of the Company as of December 31, 2018 and 2017, the related consolidated statements of operations, shareholders' equity, and cash flows for each of the years in the two-year period ended December 31, 2018, and the related notes (collectively, the consolidated financial statements), and our report dated February 22, 2019 expressed an unqualified opinion on those consolidated financial statements.

Basis for Opinion

The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

Definition and Limitations of Internal Control Over Financial Reporting

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ KPMG LLP

Portland, Oregon

February 22, 2019

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ITEM 9B: OTHER INFORMATION

None

PART III

Certain information required by Part III of this Annual Report on Form 10-K is incorporated herein by reference to the Proxy Statement for our 2019 annual meeting of shareholders, which we intend to file no later than 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K.

ITEM 10: DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

Code of Ethics

We have adopted a Code of Business Conduct that applies to our principal executive officer, principal financial officer and controller, as well as a Code of Ethics for Financial Professionals that applies to our principal financial officer and controller. We have made these codes available in the Corporate Governance section of our website at www.digimarc.com/about/company/corporate-governance. If we waive, or implicitly waive, any material provision of the codes, or substantively amend the codes, we will disclose that fact on our website within four business days.

The other information required by this item is incorporated herein by reference to the information in the Proxy Statement, which we intend to file with the SEC no later than 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K under the captions “Election of Directors,” “Management,” “Report of the Governance and Nominating Committee of the Board of Directors—Audit Committee,” and “Other Matters—Section 16(a) Beneficial Ownership Reporting Compliance.”

ITEM 11: EXECUTIVE COMPENSATION

The information required by this item is incorporated herein by reference to the information in the Proxy Statement, which we intend to file with the SEC no later than 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K, under the captions “Director Compensation” and “Management.”

ITEM 12: SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information required by this item is incorporated herein by reference to the information in the Proxy Statement, which we intend to file with the SEC no later than 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K, under the captions “Security Ownership of Certain Beneficial Owners and Management” and “Equity Compensation Plan Information.”

ITEM 13: CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The information required by this item is incorporated herein by reference to the information in the Proxy Statement, which we intend to file with the SEC no later than 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K under the caption “Election of Directors—Determination of Independence,” and “Related Person Transactions.”

ITEM 14: PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information required by this item is incorporated herein by reference to the information in the Proxy Statement, which we intend to file with the SEC no later than 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K, under the caption “Audit Fees.”

ITEM 15: EXHIBITS AND FINANCIAL STATEMENT SCHEDULES
(a)(1) Financial Statements

The following documents are filed as part of this Annual Report on Form 10-K:

(i) Report of Independent Registered Public Accounting Firm
Consolidated Balance Sheets as of December 31, 2018 and 2017

Consolidated Statements of Operations for the years ended December 31, 2018 and 2017

Consolidated Statements of Shareholders' Equity for the years ended December 31, 2018 and 2017

Consolidated Statements of Cash Flows for the years ended December 31, 2018 and 2017

(ii) Notes to Consolidated Financial Statements
(a)(2) Financial Statement Schedules

All schedules have been omitted since they are not required or are not applicable or the required information is shown in the consolidated financial statements or related notes.

(a)(3) Exhibits

EXHIBIT INDEX

The agreements included or incorporated by reference as exhibits to this report may contain representations and warranties by each of the parties to the applicable agreement. These representations and warranties have been made solely for the benefit of the other party or parties to the applicable agreement and:

- were not intended to be treated as categorical statements of fact, but rather as a means of allocating the risk to one of the parties if those statements prove to be inaccurate;
- were qualified by disclosures that were made to the other party or parties in connection with the negotiation of the applicable agreement, which disclosures are not necessarily reflected in the agreement;
- may apply standards of "materiality" that are different from "materiality" under the securities laws; and
- were made only as of the date of the applicable agreement or other date or dates that may be specified in the agreement.

Accordingly, these representations and warranties may not describe the actual state of affairs as of the date they were made or at any other time. Additional information about Digimarc may be found elsewhere in this Annual Report on Form 10-K and in Digimarc's other public filings, which are available without charge through the SEC's website at http://www.sec.gov.

Exhibit Number	Exhibit Description
2.1	Separation Agreement among DMRC Corporation, DMRC LLC, Digimarc Corporation and, with respect to certain sections, L-1 Identity Solutions, Inc. (incorporated by reference to Exhibit 2.1 to Amendment No. 2 to the Company's Registration Statement on Form 10, filed with the Commission on August 13, 2008 (File No.

001-34108))†

2.2 Agreement and Plan of Merger dated April 30, 2010 between Digimarc Corporation, a Delaware corporation, and Digimarc Oregon Corporation, an Oregon corporation (incorporated by reference to Exhibit 2.1 to the Company's Current Report on Form 8-K, filed with the Commission on May 4, 2010 (File No. 001-34108))

3.1 Articles of Incorporation of Digimarc Corporation (incorporated by reference to Exhibit 3.1 to the Company's Current Report on Form 8-K, filed with the Commission on May 4, 2010 (File No. 001-34108))

3.2 Bylaws of Digimarc Corporation (incorporated by reference to Exhibit 3.2 to the Company's Current Report on Form 8-K, filed with the Commission on May 4, 2010 (File No. 001-34108))

Exhibit Number	Exhibit Description
4.1	Specimen common stock certificate of Digimarc Corporation (incorporated by reference to Exhibit 4.1 to the Company's Quarterly Report on Form 10-Q, filed with the Commission on July 25, 2014 (File No. 001-34108))
10.1	License Agreement between DMRC Corporation and L-1 Identity Solutions Operating Company (incorporated by reference to Exhibit 10.2 to Amendment No. 4 to the Company's Registration Statement on Form 10, filed with the Commission on October 2, 2008 (File No. 001-34108))(1)
10.2	Counterfeit Deterrence System Development and License Agreement, dated as of December 6, 2012, between Digimarc Corporation and the Bank for International Settlements (incorporated by reference to Exhibit 10.2 to the Company's amended Annual Report on Form 10-K/A, filed with the Commission on August 7, 2013 (File No. 001-34108))(5)
*10.3	Digimarc Corporation 2008 Incentive Plan, as amended (incorporated by reference to Exhibit 10.1 to the Company's Quarterly Report on Form 10-Q, filed with the Commission on April 25, 2014 (File No. 001-34108))
*10.4	Equity Compensation Program for Nonemployee Directors under the Digimarc Corporation 2008 Incentive Plan (as amended on February 21, 2011, February 20, 2014 and March 27, 2015) (incorporated by reference to Exhibit 10.1 to the Company's Quarterly Report on Form 10-Q, filed with the Commission on April 28, 2015 (File No. 001-34108))
*10.5	Form of Indemnification Agreement between Digimarc Corporation and each of its executive officers and directors (incorporated by reference to Exhibit 10.1 to Digimarc Corporation's Annual Report on Form 10-K, as filed by Digimarc Corporation with the Securities and Exchange Commission on March 13, 2006 (File No. 000-28317))
*10.6	Form of Change of Control Retention Agreement entered into by and between Digimarc Corporation and each of Messrs. Chamness, Meyer, Beck, Rodriguez and Arana
10.7	Patent License Agreement, dated as of June 11, 2009 between Digimarc Corporation and The Nielsen Company (US), LLC (incorporated by reference to Exhibit 10.1 to the Company's Quarterly Report on Form 10-Q, filed with the Commission on July 31, 2009 (File No. 001-34108))(2)
10.8	Limited Liability Company I Agreement, dated June 11, 2009 between Digimarc Corporation and The Nielsen Company (US), LLC (incorporated by reference to Exhibit 10.2 to the Company's Quarterly Report on Form 10-Q, filed with the Commission on July 31, 2009 (File No. 001-34108))(2)
10.9	Limited Liability Company II Agreement, dated June 11, 2009 between Digimarc Corporation and The Nielsen Company (US), LLC (incorporated by reference to Exhibit 10.3 to the Company's Quarterly Report on Form 10-Q, filed with the Commission on July 31, 2009 (File No. 001-34108))(2)
10.10	Lease Agreement, dated March 22, 2004, between Digimarc Corporation and PS Business Parks, L.P., as amended on May 13, 2010 (incorporated by reference to Exhibit 10.1 to the Company's Quarterly Report on Form 10-Q, filed with the Commission on July 30, 2010 (File No. 001-34108))

10.11	Second Amendment to Lease, dated July 31, 2015, by and between PD Office Owner 9, L.P. and Digimarc Corporation (incorporated by reference to Exhibit 10.1 to the Company’s Quarterly Report on Form 10-Q, filed with the Commission on October 30, 2015 (File No. 001-34108))
10.12	Patent License Agreement, effective as of October 5, 2010, between Digimarc Corporation and IV Digital Multimedia Inventions, LLC (incorporated by reference to Exhibit 10.1 to the Company’s Quarterly Report on Form 10-Q, filed with the Commission on April 28,2016 (File No. 001-34108))(4)
10.13	Grant-Back License Agreement, dated October 5, 2010, between Digimarc Corporation and IV Digital Multimedia Inventions, LLC (incorporated by reference to Exhibit 10.13 to the Company’s Annual Report on Form 10-K, filed with the Commission on March 3, 2011 (File No. 001-34108))(3)
10.14	Patent Rights Agreement, dated October 5, 2010, between Digimarc Corporation and IV Digital Multimedia Inventions, LLC (incorporated by reference to Exhibit 10.14 to the Company’s Annual Report on Form 10-K, filed with the Commission on March 3, 2011 (File No. 001-34108))

Exhibit Number	Exhibit Description
10.15	Work Agreement, dated October 5, 2010, by and among Digimarc Corporation, Invention Law Group, P.C. and IV Digital Multimedia Inventions, LLC (incorporated by reference to Exhibit 10.2 to the Company's Quarterly Report on Form 10-K, filed with the Commission on April 28, 2016 (File No. 001-34108))(4)
*10.16	Employment Agreement, effective as of September 1, 2017, between Digimarc Corporation and Bruce Davis (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K, filed with the Commission on September 6, 2017 (File No. 001-34108))
*10.17	Digimarc Corporation 2018 Incentive Plan (incorporated by reference to Appendix A of the Company's Definitive Proxy Statement on Schedule 14A, filed with the Commission on April 21, 2018 (File No. 001-34108))
*10.18	Equity Compensation Program for Nonemployee Directors under the Digimarc Corporation 2018 Incentive Plan
21.1	List of Subsidiaries
23.1	Consent of Independent Registered Public Accounting Firm
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
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Label Linkbase Document

* Management contract or compensatory plan or arrangement.

Schedules and certain exhibits to this agreement have been omitted pursuant to Item 601(b)(2) of Regulation S-K. Digimarc hereby undertakes to furnish to the Securities and Exchange Commission (the "Commission") copies of the omitted schedules and exhibits upon request by the Commission.

(1)

Confidential treatment has been granted for certain portions omitted from this exhibit pursuant to an order granted by the Commission on October 21, 2008, under Rule 24b-2 of the Securities Exchange Act of 1934, as amended. Confidential portions of this exhibit have been separately filed with the Securities and Exchange Commission.

(2) Confidential treatment has been granted for certain portions omitted from this exhibit pursuant to an order granted by the Commission on September 10, 2009, under Rule 24b-2 under the Securities Exchange Act of 1934, as amended. Confidential portions of this exhibit have been separately filed with the Securities and Exchange Commission.

(3) Confidential treatment has been granted for certain portions omitted from this exhibit pursuant to an order granted by the Commission on March 17, 2011, under Rule 24b-2 under the Securities Exchange Act of 1934, as amended. Confidential portions of this exhibit have been separately filed with the Securities and Exchange Commission.

(4) Confidential treatment has been granted for certain portions omitted from this exhibit pursuant to an order granted by the Commission on May 6, 2016, under Rule 24b-2 under the Securities Exchange Act of 1934, as amended. Confidential portions of this exhibit have been separately filed with the Securities and Exchange Commission.

(5) Confidential treatment has been granted for certain portions omitted from this exhibit pursuant to an order granted by the Commission on September 3, 2013, under Rule 24b-2 under the Securities Exchange Act of 1934, as amended. Confidential portions of this exhibit have been separately filed with the Securities and Exchange Commission.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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: February 22, 2019	By:	/S/ CHARLES BECK Charles Beck
		Title: Chief Financial Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated:

Signature	Title	Date
/S/ BRUCE DAVIS Bruce Davis	Chief Executive Officer and Chairman of the Board of Directors (Principal Executive Officer)	February 22, 2019
/S/ CHARLES BECK Charles Beck	Chief Financial Officer and Treasurer (Principal Financial and Accounting Officer)	February 22, 2019
/S/ GARY DESTEFANO Gary DeStefano	Director	February 22, 2019
/S/ RICHARD L. KING Richard L. King	Director	February 22, 2019
/S/ JAMES T. RICHARDSON James T. Richardson	Director	February 22, 2019
/S/ ANDREW WALTER Andrew Walter	Director	February 22, 2019
/S/ BERNARD WHITNEY Bernard Whitney	Director	February 22, 2019

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

Report of Independent Registered Public Accounting Firm

To the Shareholders and Board of Directors

Digimarc Corporation:

Opinion on the Consolidated Financial Statements

We have audited the accompanying consolidated balance sheets of Digimarc Corporation and subsidiaries (the “Company”) as of December 31, 2018 and 2017, the related consolidated statements of operations, shareholders’ equity, and cash flows for each of the years in the two-year period ended December 31, 2018 and the related notes (collectively, the “consolidated financial statements”). In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2018 and 2017, and the results of its operations and its cash flows for each of the years in the two year period ended December 31, 2018, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (“PCAOB”), the Company’s internal control over financial reporting as of December 31, 2018, based on criteria established in Internal Control – Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission, and our report dated February 22, 2019 expressed an unqualified opinion on the effectiveness of the Company’s internal control over financial reporting.

Change in Accounting Principle

As discussed in Note 1 to the consolidated financial statements, the Company has changed its method of accounting for revenue recognition in 2018 due to the adoption of Accounting Standards Codification 606 Revenue from Contracts with Customers.

Basis for Opinion

These consolidated financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the consolidated financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the consolidated financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. We believe that our audits provide a reasonable basis for our opinion.

/s/ KPMG LLP

We have served as the Company’s auditor since 2010.

Portland, Oregon

February 22, 2019

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DIGIMARC CORPORATION

CONSOLIDATED BALANCE SHEETS

(In thousands, except per share data)

	December 31, 2018	December 31, 2017
ASSETS		
Current assets:		
Cash and cash equivalents	$ 27,278	$ 40,823
Marketable securities	16,378	26,915
Trade accounts receivable, net	3,888	6,404
Other current assets	2,100	2,171
Total current assets	49,644	76,313
Property and equipment, net	3,955	4,236
Intangibles, net	6,649	6,381
Goodwill	1,114	1,114
Other assets	425	326
Total assets	$ 61,787	$ 88,370
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable and other accrued liabilities	$ 1,092	$ 1,914
Deferred revenue	3,226	3,124
Total current liabilities	4,318	5,038
Deferred rent and other long-term liabilities	854	985
Total liabilities	5,172	6,023
Commitments and contingencies (Note 13)		
Shareholders' equity:		
Preferred stock (par value $0.001 per share, 2,500 authorized, 10 shares issued and outstanding at December 31, 2018 and 2017)	50	50
Common stock (par value $0.001 per share, 50,000 authorized, 11,891 and 11,651 shares issued and outstanding at December 31, 2018 and 2017, respectively)	12	12
Additional paid-in capital	162,428	155,793
Accumulated deficit	(105,875)	(73,508)
Total shareholders' equity	56,615	82,347
Total liabilities and shareholders' equity	$ 61,787	$ 88,370

See Notes to Consolidated Financial Statements.

DIGIMARC CORPORATION

CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share data)

	Year Ended December 31, 2018	Year Ended December 31, 2017
Revenue:		
Service	$ 12,774	$ 12,936
Subscription	6,041	5,519
License	2,377	6,758
Total revenue	21,192	25,213
Cost of revenue:		
Service	5,922	5,792
Subscription	1,907	2,264
License	597	502
Total cost of revenue	8,426	8,558
Gross profit	12,766	16,655
Operating expenses:		
Sales and marketing	19,140	16,636
Research, development and engineering	15,971	15,435
General and administrative	9,897	9,680
Intellectual property	1,282	1,469
Total operating expenses	46,290	43,220
Operating loss	(33,524)	(26,565)
Other income, net	1,057	588
Loss before income taxes	(32,467)	(25,977)
Benefit (provision) for income taxes	(39)	206
Net loss	$ (32,506)	$ (25,771)
Earnings (loss) per common share:		
Loss per common share — basic	$ (2.86)	$ (2.44)
Loss per common share — diluted	$ (2.86)	$ (2.44)
Weighted average common shares outstanding — basic	11,360	10,571
Weighted average common shares outstanding — diluted	11,360	10,571

See Notes to Consolidated Financial Statements.

DIGIMARC CORPORATION

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

(In thousands)

	Preferred Stock Shares	Preferred Stock Amount	Common Stock Shares	Common Stock Amount	Additional Paid-in Capital	Accumulated Deficit	Total Shareholders' Equity
BALANCE AT DECEMBER 31, 2016	10	$ 50	10,523	$ 11	$ 120,985	$ (47,712)	$ 73,334
Issuance of common stock, net of issuance costs	—	—	831	1	29,676	—	29,677
Exercise of stock options	—	—	106	—	1,183	—	1,183
Issuance of restricted common stock	—	—	317	—	—	—	—
Forfeiture of restricted common stock	—	—	(26)	—	—	—	—
Purchase and retirement of common stock	—	—	(100)	—	(3,030)	—	(3,030)
Stock-based compensation	—	—	—	—	6,979	(25)	6,954
Net loss	—	—	—	—	—	(25,771)	(25,771)
BALANCE AT DECEMBER 31, 2017	10	$ 50	11,651	$ 12	$ 155,793	$ (73,508)	$ 82,347
BALANCE AT DECEMBER 31, 2017	10	$ 50	11,651	$ 12	$ 155,793	$ (73,508)	$ 82,347
Exercise of stock options	—	—	102	—	1,256	—	1,256
Issuance of restricted common stock	—	—	239	—	—	—	—
Forfeiture of restricted common stock	—	—	(24)	—	—	—	—
Purchase and retirement of common stock	—	—	(77)	—	(2,089)	—	(2,089)
Stock-based compensation	—	—	—	—	7,468	—	7,468
Cumulative effect of the adoption of the new revenue standard, net of tax	—	—	—	—	—	139	139
Net loss	—	—	—	—	—	(32,506)	(32,506)
BALANCE AT DECEMBER 31, 2018	10	$ 50	11,891	$ 12	$ 162,428	$ (105,875)	$ 56,615

See Notes to Consolidated Financial Statements.

DIGIMARC CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

	Year Ended December 31, 2018	Year Ended December 31, 2017
Cash flows from operating activities:		
Net loss	$ (32,506)	$ (25,771)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation, amortization and write-off of property and equipment	1,554	1,430
Amortization and write-off of intangibles	589	996
Stock-based compensation	7,298	6,757
Changes in operating assets and liabilities:		
Trade accounts receivable	2,516	(1,326)
Other current assets	92	(476)
Other assets	(57)	5
Accounts payable and other accrued liabilities	(878)	585
Deferred revenue	182	189
Net cash used in operating activities	(21,210)	(17,611)
Cash flows from investing activities:		
Purchase of property and equipment	(1,292)	(2,188)
Capitalized patent costs	(747)	(819)
Maturity of marketable securities	34,558	60,360
Purchase of marketable securities	(24,021)	(38,387)
Net cash provided by investing activities	8,498	18,966
Cash flows from financing activities:		
Issuance of common stock, net of issuance costs	—	29,677
Exercise of stock options	1,256	1,183
Purchase of common stock	(2,089)	(3,030)
Net cash provided by (used in) financing activities	(833)	27,830
Net increase (decrease) in cash and cash equivalents	(13,545)	29,185
Cash and cash equivalents at beginning of period	40,823	11,638
Cash and cash equivalents at end of period	$ 27,278	$ 40,823
Supplemental disclosure of cash flow information:		
Cash received (paid) for income taxes, net	$ 88	$ (37)
Supplemental schedule of non-cash investing activities:		
Property and equipment and patent costs in accounts payable	$ (79)	$ (153)
Stock-based compensation capitalized to software and patent costs	$ 170	$ 197

See Notes to Consolidated Financial Statements.

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DIGIMARC CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share data)

(1) Description of Business and Summary of Significant Accounting Policies

Description of Business

Digimarc Corporation ("Digimarc" or the "Company"), an Oregon corporation, enables governments, banks, retailers, consumer brands and other businesses around the world to automatically and reliably identify and interact with virtually any form of media. The Company has pioneered the Digimarc Intuitive Computing Platform (ICP), a comprehensive set of technologies for identifying, discovering and interacting with digitally-enhanced media. The platform includes Digimarc Barcode, a proprietary method for imperceptibly enhancing packaging, print, images, thermal labels, audio and other objects with data that are detected by enabled devices, such as smart phones, computers, barcode scanners and machine-vision equipment. Digimarc Discover software enables an ecosystem of connected devices to easily identify content or materials and deliver information.

Principles of Consolidation

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

Use of Estimates

The preparation of the consolidated financial statements in accordance with accounting principles generally accepted in the U.S. ("U.S. GAAP") requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses, and related disclosure of contingent assets and liabilities. The Company's accounting policies for revenue recognition require higher degrees of judgment than others in their application. Management bases its estimates on historical experience and on other assumptions that are believed to be reasonable in 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.

Reclassifications

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

Cash Equivalents

The Company considers all highly liquid marketable securities with original maturities of 90 days or less at the date of acquisition to be cash equivalents. Cash equivalents include commercial paper and money market funds totaling $25,543 and $39,761 at December 31, 2018 and 2017, respectively. Cash equivalents are carried at either cost or amortized cost depending on the type of security, which approximates fair value.

Marketable Securities

The Company considers all investments with original maturities over 90 days that mature in less than one-year from the balance sheet date to be short-term marketable securities. Short-term marketable securities primarily include commercial paper and corporate notes. The Company’s marketable securities are classified as held-to-maturity and are reported at amortized cost, which approximates market value.

A decline in the market value of any security below amortized cost that is deemed to be other-than-temporary results in a reduction in the carrying amount. The impairment is charged to earnings and a new cost basis for the security is established. To determine whether an impairment is other-than-temporary, the Company considers

DIGIMARC CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(In thousands, except per share data)

whether it has the ability and intent to hold the investment until a market price recovery and considers whether evidence indicating that the cost of the investment is recoverable outweighs evidence to the contrary. There have been no other-than-temporary impairments identified or recorded by the Company.

Premiums and discounts are amortized or accreted over the life of the related security as an adjustment to yield using a method that approximates the effective interest method. Under this method, dividend and interest income are recognized when earned.

Fair Value of Financial Instruments

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

- Level 1—Pricing inputs are quoted prices available in active markets for identical investments as of the reporting date.
- Level 2—Pricing inputs are quoted for similar investments, or inputs that are observable, either directly or indirectly, for substantially the full term through corroboration with observable market data. Level 2 includes investments valued at quoted prices adjusted for legal or contractual restrictions specific to these investments.
- Level 3—Pricing inputs are unobservable for the investment; that is, the inputs reflect the reporting entity's own assumptions about the assumptions market participants would use in pricing the asset or liability.

The estimated fair values of the Company's financial instruments, which include cash equivalents, accounts receivable, accounts payable and other accrued liabilities, approximate their carrying values due to the short-term nature of these instruments.

The Company's fair value hierarchy for its cash equivalents and marketable securities as of December 31, 2018 and 2017, respectively, was as follows:

December 31, 2018	Level 1	Level 2	Level 3	Total
Money market securities	$1,472	$—	$ —	$1,472
Commercial paper	—	28,343	—	28,343
Corporate notes	—	12,106	—	12,106
Total	$1,472	$40,449	$ —	$41,921

December 31, 2017	Level 1	Level 2	Level 3	Total
Money market securities	$2,197	$—	$ —	$2,197
Commercial paper	—	49,834	—	49,834

Federal agency notes	—	10,715	—	10,715
U.S. treasuries	—	1,996	—	1,996
Corporate notes	—	1,934	—	1,934
Total	$2,197	$64,479	$ —	$66,676

The fair value maturities of the Company's cash equivalents and marketable securities as of December 31, 2018 are as follows:

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DIGIMARC CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(In thousands, except per share data)

	Maturities by Period				
	Total	Less than 1 year	1-5 years	5 - 10 years	More than 10 years
Cash equivalents and marketable securities	$41,921	$ 41,921	$ —	$ —	$ —

Concentrations of Business and Credit Risk

A significant portion of the Company's business depends on a limited number of large contracts. The loss of any large contract may result in loss of revenue and margin on a prospective basis. Financial instruments that potentially subject Digimarc to concentrations of credit risk consist primarily of cash and cash equivalents, marketable securities, and accounts receivable. Digimarc places its cash and cash equivalents with major banks and financial institutions and at times deposits may exceed insured limits. Other than cash used for operating needs, which may include short-term marketable securities with the Company's principal banks, Digimarc's investment policy limits its credit exposure to any one financial institution or type of financial instrument by limiting the maximum of 5% of its cash equivalents and marketable securities or $1,000, whichever is greater, to be invested in any one issuer except for the U.S. government, U.S. federal agencies and U.S. backed securities, which have no limits, at the time of purchase. The Company's investment policy also limits its credit exposure by limiting the maximum of 40% of its cash equivalents and marketable securities, or $15,000, whichever is greater, to be invested in any one industry category, (e.g., financial or energy industries), at the time of purchase. As a result, Digimarc's credit risk associated with cash and cash equivalents and marketable securities is believed to be minimal.

Contingencies

The Company evaluates all pending or threatened contingencies or commitments, if any, that are reasonably likely to have a material adverse effect on the Company's operations or financial position. The Company assesses the probability of an adverse outcome and determines if it is remote, reasonably possible or probable as defined in accordance with the provisions of ASC 450 "Contingencies." If information available prior to the issuance of the financial statements indicates that it is probable that an asset has been impaired or a liability has been incurred at the date of the financial statements, and the amount of the loss, or the range of probable loss can be reasonably estimated, then the 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 ASC 450 are not met, but the probability of an adverse outcome is at least reasonably possible, the Company 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.

Equity Method Investments

The Company accounts for its joint ventures under the equity method of accounting pursuant to ASC 323 "Investments—Equity Method and Joint Ventures." Under the equity method, investments are carried at cost, plus or minus the Company's proportionate share, based on present ownership interests, of: (a) the investee's profit or loss after the date of acquisition; (b) changes in the Company's equity that have not been recognized in the investee's profit or loss; and (c) certain other adjustments. Distributions received from the investee (such as dividends) reduce the carrying amount of the investment.

Goodwill

The Company accounts for business combinations under the acquisition method of accounting in accordance with ASC 805, "Business Combinations," where the total purchase price is allocated to the tangible and identified intangible assets acquired and liabilities assumed based on their estimated fair values. The purchase price is allocated using the information currently available, and may be adjusted, up to one-year from the acquisition date, after obtaining more information regarding, among other things, asset valuations, liabilities assumed and revisions to preliminary estimates.

DIGIMARC CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(In thousands, except per share data)

Contingent consideration, if any, is recorded at the acquisition date based upon the estimated fair value of the contingent payments. The fair value of the contingent consideration is re-measured each reporting period with any adjustments in fair value being recognized in earnings from operations.

The purchase price in excess of the fair value of the tangible and identified intangible assets acquired less liabilities assumed is recognized as goodwill.

The Company tests goodwill for impairment annually in June and whenever events or changes in circumstances indicate that the carrying value may exceed the fair value. The Company operates as a single reporting unit. The Company estimates the fair value of its single reporting unit using a market approach, which takes into account the Company's market capitalization plus an estimated control premium. In connection with the Company's annual impairment test of goodwill as of June 30, 2018 and 2017, it was concluded that there was no impairment to goodwill as the estimated fair value of the Company's reporting unit exceeded the carrying value.

Impairment of Long-Lived Assets

The Company assesses 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 ASC 360 "Property, Plant and Equipment."

Recoverability of assets to be held and used is measured by a comparison of the carrying amount of the assets to future net undiscounted cash flows expected to be generated by the assets over their remaining useful life. If such assets are considered to be impaired, the impairment would be recognized in operating results at 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 assets.

Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell.

Research and Development

Research and development costs are expensed as incurred in accordance with ASC 730 "Research and Development."

Software Development Costs

Under ASC 985 "Software," 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.

Patent Costs

Costs associated with the application and award of patents in the U.S. and various other countries are capitalized and amortized on a straight-line basis over the term of the patents as determined at award date, which varies depending on the pendency period of the application, generally approximating seventeen years. Capitalized patent costs, also referred to as patent prosecution costs, include internal legal labor, professional legal fees, government filing fees and translation fees related to expanding the Company’s patent portfolio.

Costs associated with the maintenance and annuity fees of patents are accounted for as prepaid assets at the time of payment and amortized over the shorter of the maintenance period or remaining life of the related patent.

DIGIMARC CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(In thousands, except per share data)

Revenue Recognition

See Note 2 for detailed disclosures of the Company's revenue recognition policy.

Stock-Based Compensation

The Company accounts for stock-based compensation in accordance with ASC 718 "Compensation—Stock Compensation," which requires the measurement and recognition of compensation for all stock-based awards made to employees and directors including stock options and restricted stock based on estimated fair values.

For stock option awards, the Company uses the Black-Scholes option pricing model as its method of valuation. The Company's determination of the fair value on the date of grant (measurement date) is affected by its stock price as well as assumptions regarding a number of subjective variables. These variables include, but are not limited to, the expected life of the award, the Company's expected stock price volatility over the term of the award, the risk-free interest rate and the expected dividend yield. Although the fair value of stock-based awards is determined in accordance with ASC 718 and Staff Accounting Bulletin ("SAB") No. 107 "Shared-Based Payment," the Black-Scholes option pricing model requires the input of subjective assumptions, and other reasonable assumptions could provide differing results.

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

Income Taxes

The Company accounts for income taxes in accordance with ASC 740 "Income Taxes" utilizing the asset and liability method. Under the asset and liability method, deferred income taxes reflect the future tax consequences of differences between the tax basis of assets and liabilities and their financial reporting amounts. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period of enactment.

The Company records valuation allowances on deferred tax assets if, based on available evidence, it is more-likely-than-not that all or some portion of the assets will not be realized.

The Company is subject to income taxes within the U.S. and other countries, and, in the ordinary course of business, there are transactions and calculations where the ultimate tax determination is uncertain. The Company reports a liability (or contra asset) for unrecognized tax benefits resulting from uncertain tax positions taken (or expected to be taken) on a tax return. The Company recognizes interest and penalties, if any, related to the unrecognized tax benefits in income tax expense.

DIGIMARC CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(In thousands, except per share data)

Accounting Pronouncements Adopted

In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2014-09, “Revenue from Contracts with Customers (Topic 606).” ASU No. 2014-09 provides specific guidance to recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The ASU replaces most existing revenue recognition guidance in U.S. GAAP. In August 2015, the FASB issued ASU No. 2015-14 to defer the effective date of the new revenue standard for public entities by one-year to annual reporting periods beginning after December 31, 2017, and interim periods beginning in the first interim period within the year of adoption. The guidance permits the use of either the retrospective or cumulative effect transition method. The Company adopted the new standard on January 1, 2018 and elected to use the cumulative effect transition method. Upon adoption, the Company recorded a $139 increase to opening retained earnings to reflect the impact of adopting the new standard using the cumulative effect transition method. The adoption of the standard did not have a material impact on the Company’s financial condition, results of operations and cash flows.

In August 2016, the FASB issued ASU No. 2016-15, “Statement of Cash Flows – Classification of Certain Cash Receipts and Cash Payments (Topic 230).” ASU No. 2016-15 adds or clarifies guidance on specific cash flow issues to reduce diversity in practice in how certain transactions are classified in the statement of cash flows. The amendments in this update are effective for fiscal years beginning after December 31, 2017, and interim periods beginning in the first interim period within the year of adoption. Any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. The amendments in this update are to be applied retrospectively to all periods presented but may be applied prospectively from the earliest date practicable if retrospective application would be impracticable. The adoption of this standard did not to have a material impact on the Company’s cash flows and disclosures.

Accounting Pronouncements Issued But Not Yet Adopted

In February 2016, the FASB issued ASU No. 2016-02, “Leases (Topic 842),” which supersedes Topic 840, Leases. ASU No. 2016-02 increases the transparency and comparability of organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. This guidance requires that operating leases recognize a right-of-use asset and a lease liability measured at the present value of the lease payments in the statement of financial position, recognize a single lease cost allocated over the lease term on a straight-line basis, and classify all cash payments within operating activities in the statement of cash flows. The amendments in this update are effective for fiscal years beginning after December 31, 2018, and interim periods beginning in the first interim period within the year of adoption. Early adoption is permitted. In July 2018, the FASB issued ASU No. 2018-11, “Leases (Topic 842) Targeted Improvements,” to provide a transition election to not restate comparative periods for the effects of applying the new standard. This transition election permits entities to change the date of initial application to the beginning of the year of adoption and to recognize the effects of applying the new standard as a cumulative-effect adjustment to the opening balance of retained earnings. The Company has chosen to elect this transition approach and recognize the cumulative impact of adoption in the opening balance of retained earnings as of January 1, 2019. The adoption of this standard will require the Company to record its minimum commitments under non-cancelable operating leases on its consolidated balance sheets, resulting in the recording of right of use assets and lease obligations. The Company estimates that the right of use assets will be recorded at approximately $2.7 million and the lease liabilities will be recorded at approximately $3.8 million on January 1, 2019.

DIGIMARC CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(In thousands, except per share data)

(2) Revenue Recognition

The Company adopted ASC 606 “Revenue from Contracts with Customers” using the cumulative effect method with an effective date of January 1, 2018. Therefore, the comparative period information prior to January 1, 2018 has not been adjusted and continues to be reported under ASC 605 “Revenue Recognition” and ASC 985 “Software.”

ASC 606

Effective January 1, 2018, revenue is recognized in accordance with ASC 606 by applying the following steps:

Step 1: Identify the contract(s) with a customer.

Step 2: Identify the performance obligations in the contract.

Step 3: Determine the transaction price.

Step 4: Allocate the transaction price to the performance obligations in the contract.

Step 5: Recognize when (or as) the entity satisfies a performance obligation.

The Company derives its revenue primarily from professional services, subscriptions and licensing of its intellectual property. Applicable revenue recognition criteria are considered separately for each performance obligation as follows:

- Service revenue consists primarily of software development and consulting services. The majority of service revenue arrangements are structured as time and materials consulting agreements. Revenue for development and consulting services is recognized as the services are performed. Billing for services rendered generally occurs within one month after the services are provided.
- Subscription revenue includes revenue derived from the sale of Digimarc Discover, Digimarc Barcode and Digimarc Guardian products and services, is generally recurring, paid in advance and recognized over the term of the subscription, which is generally one to three years.
- License revenue originates primarily from licensing the Company’s intellectual property where the Company receives license fees and/or royalties as its income stream. License fees are typically paid in advance and recognized when the customer has the right to the intellectual property and the license period has begun, and royalties are typically billed in arrears and recognized in the quarter in which the royalty was earned.

Some customer arrangements contain multiple performance obligations such as professional services, software licenses, and maintenance and support fees. The Company accounts for individual products and services separately if they are distinct. To determine the transaction price, the Company considers the terms of the contract and the Company’s customary business practices. Some contracts may contain variable consideration. In those cases, the Company estimates the amount of variable consideration based on the sum of probability-weighted amounts in a range of possible consideration amounts. As part of this assessment, the Company will evaluate whether any of the variable consideration is constrained and if it is the Company will not include it in the transaction price. The consideration is allocated between distinct products and services based on their stand-alone selling prices. For items that are not sold separately, the Company estimates the standalone selling price based on reasonably available information, including market conditions, specific factors affecting the Company, and information about the customer. For distinct products and services, the Company typically recognizes the revenue associated with these performance obligations as they are delivered to the customer. For performance obligations which are not considered distinct, the Company typically recognizes revenue over the term of the contract as the customer simultaneously receives and consumes the goods and services as the Company performs them.

DIGIMARC CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(In thousands, except per share data)

ASC 605 and ASC 985

For the comparative period prior to January 1, 2018, revenue was recognized under ASC 605 and ASC 985 when the following four criteria were met:

(i) persuasive evidence of an arrangement exists,
(ii) delivery has occurred,
(iii) the fee is fixed or determinable, and
(iv) collection is reasonably assured or probable.

All revenue recognized in the Consolidated Statements of Operations is considered to be revenue from contracts with customers.

The following table provides information about disaggregated revenue by major product line in the Company's single reporting segment:

	Year Ended December 31, 2018	Year Ended December 31, 2017
Service	$ 12,774	$ 12,936
Subscription		
Digimarc Guardian	3,660	4,165
Digimarc Discover and Digimarc Barcode	2,381	1,354
License	2,377	6,758
Total	$ 21,192	$ 25,213

The Company has contract assets from contracts with customers that are classified as "trade accounts receivable." Financial information about trade accounts receivable is included in Note 6.

The Company has contract liabilities from contracts with customers that are classified as "deferred revenue." Deferred revenue consists of billings in advance for professional services, subscriptions and licenses for which the performance obligation has not been satisfied.

The following table provides information about contract liabilities from contracts with customers:

	December 31, 2018	December 31, 2017
Deferred revenue, current	$ 3,226	$ 3,124
Deferred revenue, long term	46	42
Total	$ 3,272	$ 3,166

As of December 31, 2018, the aggregate amount of the transaction price from contractual obligations that are unsatisfied or partially unsatisfied was $17,496. The Company expects $15,976 of this amount to be recognized as revenue during 2019.

(3) Segment Information

Geographic Information

The Company derives its revenue from a single reporting segment: media management solutions. Revenue is generated in this segment through development services, subscriptions and licensing of intellectual property. The Company markets its products in the U.S. and in non-U.S. countries through its sales and licensing personnel and channel partners.

DIGIMARC CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(In thousands, except per share data)

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

	Year Ended December 31, 2018	Year Ended December 31, 2017
Domestic	$ 5,573	$ 5,116
International (1)	15,619	20,097
Total	$ 21,192	$ 25,213

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

Major Customers

The following customers accounted for 10% or more of revenue:

	Year Ended December 31, 2018	Year Ended December 31, 2017
Central Banks	65 %	55 %

In addition to the above, the Company had another customer who accounted for 10% or more of the Company's revenue during 2017. The increase in revenue associated with this customer was primarily due to a one-time $3,500 upfront license fee realized in the third quarter of 2017.

Long-lived assets by geographical area

The Company's long-lived assets are all domestic, domiciled in the U.S.

(4) Stock-Based Compensation

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

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

Determining Fair Value

Stock Options

Valuation and Amortization Method. The Company estimates the fair value of stock options on the date of grant (measurement date) 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 and vesting schedules of the awards. Stock options granted generally vest over three years and have contractual terms of ten years.

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

DIGIMARC CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(In thousands, except per share data)

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

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

Stock Option Valuation Assumptions:

	Year Ended December 31, 2018		Year Ended December 31, 2017	
Expected life (years)	4.50		4.50	
Expected volatility	57.11	%	57.24	%
Risk-free interest rate	2.77	%	1.77	%
Expected dividend yield	0	%	0	%

Restricted Stock

The fair value of restricted stock awarded is based on the fair market value of the Company's common stock on the date of the grant (measurement date), and is recognized over the vesting period of the award using the straight-line method. Restricted stock awards granted generally vest over three to four years for employee grants and one to three years for director grants.

Stock-based Compensation

	Year Ended December 31, 2018	Year Ended December 31, 2017
Stock-based compensation:		
Cost of revenue	$ 613	$ 663
Sales and marketing	1,649	1,440
Research, development and engineering	1,361	1,359
General and administrative	3,386	2,974
Intellectual property	289	321
Stock-based compensation expense	7,298	6,757
Capitalized to software and patent costs	170	197
Total stock-based compensation	$ 7,468	$ 6,954

The following table sets forth total unrecognized compensation cost related to non-vested stock-based awards granted under all equity compensation plans:

	Year Ended December 31, 2018	Year Ended December 31, 2017
Total unrecognized compensation costs	$ 14,055	$ 13,669

Total unrecognized compensation costs will be adjusted for any future forfeitures if and when they occur.

The Company expects to recognize the total unrecognized compensation costs as of December 31, 2018 for stock options and restricted stock over weighted average periods through December 31, 2022 as follows:

DIGIMARC CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(In thousands, except per share data)

	Stock Options	Restricted Stock
Weighted average period	1.22 years	1.36 years

(5) Earnings Per Common Share

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

Basic earnings per common share excludes dilution and is calculated by dividing earnings to common shares by the weighted-average number of common shares outstanding for the period. Diluted earnings per common share is calculated by dividing earnings to common shares by the weighted-average number of common shares, as adjusted for the potentially dilutive effect of stock options.

The following table reconciles earnings (loss) per common share for the years ended December 31, 2018 and 2017:

	Year Ended December 31, 2018	Year Ended December 31, 2017
Basic Earnings (Loss) per Common Share:		
Numerator:		
Net loss	$ (32,506)	$ (25,771)
Distributed earnings to common shares	—	—
Distributed earnings to participating securities	—	—
Total distributed earnings	—	—
Undistributed loss allocable to common shares	(32,506)	(25,771)
Undistributed earnings allocable to participating securities	—	—
Total undistributed loss	(32,506)	(25,771)
Loss to common shares — basic	$ (32,506)	$ (25,771)
Denominator		
Weighted average common shares outstanding — basic	11,360	10,571
Basic earnings (loss) per common share	$ (2.86)	$ (2.44)

	Year Ended December 31,	Year Ended December 31,

	2018	2017
Diluted Earnings (Loss) per Common Share:		
Numerator:		
Loss to common shares — basic	$ (32,506)	$ (25,771)
Undistributed earnings allocated to participating securities	—	—
Undistributed earnings reallocated to participating securities	—	—
Loss to common shares — diluted	$ (32,506)	$ (25,771)
Denominator		
Weighted average common shares outstanding — basic	11,360	10,571
Dilutive effect of stock options	—	—
Weighted average common shares outstanding — diluted	11,360	10,571
Diluted earnings (loss) per common share	$ (2.86)	$ (2.44)

DIGIMARC CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(In thousands, except per share data)

There were 475 and 0 common stock equivalents related to stock options that were anti-dilutive and excluded from diluted earnings per common share for the years ended December 31, 2018 and 2017 respectively, because their exercise prices were higher than the average market price of the underlying common stock for the period.

There were 0 and 102 common stock equivalents related to stock options that were anti-dilutive and excluded from diluted earnings per common share for the years ended December 31, 2018 and 2017, respectively, because the Company incurred a net loss for the period.

(6) Trade Accounts Receivable and Allowance for Doubtful Accounts

Trade Accounts Receivable

Trade accounts receivable are recorded at the invoiced amount.

	December 31, 2018	December 31, 2017
Trade accounts receivable	$ 3,903	$ 6,419
Allowance for doubtful accounts	(15)	(15)
Trade accounts receivable, net	$ 3,888	$ 6,404
Unpaid deferred revenue included in trade accounts receivable	$ 2,030	$ 2,217

Allowance for doubtful accounts

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

Unpaid deferred revenue

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

Major customers

The following customers accounted for 10% or more of trade accounts receivable, net:

	December 31, 2018	December 31, 2017
Central Banks	48 %	47 %

In addition to the above, the Company had another customer who accounted for 10% or more of the Company's accounts receivable at December 31, 2017. In the third quarter of 2017, the Company recognized revenue of $3,500 for a one-time upfront license fee. The license fee was paid in two equal installments of $1,750 in October 2017 and January 2018. As of December 31, 2017, $1,750 remained in accounts receivable.

DIGIMARC CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(In thousands, except per share data)

(7) Property and Equipment

Property and Equipment

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

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

	December 31, 2018	December 31, 2017
Office furniture and fixtures	$ 1,626	$ 1,551
Software	3,686	3,068
Equipment	4,814	4,390
Leasehold improvements	1,721	1,720
Gross property and equipment	11,847	10,729
Less accumulated depreciation and amortization	(7,892)	(6,493)
Property and equipment, net	$ 3,955	$ 4,236

Leases

Future minimum lease payments under non-cancelable operating leases are as follows:

Year ending December 31:	Operating Leases
2019	$ 1,055
2020	899
2021	838
2022	862
2023	867
Thereafter	218
Total minimum lease payments	$ 4,739

Rent expense on the operating leases was as follows:

	Year Ended December 31, 2018	Year Ended December 31, 2017
Rent expense	$ 1,104	$ 1,194

(8) Intangibles

Intangible assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. No impairment charges were recorded for the years ended December 31, 2018 and 2017.

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

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DIGIMARC CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(In thousands, except per share data)

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

	Estimated Life (years)	December 31, 2018	December 31, 2017
Capitalized patent costs	17-20	$ 8,757	$ 7,978
Intangible assets acquired:			
Purchased patents and intellectual property	3-10	250	250
Existing technology	5	1,560	1,560
Customer relationships	7	290	290
Backlog	2	760	760
Tradenames	3	290	290
Non-solicitation agreements	1	120	120
Gross intangible assets		12,027	11,248
Accumulated amortization		(5,378)	(4,867)
Intangibles, net		$ 6,649	$ 6,381

Amortization expense on intangible assets was as follows:

	Year Ended December 31, 2018	Year Ended December 31, 2017
Amortization expense	$ 516	$ 741

For intangible assets recorded at December 31, 2018, the estimated future aggregate amortization expense for the years ending December 31, 2019 through December 31, 2023 is approximately as follows:

Year ending December 31:	Amortization Expense
2019	$ 502
2020	443
2021	380
2022	364
2023	352

(9) Shareholders’ Equity

Preferred Stock

In June 2008, the Board of Directors authorized 2,500 shares of preferred stock, par value $0.001 per share. The Board of Directors has the authority to issue the undesignated preferred stock in one or more series and to determine the powers, preferences and rights and the qualifications, limitations or restrictions granted to or imposed upon any wholly unissued series of undesignated preferred stock and to fix the number of shares constituting any series and the designation of such series, without any further vote or action by the shareholders. The issuance of preferred stock may have the effect of delaying, deferring or preventing a change of control of the Company without further action by shareholders and may adversely affect the voting and other rights of the holders of common stock.

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

DIGIMARC CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(In thousands, except per share data)

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

Common Stock

In June 2008, the Board of Directors authorized 50,000 shares of common stock, par value $0.001 per share. The holders of Digimarc common stock are entitled to one vote for each share held of record on all matters submitted to a vote of its shareholders, including the election of directors. Subject to preferences that may be granted to any then outstanding preferred stock, holders of common stock are entitled to receive ratably those dividends as may be declared by the Board of Directors out of funds legally available for such purpose, as well as any distributions to the Company's shareholders. In the event of the Company's liquidation, dissolution or winding up, holders of common stock are entitled to share ratably in all of the Company's assets remaining after payment of liabilities and the liquidation preference of any then outstanding preferred stock. Holders of common stock have no preemptive or other subscription or conversion rights. There are no redemption or sinking fund provisions applicable to the common stock. All outstanding shares of common stock are fully paid and non-assessable.

In June 2017, the Company sold 500 shares of its common stock in a registered direct offering to a certain investor at a price of $35.55 per share. The offering was made without an underwriter or placement agent. The Company received $17,775 of cash proceeds from the offering, and paid $77 in stock issuance costs.

In November 2017, the Company sold 331 shares of its common stock in a registered direct offering to a certain investor at a price of $36.25 per share. The offering was made without an underwriter or placement agent. The Company received $12,000 of cash proceeds from the offering, and paid $21 in stock issuance costs.

Stock Incentive Plan

In March 2018, the Company's Board of Directors approved the 2018 Incentive Plan (2018 Plan) which was later approved by the Company's shareholders at the Company's 2018 Annual Meeting of Shareholders in April 2018. The 2018 Plan replaced the 2008 Incentive Plan (2008 Plan). The 2018 Plan provides for the grant of incentive and non-qualified stock options, stock appreciation rights, stock awards, restricted stock awards, restricted stock units, performance shares, performance units, and other stock or cash-based awards, which may be granted to officers, directors, employees, consultants, agents, advisors and independent contractors who provide services to the Company and its affiliated companies.

The 2018 Plan authorizes the issuance of 1,000 shares of common stock. In addition, up to 770 shares of common stock subject to awards outstanding under the 2008 Plan became available for issuance under 2018 Plan to the extent that those shares cease to be subject to the awards (as a result of, for example, expiration, cancellation or forfeiture of the award). The shares authorized under the 2018 Plan are subject to adjustment in the event of a stock split, stock dividend, recapitalization or similar event. Shares issued under the 2018 Plan will consist of authorized and unissued shares or shares held by the Company as treasury shares. If an award granted under the 2018 Plan lapses, expires, terminates or is forfeited or surrendered without having been fully exercised or without the issuance of all the shares subject to the award, the shares covered by that award will again be available for issuance under the 2018 Plan. Shares that are (i) tendered by a participant or retained by the Company as payment for the purchase price of an award or to satisfy tax withholding obligations or (ii) covered by an award that is settled in cash, or in some manner that some or all of the shares covered by the award are not issued, will again be available for issuance under the 2018 Plan. In addition, awards granted as substitute awards in connection with acquisition transactions will not reduce the number of shares authorized for issuance under the 2018 Plan.

As of December 31, 2018, under all of the Company’s stock-based compensation plans, equity awards to purchase an additional 1,628 shares were authorized for future grants under the 2018 Plan.

Stock Options

The Company issues new shares upon option exercises.

DIGIMARC CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(In thousands, except per share data)

Options granted, exercised and forfeited under the stock incentive plan are summarized as follows:

	Options	Weighted Average Exercise Price	Weighted Average Grant Date Fair Value	Aggregate Intrinsic Value
Options outstanding, December 31, 2016	421	$ 19.06	$ 9.01	
Granted	200	$ 30.50	$ 14.58	
Exercised	(106)	$ 11.17	$ 6.75	
Forfeited or expired	—	—	—	
Options outstanding, December 31, 2017	515	$ 25.13	$ 11.64	
Granted	100	$ 29.55	$ 14.46	
Exercised	(102)	$ 12.38	$ 7.02	
Forfeited or expired	—	—	—	
Options outstanding, December 31, 2018	513	$ 28.52	$ 13.10	$ 46
Options exercisable, December 31, 2018	305	$ 27.46		$ 46
Options unvested, December 31, 2018	208	$ 30.08		$ -

The aggregate intrinsic value is based on the closing price of $14.50 per share of Digimarc common stock on December 31, 2018, which would have been received by the optionees had all of the options with exercise prices less than $14.50 per share been exercised on that date.

The following table summarizes information about stock options outstanding at December 31, 2018:

	Options Outstanding			Options Exercisable		
Exercise Price	Number Outstanding	Remaining Contractual Life (Years)	Weighted Average Exercise Price	Number Outstanding	Remaining Contractual Life (Years)	Weighted Average Exercise Price
$9.91	10	0.33	$ 9.91	10	0.33	$ 9.91
$14.99 - $18.01	28	1.18	$ 16.61	28	1.18	$ 16.61
$27.61 - $29.55	200	6.26	$ 28.58	108	3.37	$ 27.76
$30.01 - $30.50	275	6.86	$ 30.37	159	5.52	$ 30.27
$9.91 - $30.50	513	6.19	$ 28.52	305	4.19	$ 27.46

Restricted Stock

The Compensation Committee of the Board of Directors has awarded shares of restricted stock under the Company's 2018 Plan to employees and directors. The shares subject to the restricted stock awards vest over a certain period, usually four years, following the date of the grant. Specific terms of the restricted stock awards are governed by Restricted Stock Agreements between the Company and the award recipients.

DIGIMARC CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(In thousands, except per share data)

The following table reconciles the unvested balance of restricted stock:

	Number of Shares	Weighted Average Grant Date Fair Value
Unvested balance, December 31, 2016	385	$ 26.28
Granted	317	$ 27.56
Vested	(250)	$ 24.05
Forfeited	(26)	$ 27.79
Unvested balance, December 31, 2017	426	$ 28.44
Granted	239	$ 29.73
Vested	(215)	$ 28.96
Forfeited	(24)	$ 29.29
Unvested balance, December 31, 2018	426	$ 28.85

The following table indicates the fair value of all restricted stock awards that vested during the years ended December 31, 2018 and 2017, respectively:

	Year Ended December 31, 2018	Year Ended December 31, 2017
Fair value of restricted stock awards vested	$ 5,835	$ 7,683

(10) Defined Contribution Plan

The Company sponsors an employee retirement savings plan (the “Plan”) which qualifies as a deferred salary arrangement under Section 401(k) of the Internal Revenue Code. The Plan combines both an employee savings plan and company matching plan into one plan under Section 401(k), including a 401(k) Roth option. Employees become eligible to participate in the Plan at the beginning of the month following the employee’s hire date. Employees may contribute up to 75% of their pay to the Plan, subject to the limitations of the Internal Revenue Service Code. Company matching contributions are mandatory under the Plan.

The Company made matching contributions in the aggregate amount as follows:

	Year Ended December 31, 2018	Year Ended December 31, 2017
Matching contributions	$ 1,026	$ 938

(11) Joint Venture and Related Party Transactions

In June 2009, the Company entered into two joint venture agreements with The Nielsen Company (“Nielsen”) to launch two new companies: TVaura LLC (in which Digimarc holds a 51% ownership interest) and TVaura Mobile LLC (in which Digimarc holds a 49% ownership interest). The two joint venture agreements and a revised patent license agreement expanded and replaced the previous license and services agreement between the Company and Nielsen that had been in operation since late 2007. Under the joint venture agreements, the Company and Nielsen agreed to work together to develop new products and services, including the expansion and deployment of those products and services that were in development under the prior agreement.

Under the terms of the revised patent license agreement, Nielsen agreed to pay Digimarc $18,750 during the period from July 2009 through January 2014, and Digimarc granted to Nielsen a non-exclusive license to Digimarc’s

DIGIMARC CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(In thousands, except per share data)

patents for use within Nielsen's business. The term of the license continues until the expiration of the last patent under the license.

In March 2012, Digimarc and Nielsen reduced the investments in their two joint ventures to minimal levels while assessing alternative approaches to achieving each of their goals in the emerging market opportunity of synchronized second screen television.

In October 2015, Digimarc and Nielsen reactivated the TVaura Mobile LLC joint venture to develop solutions for programmers and advertisers to engage with consumers on second screens and otherwise provide enhanced flexibility to brand strategies targeting modern consumers. Neither Digimarc nor Nielsen has contributed any capital to the joint venture since reactivation. Digimarc and Nielsen continue to assess the market opportunities of the TVaura LLC joint venture.

The Company's investment in each joint venture was $0 as of December 31, 2018 and 2017.

Pursuant to the terms of the agreements and ASC 810 "Consolidation," the joint ventures are not consolidated with the Company because the minority member of each joint venture has substantive participating rights, or veto rights, such that no member has majority control.

Related Party Transactions

Summarized financial information for TVaura LLC has not been provided as the disclosures are immaterial to the Company's filing given the operations of the joint venture were suspended during the last two fiscal years. The joint venture had no revenue or expenses for the years ended December 31, 2018 and 2017, and there were no assets or liabilities as of December 31, 2018 and 2017.

Summarized financial data for TVaura Mobile LLC:

	December 31, 2018	December 31, 2017
Current assets	$ 31	$ 35
Noncurrent assets	$ —	$ —
Current liabilities	$ 12	$ 12
Noncurrent liabilities	$ —	$ —

	Year Ended December 31, 2018	Year Ended December 31, 2017

Revenue	$	—	$	—
Gross profit	$	—	$	—
Operating expenses	$	5	$	5
Net loss from continuing operations	$	(5)	$	(5)
The Company's pro-rata share—net loss	$	—	$	—
The Company's loss on investment	$	—	$	—

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(In thousands, except per share data)

(12) Income Taxes

The benefit (provision) for income taxes reflects current taxes, deferred taxes, and withholding taxes. The effective tax rates for the years ended December 31, 2018 and 2017 were 0% and 1%, respectively. The Company continues to provide for a full valuation allowance to offset its net deferred tax assets until such time it is more likely than not the tax assets or portions thereof will be realized.

The U.S. enacted tax reform legislation on December 22, 2017 commonly known as the Tax Cuts and Jobs Act, (“the Act”), resulting in significant modifications to existing U.S. tax law. Accounting for the income tax effects of the Act has been completed and included in the Company’s financial statements as of December 31, 2017. As a result of the Act, the Company has recorded a one-time tax provision and corresponding reduction to valuation allowance of $10,529, which consisted primarily of the remeasurement of deferred tax assets and liabilities from a tax rate of 35% to a tax rate of 21%. The future impact of the Act is not expected to have a material effect on the Company’s financial results and cash flows in the foreseeable future because the Company has a full valuation allowance recorded against its deferred tax assets.

Components of tax benefit (provision) allocated to continuing operations include the following:

	Year Ended December 31, 2018	Year Ended December 31, 2017
Current:		
Federal	$ —	$ (8)
State	(28)	(30)
Foreign	(11)	(9)
Sub-total	$ (39)	$ (47)
Deferred:		
Federal	$ —	$ 253
State	—	—
Foreign	—	—
Sub-total	$ —	$ 253
Total tax benefit (provision)	$ (39)	$ 206

The reconciliation of the statutory federal income tax rate to the Company’s effective income tax rate is as follows:

	Year Ended December 31, 2018	%	Year Ended December 31, 2017	%

Income taxes computed at statutory rates	$ 6,818	(21)%	$ 8,834	(34)%
(Increases) decreases resulting from:				
State income taxes, net of federal tax benefit	2,054	(6)%	1,576	(6)%
Federal and state research and experimentation credits	1,064	(4)%	1,081	(4)%
Change in valuation allowance	(10,024)	31 %	(1,216)	5 %
Impact of expired tax positions	1	— %	(7)	— %
Impact of recent U.S. tax reform	—	— %	(10,529)	40 %
Other	48	— %	467	(2)%
Total	$ (39)	— %	$ 206	(1)%

DIGIMARC CORPORATION

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(In thousands, except per share data)

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. The tax effects of significant items comprising the Company's deferred tax assets and deferred tax liabilities are as follows:

	Year Ended December 31, 2018	Year Ended December 31, 2017
Deferred tax assets:		
Stock based compensation	$ 998	$ 926
Federal and state net operating losses	34,873	26,064
Goodwill	341	423
Accrued compensation	11	11
Deferred rent	290	281
Federal and state research and experimentation credit	7,528	6,055
Intangible asset differences	185	222
Other	76	75
Total gross deferred tax assets	44,302	34,057
Less valuation allowance	(42,349)	(32,325)
Net deferred tax assets	$ 1,953	$ 1,732
Deferred tax liabilities:		
Patent expenditures	$ (1,442)	$ (1,427)
Fixed asset differences	(511)	(305)
Total gross deferred tax liabilities	$ (1,953)	$ (1,732)
Total net deferred tax assets	$ —	$ —

The Company had a valuation allowance of $42,349 and $32,325 on deferred tax assets as of December 31, 2018 and 2017, respectively, an increase of $10,024 during the year ended December 31, 2018.

As of December 31, 2018, the Company has federal and state net operating loss carry-forwards of $122,834 and $147,586, respectively, which have a carry-forward of 5 years to indefinite depending on the jurisdiction. The gross deferred tax assets for federal and state net operating loss carryforwards acquired in the Attributor acquisition have been reduced to the amount of losses allowed to be utilized in the post-acquisition period before expiration after considering the applicable limitations of Internal Revenue Code Section 382.

As of December 31, 2018, the Company has federal and state research and experimental tax credits of $6,415 and $2,186, respectively, which have a carry-forward of 5 to 20 years depending on the jurisdiction.

The Company records accrued interest and penalties associated with uncertain tax positions in income tax expense in the consolidated statements of operations. For the years ended December 31, 2018 and 2017, the Company recognized accrued interest and penalties associated with uncertain tax positions of $0 and $0, respectively. The Company does not anticipate any of its unrecognized benefits will significantly increase or decrease within the next 12 months.

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(In thousands, except per share data)

A summary reconciliation of the Company's uncertain tax positions is as follows:

	Year Ended December 31, 2018			Year Ended December 31, 2017		
Beginning balance	$	549		$	486	
Addition for current year tax positions		88			101	
Addition for prior year tax positions		—			16	
Reduction for prior year positions		(23	)		(52	)
Reduction for prior year positions resolved during the current year		(1	)		(2	)
Ending balance	$	613		$	549	

Uncertain tax positions are classified as a long-term liability (or a contra deferred tax asset) on the consolidated balance sheets for uncertain tax positions taken (or expected to be taken) on a tax return.

The Company's open tax years subject to examination in the U.S. federal jurisdiction are 2014 through 2017 and applicable state jurisdictions for the tax years 2014 through 2017. To the extent allowed by law, the taxing authorities may have the right to examine prior periods where net operating losses or tax credits were generated and carried forward, and make adjustments up to the amount of the net operating loss or tax credit carryforward.

(13) Commitments and Contingencies

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

The Company is subject from time to time to other legal proceedings and claims arising in the ordinary course of business. At this time, the Company does not believe that the resolution of any such matters will have a material adverse effect on its financial position, results of operations or cash flows.

DIGIMARC CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(In thousands, except per share data)

(14) Quarterly Financial Information—Unaudited

	Quarter Ended March 31	June 30	September 30	December 31
2018				
Service revenue	$3,507	$3,336	$ 2,787	$ 3,144
Subscription revenue	1,578	1,444	1,532	1,487
License revenue [1]	528	658	595	596
Total revenue	5,613	5,438	4,914	5,227
Total cost revenue	2,185	2,205	1,935	2,101
Gross profit	3,428	3,233	2,979	3,126
Gross profit percent, service revenue	55 %	54 %	53 %	52 %
Gross profit percent, subscription revenue	69 %	65 %	69 %	71 %
Gross profit percent, license revenue	73 %	77 %	74 %	74 %
Gross profit percent, total	61 %	59 %	61 %	60 %
Sales and marketing	$4,887	$4,757	$ 4,741	$ 4,755
Research, development and engineering	3,947	4,058	4,069	3,897
General and administrative	2,632	2,416	2,447	2,402
Intellectual property	315	305	328	334
Operating loss	(8,353)	(8,303)	(8,606)	(8,262)
Net loss	(8,112)	(8,038)	(8,342)	(8,014)
Earnings (loss) per common share:				
Loss per common share—basic	$(0.72)	$(0.71)	$ (0.73)	$ (0.70)
Loss per common share—diluted	$(0.72)	$(0.71)	$ (0.73)	$ (0.70)
Weighted average common shares outstanding—basic	11,266	11,337	11,394	11,443
Weighted average common shares outstanding—diluted	11,266	11,337	11,394	11,443

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(In thousands, except per share data)

	Quarter Ended March 31	June 30	September 30	December 31
2017				
Service revenue	$3,696	$3,253	$ 2,986	$ 3,001
Subscription revenue	1,445	1,420	1,306	1,348
License revenue [1]	950	914	4,385	509
Total revenue	6,091	5,587	8,677	4,858
Total cost revenue	2,309	2,120	2,072	2,057
Gross profit	3,782	3,467	6,605	2,801
Gross profit percent, service revenue	56 %	55 %	55 %	55 %
Gross profit percent, subscription revenue	62 %	62 %	53 %	58 %
Gross profit percent, license revenue	88 %	87 %	97 %	74 %
Gross profit percent, total	62 %	62 %	76 %	58 %
Sales and marketing	$3,992	$3,997	$ 4,075	$ 4,572
Research, development and engineering	3,459	3,936	4,108	3,932
General and administrative	2,385	2,239	2,442	2,614
Intellectual property	392	345	387	345
Operating loss	(6,446)	(7,050)	(4,407)	(8,662)
Net loss	(6,218)	(6,943)	(4,240)	(8,370)
Earnings (loss) per common share:				
Loss per common share—basic	$(0.61)	$(0.68)	$ (0.39)	$ (0.76)
Loss per common share—diluted	$(0.61)	$(0.68)	$ (0.39)	$ (0.76)
Weighted average common shares outstanding— basic	10,161	10,266	10,797	11,046
Weighted average common shares outstanding— diluted	10,161	10,266	10,797	11,046

(1) In the third quarter of 2017, the Company recognized a one-time $3,500 upfront license fee from an existing licensee.