DIGIMARC CORP
Form 10-K/A
June 01, 2005

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K/A

(Amendment No. 1)

(Mark One)

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

For the fiscal year ended December 31, 2004

OR

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

For the transition period from to

Commission File Number 000-28317

DIGIMARC CORPORATION

(Exact name of registrant as specified in its charter)

Delaware	**94 3342784**

(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

9405 SW Gemini Drive, Beaverton, Oregon	**97008**

(Address of principal executive offices)	(Zip Code)

(503) 469-4800

(Registrant s telephone number, including area code)

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

NONE

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

Common Stock, $0.001 par value

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

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

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

The aggregate market value of common stock, par value $0.001 per share, held by non-affiliates of the registrant, based on the closing price for the common stock on The Nasdaq National Market on the last business day of the registrant s most recently completed fiscal second quarter (June 30, 2004), was approximately $265 million. Shares of common stock beneficially held by each officer and director have been excluded from this computation in that such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for any other purposes.

As of March 31, 2005, there were 20,723,429 shares of the registrant s common stock outstanding.

Documents Incorporated by Reference

None.

Explanatory Note

Digimarc Corporation is filing this Amendment No. 1 to Form 10-K to amend its Form 10-K for the year ended December 31, 2004, filed with the Securities and Exchange Commission on April 7, 2005 (the Original Filing), in order to amend Item 9A, Controls and Procedures .

Management s report on internal controls over financial reporting, the related attestation report of the Company s independent registered public accounting firm and a revised report of the Independent Registered Public Accounting Firm, dated May 27, 2005, on the Consolidated Financial Statements as of December 31, 2004 and 2003 and for each of the years in the three-year-period ended December 31, 2004 are included in this Amendment No. 1 in Item 9A.

As a result of this Amendment No. 1, an additional Consent of Independent Registered Public Accounting Firm dated June 1, 2005 is being filed to cover the reports related to our internal control over financial reporting and Consolidated Financial Statements included herein.

Except for the matters disclosed in Item 9A and Exhibits 23.1, 31.1 and 31.2, which are filed herewith pursuant to the requirements of Rule 12b-15 under the Securities Exchange Act of 1934, this Amendment No. 1 to Form 10-K continues to speak as of the date of the Original Filing and does not modify, amend or update in any way the financial statements or any other item or disclosures in the Original Filing.

Table of Contents

PART II	
Item 9A.	Controls and Procedures
PART IV	
Item 15.	Exhibits and Financial Statement Schedules
SIGNATURES	

ITEM 9A: CONTROLS AND PROCEDURES

We identified during the third quarter of 2004 certain errors in the accounting for software development costs and project capitalization at DIDS, and we postponed the release of our financial results for the quarter ended September 30, 2004 pending the completion of our review of these accounting errors. We identified these errors as a result of our review of our accounting and our review of our internal control over financial reporting in preparation for compliance with Section 404 of the Sarbanes-Oxley Act of 2002 and its implementing regulations. This review involved a detailed analysis and documentation of the processes that impact the preparation of our financial statements, an assessment of the risks that could adversely affect the accurate and timely preparation of those financial statements and the identification of the controls that are in place to mitigate the risks of untimely or inaccurate preparation of those financial statements. During the course of our review, we determined that certain prior period financial statements required restatement. As a result, the Original Filing included restated consolidated financial statements as of and for (1) the fiscal year ended December 31, 2003, including each of the quarterly periods in the fiscal year ended December 31, 2003, and (2) the quarterly periods ended March 31, 2004 and June 30, 2004.

The certifications of our principal executive officer and the principal financial officer required in accordance with Section 302 of the Sarbanes-Oxley Act of 2002 are attached as exhibits to this Form 10-K/A. The disclosures set forth in this Item 9A contain information concerning the evaluation of our disclosure controls and procedures, and changes in internal control over financial reporting, referred to in paragraph 4 of the certifications. This Item 9A should be read in conjunction with the officer certifications for a more complete understanding of the topics presented.

(1) Management s Report on Internal Control Over Financial Reporting

Our 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. generally accepted accounting principles (U.S. GAAP). Our internal control over financial reporting includes those policies and procedures that:

Pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of our assets;

Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with U.S. GAAP, and that receipts and expenditures are being made only in accordance with authorizations from our management and directors; and

Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of our 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.

With the participation of our principal executive officer and our principal financial officer, our management conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this evaluation, our management has concluded that our internal control over financial reporting was not effective as of December 31, 2004, due to the material weaknesses in interim and annual financial reporting described as follows.

The Public Company Accounting Oversight Board (PCAOB) has defined material weakness as a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

In connection with our restatement, we identified and reported to our audit committee the following areas for improvement in our internal control over financial reporting. These matters constitute material weaknesses as defined under standards established by the PCAOB.

Inadequate supervision and technical accounting expertise within the accounting and finance department. There was not adequate supervision and technical accounting expertise within our accounting and finance department. The personnel resources and technical accounting expertise in the accounting and finance department were not sufficient to adequately resolve non-routine matters or complex accounting processes, such as those matters and processes relating to the recording of software capitalization, standard costing, and revenue recognition in accordance with U.S. GAAP.

Inadequate design and implementation of new accounting system. The new accounting system we began to implement in the second quarter of 2002, and which was placed in service during the fourth quarter of 2003, was not designed or implemented properly. There was a lack of accounting expertise within our accounting and finance department and, as a result, our internally developed guidelines were not properly implemented during the setup and configuration of the new accounting system. Implementation of the new accounting system also was flawed because some of our accounting, finance and operations employees were not properly trained in the use of the new accounting system. In addition, the new and old accounting systems were not operated in parallel prior to the Company s reliance on the new system. These implementation issues resulted in errors with respect to accounting for fixed assets and inventory, including the duplicate recording of purchases, the capitalization of assets that should have been expensed and the expensing of assets that should have been capitalized.

Inadequate quarterly and year-end financial statement close and review process. For each quarterly and fiscal year-end period, a financial statement close and review process occurs. Our staffing for the quarterly and year-end financial statement close process was not sufficient, and in some instances, we failed to have adequate management review and supervision over the financial statement close and review process, including timely reconciliation of inventory, tax and accounts payable accounts to ensure our financial statements were prepared in accordance with U.S. GAAP. Where there was a review process, documentation of approvals was not always evident.

Insufficient controls both for determining the nature and types of costs that should be capitalized and for ensuring allocation of costs to particular projects are appropriate. Controls for determining the nature and types of costs that should be capitalized in accordance with U.S. GAAP, and for ensuring that costs were allocated to appropriate projects, were inadequate, which affected our accounting for fixed asset accounts and research and development expense. We lacked adequate personnel with sufficient expertise in complex software capitalization and project accounting rules under U.S. GAAP and there was not a clear understanding regarding the application of our internal policies in these areas. Some of our employees who performed accounting functions were not adequately trained and supervised, and there were deficiencies in communication between functional departments within the Company. Such controls also were insufficient because the documentary support for the historical capitalization of certain software development costs and the system for tracking costs that qualify for capitalization needed improvement, and the detective controls related to the capitalization of internally developed software were not adequate.

Insufficient controls to ensure that various international, state and local tax exposures were quantified and properly accrued on a timely basis. Internal controls related to the quantification and accrual of international, state and local taxes incurred by the Company were insufficient. There was not sufficient staff to properly quantify, accrue, and record such taxes on a timely basis in accordance with U.S. GAAP.

This affected our income tax payable and income tax expense accounts, as well as sales, use, and property tax expense and accrual accounts.

Insufficient training and inadequate reconciliation processes for complex revenue recognition requirements primarily related to international transactions. Training and reconciliation processes related to complex revenue recognition requirements regarding distributor discounts, partial deliveries of goods and the acceptance criteria for shipped goods were insufficient to ensure these transactions were recorded in accordance with U.S. GAAP. This affected our revenue and our deferred revenue accounts.

Insufficient controls related to system access and segregation of duties. The Company did not maintain adequate segregation of duties among employees. Users of our new accounting system had access to multiple accounting processes within the system, including vendor set-up and account maintenance, instead of only those processes that were the responsibility of such user. In the absence of such controls, inappropriate or unauthorized transactions could be entered into the system which increases susceptibility to the misappropriation of assets.

Inadequacies related to entity-level controls. There were deficiencies in the design and execution of our entity-level controls relating to training, job descriptions, managing of employee turnover, application of U.S. GAAP, documentation of expenditure approvals, and communication between departments. These deficiencies contributed to the restatement of our previously issued financial statements as discussed herein, delays in compliance efforts with Section 404 of the Sarbanes-Oxley Act of 2002 and the rules issued thereunder, and the delayed filing of our Form 10-K for the year ended December 31, 2004.

KPMG LLP has issued an attestation report on management s assessment of our internal control over financial reporting. This report appears below.

(2) Remediation Activities

Digimarc places the highest priority on addressing these matters. Under the direction of our senior management and the participation and oversight of our audit committee, we have implemented significant changes to our infrastructure and related processes over the past nine months, and continue to address these matters and will make changes as appropriate. The numbers set forth opposite each identified area for improvement in the chart below correspond to the numbered descriptions of the changes we have implemented, or are in the process of implementing, to improve such areas of our internal controls which appear immediately following the chart.

Identified Areas for Improvement in Internal Controls	Changes Implemented
Inadequate supervision and technical accounting expertise within the accounting and finance department	1, 2, 3, 4, 8
Inadequate design and implementation of new accounting systems	1, 2, 3, 4, 6, 9
Inadequate quarterly and year-end financial statement close and review process	1, 2, 3, 4, 5, 6, 7, 8
Insufficient controls for determining the nature and types of costs that should be capitalized and for ensuring allocation of costs to particular projects are appropriate	1, 2, 3, 4, 8
Insufficient controls to ensure that various international, state and local tax exposures were quantified and accrued on a timely basis	1, 2, 4, 7
Insufficient training and inadequate reconciliation processes for complex revenue recognition requirements primarily related to international transactions	1, 2, 4, 7
Insufficient controls related to system access and segregation of duties	1, 2, 9
Inadequacies related to entity-level controls	1, 2, 4, 5

Description of Changes Implemented to Improve Internal Controls

1. We hired a new Chief Financial Officer in June 2004, a new President of DIDS in April 2005, and a number of other personnel and consultants who have expertise in financial controls or accounting, and we are actively recruiting other senior level members of the finance and accounting organization, including adding a Director of Tax in May 2005, to improve the overall quality and level of experience in our finance and accounting organization.

2. We have made, and will continue to make, changes in our finance and accounting organization to provide clearer segregation of responsibilities and supervision with regard to, among others, documentation supporting our quarterly and annual financial statements.

3. We have initiated additional training of our management and other employees at DIDS regarding timekeeping practices and other best practices.

4. We are implementing an enhanced quarterly and annual financial statement close and review close process to include additional analysis and support for the financial accounts.

5. We have deployed significant internal and external resources directed at documenting and testing our internal control over financial reporting as contemplated by Section 404 of Sarbanes-Oxley, and such efforts have been helpful in improving our overall process and control environment.

6. We have strengthened our inventory management and controls systems and procedures, including those governing the usability and disposition of slow-moving or excess inventories, by performing timely physical inventory counts that reconcile to the general ledger, analyzing historical and expected usage levels, and reviewing manufacturing standard costs.

7. We have enhanced our review and documentation of accounting estimates. This includes changes in people, processes, and documentation in areas such as inventory reserves, allowance for bad debt, long-lived asset impairment analyses, estimated revenue amounts, estimated international taxes, and estimates related to percentage of completion contracts.

8. We have continued to implement steps, including changes to our processes and systems, to improve the information flow among the various personnel that have a role in the determination of proper cost capitalization as well as to improve the review and approval process relating to such determination, and we are implementing processes to improve communication among our various functional groups, which include sales, manufacturing, customer support, engineering, accounting, and legal, during the contract negotiation, implementation and fulfillment phases.

9. We have established a staff position to implement preventive control procedures related to system access and to monitor and control access to system modules in accordance with appropriate guidelines in order to ensure safeguarding of assets, and are in the process of implementing such preventative controls at the system and procedural levels. In addition, we have implemented detective controls such as the enhanced review of accounting transactions and financial statements.

We continue to take remedial steps to strengthen our internal controls and enhance our reporting processes. Additionally, our on-going accounting review has resulted in some, and may result in further, remediation efforts with respect to some of our accounting processes, in particular with regard to cost capitalization and project accounting.

(3) Evaluation Process; Conclusion on Ineffectiveness of Disclosure Controls and Procedures at December 31, 2004

Our current management, with the participation of our principal executive officer and principal financial officer, carried out a separate evaluation of the effectiveness of our disclosure controls and procedures (as defined in Rules 240.13a-15(e) and 240.15d-15(e) of the Securities Exchange Act of 1934) as of December 31, 2004, which included an evaluation of disclosure controls and procedures applicable to the period covered by the filing of this periodic report. As noted above, we have identified a number of areas for improvement in our internal controls and procedures, as they existed as of December 31, 2004. Based on the evaluation of the effectiveness of our disclosure controls and procedures as of December 31, 2004, and subject to the information set forth in this Item 9A, our principal executive officer and principal financial officer have concluded that our disclosure controls and procedures were not effective based on the matters described in this Item 9A. However, subsequent to December 31, 2004, and up to the filing date of this report, we implemented a detailed review and analysis of our accounting records, including a reconstruction of certain accounting records, in support of the financial statements contained herein utilizing consultants with expertise in accounting under the direction of new financial management. As internal control issues have been identified, management has taken steps to remediate such matters. If additional internal control issues come to light, management intends to address them promptly.

As described above, we currently are designing and implementing new controls to address the weaknesses identified in our internal controls and procedures. Notwithstanding these improvements, our internal controls and procedures may not be capable of preventing all instances of error or fraud. 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. Further, the design of a control system must reflect the fact that there are knowledge and resource constraints in any such system, and a large number of complex permutations of facts, circumstances, accounting policies, procedural implications and business practices that must be considered. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, the control systems we develop may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

(4) Changes to Internal Controls

Other than as described above, there have not been any changes in our internal control over financial reporting that occurred during the Company s fiscal quarter ended December 31, 2004 or since the evaluation date by our management of its internal controls that have materially affected or are reasonably likely to materially affect our internal control over financial reporting.

By: /s/ Bruce Davis
Bruce Davis
Chief Executive Officer

By: /s/ Michael McConnell
Michael McConnell
Chief Financial Officer

5

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Stockholders of

Digimarc Corporation:

We have audited management s assessment, included in the accompanying Management s Report on Internal Control over Financial Reporting set forth in Item 9A(1), that Digimarc Corporation (the Company) did not maintain effective internal control over financial reporting as of December 31, 2004, because of the effect of the material weaknesses identified in management s assessment, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). 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. Our responsibility is to express an opinion on management s assessment and an opinion on the effectiveness of the Company s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). 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 included obtaining an understanding of internal control over financial reporting, evaluating management s assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

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.

A material weakness is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. The following material weaknesses have been identified and included in management s assessment as of December 31, 2004:

Inadequate supervision and technical accounting expertise within the accounting and finance department. There was not adequate supervision and technical accounting expertise within the Company s accounting and finance department. The personnel resources and technical accounting expertise in the accounting and finance department were not sufficient to adequately resolve non-routine matters or complex accounting processes, such as those matters and processes relating to the recording of software capitalization, standard costing, and revenue recognition in accordance with U.S. generally accepted accounting principles (U.S. GAAP).

Inadequate design and implementation of new accounting system. The new accounting system the Company began to implement in the second quarter of 2002, and which was placed in service during the fourth quarter of 2003, was not designed or implemented properly. There was a lack of accounting expertise within the Company s accounting and finance department and, as a result, the Company s internally developed guidelines were not properly implemented during the setup and configuration of the new accounting system. Implementation of the new accounting system also was flawed because some of the Company s accounting, finance and operations employees were not properly trained in the use of the new accounting system. In addition, the new and old accounting systems were not operated in parallel prior to the Company s reliance on the new system. These implementation issues resulted in errors with respect to accounting for fixed assets and inventory, including the duplicate recording of purchases, the capitalization of assets that should have been expensed and the expensing of assets that should have been capitalized.

Inadequate quarterly and year-end financial statement close and review process. For each quarterly and fiscal year-end period, a financial statement close and review process occurs. The Company s staffing for the quarterly and year-end financial statement close process was not sufficient, and in some instances, the Company failed to have adequate management review and supervision over the financial statement close and review process, including timely reconciliation of inventory, tax and accounts payable accounts to ensure the Company s financial statements were prepared in accordance with U.S. GAAP. Where there was a review process, documentation of approvals was not always evident.

Insufficient controls both for determining the nature and types of costs that should be capitalized and for ensuring allocation of costs to particular projects are appropriate. Controls for determining the nature and types of costs that should be capitalized in accordance with U.S. GAAP, and for ensuring that costs were allocated to appropriate projects, were inadequate, which affected the Company s accounting for fixed asset accounts and research and development expense. The Company lacked adequate personnel with sufficient expertise in complex software capitalization and project accounting rules under U.S. GAAP and there was not a clear understanding regarding the application of the Company s internal policies in these areas. Some of the Company s employees who performed accounting functions were not adequately trained and supervised, and there were deficiencies in communication between functional departments within the Company. Such controls also were insufficient because the documentary support for the historical capitalization of certain software development costs and the system for tracking costs that qualify for capitalization needed improvement, and the detective controls related to the capitalization of internally developed software were not adequate.

Insufficient controls to ensure that various international, state and local tax exposures were quantified and properly accrued on a timely basis. Internal controls related to the quantification and accrual of international, state and local taxes incurred by the Company were insufficient. There was not sufficient staff to properly quantify, accrue, and record such taxes on a timely basis in accordance with U.S. GAAP. This affected the Company s income tax payable and income tax expense accounts, as well as sales, use and property tax expense and accrual accounts.

Insufficient training and inadequate reconciliation processes for complex revenue recognition requirements primarily related to international transactions. Training and reconciliation processes related to complex revenue recognition requirements regarding distributor discounts, partial deliveries of goods and the acceptance criteria for shipped goods were insufficient to ensure these transactions were recorded in accordance with U.S. GAAP. This affected the Company s revenue and the Company s deferred revenue accounts.

Insufficient controls related to system access and segregation of duties. The Company did not maintain adequate segregation of duties among employees. Users of the Company s new accounting system had access to multiple accounting processes within the system, including vendor set-up and account maintenance, instead of only those processes that were the responsibility of such user. In the absence of such controls, inappropriate or unauthorized transactions could be entered into the system which increases susceptibility to the misappropriation of assets.

Inadequacies related to entity-level controls. There were deficiencies in the design and execution of the Company s entity-level controls relating to training, job descriptions, managing of employee turnover, application of U.S. GAAP, documentation of expenditure approvals, and communication between departments. These deficiencies contributed to the restatement of the Company s previously issued financial statements as discussed herein, delays in compliance efforts with Section 404 of the Sarbanes-Oxley Act of 2002 and the rules issued thereunder, and the delayed filing of the Company s Form 10-K for the year ended December 31, 2004.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Digimarc Corporation and subsidiaries as of December 31, 2004 and 2003, and the related consolidated statements of operations, stockholders equity, and cash flows for each of the years in the three-year period ended December 31, 2004. This report does not affect our report dated May 27, 2005, which expressed an unqualified opinion on the consolidated financial statements.

In our opinion, management s assessment that the Company did not maintain effective internal control over financial reporting as of December 31, 2004, is fairly stated, in all material respects, based on the criteria established in Internal Control Integrated Framework issued by COSO. Also, in our opinion, because of the effect of the material weaknesses described above on the achievement of the objectives of the control criteria, the Company has not maintained effective internal control over financial reporting as of December 31, 2004, based on the criteria established in Internal Control Integrated Framework issued by COSO.

/s/ KPMG LLP

Portland, Oregon

May 27, 2005

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and
Stockholders of Digimarc Corporation

We have audited the accompanying consolidated balance sheets of Digimarc Corporation and subsidiaries as of December 31, 2004 and 2003, and the related consolidated statements of operations, stockholders equity, and cash flows for each of the years in the three-year period ended December 31, 2004. 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 conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Digimarc Corporation and subsidiaries as of December 31, 2004 and 2003, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2004 in conformity with U.S. generally accepted accounting principles.

As indicated in Note 2 to the consolidated financial statements, the Company has restated its consolidated financial statements as of and for the year ended December 31, 2003.

We also have audited, in accordance with the standards of the Public Accounting Oversight Board (United States), the effectiveness of Digimarc Corporation and its subsidiaries internal control over financial reporting as of December 31, 2004, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated May 27, 2005 expressed an unqualified opinion on management s assessment of, and an adverse opinion on the effective operation of, internal control over financial reporting.

/s/ KPMG LLP

Portland, Oregon
May 27, 2005

PART III

ITEM 15: EXHIBITS, FINANCIAL STATEMENT SCHEDULES, AND REPORTS ON FORM 8-K

(a)(3) Exhibits

Exhibit Number	Document
2.1	Asset Purchase Agreement among Polaroid Corporation, Polaroid ID Systems, Inc. and Digimarc Corporation (incorporated by reference to Exhibit 2.1 to the Registrant s Current Report on Form 8-K, as filed with the Securities and Exchange Commission on January 3, 2002)
3.1	Second Amended and Restated Certificate of Incorporation of the Registrant (incorporated by reference to Exhibit 3.1 to the Registrant s Quarterly Report on Form 10-Q, as filed with the Securities and Exchange Commission on November 14, 2000)
3.2	Certificate of Amendment of Second Amended and Restated Certificate of Incorporation of the Registrant (incorporated by reference to Exhibit 3.2 to the Registrant s Quarterly Report on Form 10-Q, as filed with the Securities and Exchange Commission on November 14, 2000)
3.3	Amended and Restated Bylaws of the Registrant, as amended (incorporated by reference to Exhibit 3.3 to the Registrant s Annual Report on Form 10-K, as filed with the Securities and Exchange Commission on March 15, 2004)
3.4	Certificate of Designation of the Series A Preferred Stock of Digimarc Corporation (incorporated by reference to Exhibit 3.1 to the Registrant s Current Report on Form 8-K, as filed with the Securities and Exchange Commission on November 17, 2004)
4.1	Reference is made to Exhibits 3.1, 3.2 and 3.3
4.2	Second Amended and Restated Investor Rights Agreement, dated as of November 2, 1999, between the Registrant and the holders of the Registrant s preferred stock (incorporated by reference to Exhibit 4.2 to the Registrant s Registration Statement on Form S-1 (Commission File No. 333-87501) which became effective on December 2, 1999)
4.3	Rights Agreement, dated as of November 16, 2004, between Digimarc Corporation and EquiServe Trust Company, N.A. together with: Exhibit A Form of Rights Certificate; Exhibit B Form of Summary of Rights to Purchase Preferred Stock; and Exhibit C Form of Certificate of Designation of the Series A Preferred Stock of Digimarc Corporation (incorporated by reference to Exhibit 4.1 to the Registrant s Current Report on Form 8-K, as filed with the Securities and Exchange Commission on November 17, 2004)
10.1	Form of Indemnification Agreement between the Registrant and each of its executive officers and directors (incorporated by reference to Exhibit 10.1 to the Registrant s Registration Statement on Form S-1 (Commission File No. 333-87501) which became effective on December 2, 1999)
10.2	Registrant s 1995 Stock Incentive Plan, as amended (incorporated by reference to Exhibit 99.1 to the Registrant s Registration Statement on Form S-8 (Commission File No. 333-31114) which became effective on February 25, 2000)
10.3	Registrant s Restated 1999 Stock Incentive Plan, as amended and restated on April 17, 2003 (incorporated by reference to Exhibit 10.3 to the Registrant s Annual Report on Form 10-K, as filed with the Securities and Exchange Commission on March 15, 2004)

Exhibit Number	Document
10.4	Form of Notice of Stock Option Award and Stock Option Award Agreement for the Digimarc Corporation 1999 Stock Incentive Plan (incorporated by reference to Exhibit 99(d)(2) of the Company s Schedule TO, as filed with the Securities and Exchange Commission on February 16, 2001)
10.5	Registrant s 1999 Employee Stock Purchase Plan, as amended and restated on February 19, 2004, including forms of agreements thereunder (incorporated by reference to Exhibit 99.1 to the Registrant s Registration Statement on Form S-8 (Commission File No. 333-115074) which became effective on April 30, 2004)
10.6	Lease Agreement, dated as of June 25, 1999, between the Registrant and Southplace Associates LLC (incorporated by reference to Exhibit 10.8 to the Registrant s Registration Statement on Form S-1 (Commission File No. 333-87501) which became effective on December 2, 1999)
10.7	First Amendment to Lease Agreement, dated as of February 17, 2000, between the Registrant and Southplace Associates LLC (incorporated by reference to Exhibit 10.10 to the Registrant s Registration Statement on Form S-1 (Commission File No. 333-32778) which was filed with the Securities and Exchange Commission on March 17, 2000 and withdrawn on July 31, 2000)
10.8	CityPlex Towers Lease Agreement, dated as of January 4, 2000, between the Registrant and Oral Roberts University (incorporated by reference to Exhibit 10.11 to the Registrant s Registration Statement on Form S-1 (Commission File No. 333-32778) which was filed with the Securities and Exchange Commission on March 17, 2000 and withdrawn on July 31, 2000)
10.9	Strategic Investment Agreement, dated as of September 17, 2000, between the Registrant and Macrovision Corporation (incorporated by reference to Exhibit 10.12 to the Registrant s Quarterly Report on Form 10-Q, as filed with the Securities and Exchange Commission on November 14, 2000)
10.10	Strategic Investment Agreement, dated as of September 17, 2000, between the Registrant and Koninklijke Philips Electronics N.V. (incorporated by reference to Exhibit 10.13 to the Registrant s Quarterly Report on Form 10-Q, as filed with the Securities and Exchange Commission on November 14, 2000)
10.11	Registrant s 2000 Non-Officer Employee Stock Incentive Plan, as amended and restated on February 19, 2004 (incorporated by reference to Exhibit 10.2 to the Registrant s Quarterly Report on Form 10-Q, as filed with the Securities and Exchange Commission on May 10, 2004)
10.12	Registrant s 1999 Non-Employee Director Option Program, as amended and restated on March 10, 2004 (incorporated by reference to Exhibit 10.3 to the Registrant s Quarterly Report on Form 10-Q, as filed with the Securities and Exchange Commission on May 10, 2004)
10.13	First Promissory Note, dated July 1, 2002, between Digimarc Corporation and Indraneel Paul (incorporated by reference to Exhibit 10.16 to the Registrant s Annual Report on Form 10-K, as filed with the Securities and Exchange Commission on March 31, 2003)
10.14	Second Promissory Note, dated July 1, 2002, between Digimarc Corporation and Indraneel Paul (incorporated by reference to Exhibit 10.17 to the Registrant s Annual Report on Form 10-K, as filed with the Securities and Exchange Commission on March 31, 2003)
10.15	Employment Agreement, dated as of July 16, 2001, between the Registrant and Bruce Davis (incorporated by reference to Exhibit 10.1 to the Registrant s Quarterly Report on Form 10-Q, as filed with the Securities and Exchange Commission on May 15, 2003)
10.16	Form of Warrant (incorporated by reference to Exhibit 4.1 to the Registrant s Current Report on Form 8-K, as filed with the Securities and Exchange Commission on August 27, 2003)
10.17	Purchase Agreement by and between the Registrant and each of the purchasers whose names are set forth on the signature pages thereof (incorporated by reference to Exhibit 10.1 to the Registrant s Current Report on Form 8-K, as filed with the Securities and Exchange Commission on August 27, 2003)

Exhibit Number	Document
10.18	Form of Notice of Stock Option Award and Stock Option Award Agreement for employees under the Digimarc Corporation 1999 Stock Incentive Plan (incorporated by reference to Exhibit 99(d)(2) of the Company s Schedule TO, as filed with the Securities and Exchange Commission on February 16, 2001)
10.19	Form of Restricted Stock Agreement for the Digimarc Corporation 1999 Stock Incentive Plan (incorporated by reference to Exhibit 10.1 to the Registrant s Current Report on Form 8-K, as filed with the Securities and Exchange Commission on March 1, 2005)
10.20	Form of Stock Option Award Agreement for the 1999 Non-Employee Director Option Program adopted under the Digimarc Corporation 1999 Stock Incentive Plan (incorporated by reference to Exhibit 10.2 to the Registrant s Current Report on Form 8-K, as filed with the Securities and Exchange Commission on March 1, 2005)
10.21	Forms of Notice of Stock Option Award and Stock Option Award Agreement for officers under the Digimarc Corporation 1999 Stock Incentive Plan*
10.22	Full Service Lease, dated March 22, 2004, by and between PS Business Parks, L.P., and the Registrant*
21.1	List of Subsidiaries (incorporated by reference to Exhibit 21.1 to the Registrant s Annual Report on Form 10-K, as filed with the Securities and Exchange Commission on March 31, 2003)
23.1	Consent of KPMG LLP, Independent Registered Public Accounting Firm
24.1	Power of Attorney*
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*

* Previously filed.

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

/s/ Michael McConnell
Michael McConnell
Title: Chief Financial Officer (Duly Authorized Officer and Principal Financial and Accounting Officer)

Date: June 1, 2005

EXHIBIT INDEX

Exhibit Number	Document
2.1	Asset Purchase Agreement among Polaroid Corporation, Polaroid ID Systems, Inc. and Digimarc Corporation (incorporated by reference to Exhibit 2.1 to the Registrant s Current Report on Form 8-K, as filed with the Securities and Exchange Commission on January 3, 2002)
3.1	Second Amended and Restated Certificate of Incorporation of the Registrant (incorporated by reference to Exhibit 3.1 to the Registrant s Quarterly Report on Form 10-Q, as filed with the Securities and Exchange Commission on November 14, 2000)
3.2	Certificate of Amendment of Second Amended and Restated Certificate of Incorporation of the Registrant (incorporated by reference to Exhibit 3.2 to the Registrant s Quarterly Report on Form 10-Q, as filed with the Securities and Exchange Commission on November 14, 2000)
3.3	Amended and Restated Bylaws of the Registrant, as amended (incorporated by reference to Exhibit 3.3 to the Registrant s Annual Report on Form 10-K, as filed with the Securities and Exchange Commission on March 15, 2004)
3.4	Certificate of Designation of the Series A Preferred Stock of Digimarc Corporation (incorporated by reference to Exhibit 3.1 to the Registrant s Current Report on Form 8-K, as filed with the Securities and Exchange Commission on November 17, 2004)
4.1	Reference is made to Exhibits 3.1, 3.2 and 3.3
4.2	Second Amended and Restated Investor Rights Agreement, dated as of November 2, 1999, between the Registrant and the holders of the Registrant s preferred stock (incorporated by reference to Exhibit 4.2 to the Registrant s Registration Statement on Form S-1 (Commission File No. 333-87501) which became effective on December 2, 1999)
4.3	Rights Agreement, dated as of November 16, 2004, between Digimarc Corporation and EquiServe Trust Company, N.A. together with: Exhibit A Form of Rights Certificate; Exhibit B Form of Summary of Rights to Purchase Preferred Stock; and Exhibit C Form of Certificate of Designation of the Series A Preferred Stock of Digimarc Corporation (incorporated by reference to Exhibit 4.1 to the Registrant s Current Report on Form 8-K, as filed with the Securities and Exchange Commission on November 17, 2004)
10.1	Form of Indemnification Agreement between the Registrant and each of its executive officers and directors (incorporated by reference to Exhibit 10.1 to the Registrant s Registration Statement on Form S-1 (Commission File No. 333-87501) which became effective on December 2, 1999)
10.2	Registrant s 1995 Stock Incentive Plan, as amended (incorporated by reference to Exhibit 99.1 to the Registrant s Registration Statement on Form S-8 (Commission File No. 333-31114) which became effective on February 25, 2000)
10.3	Registrant s Restated 1999 Stock Incentive Plan, as amended and restated on April 17, 2003 (incorporated by reference to Exhibit 10.3 to the Registrant s Annual Report on Form 10-K, as filed with the Securities and Exchange Commission on March 15, 2004)
10.4	Form of Notice of Stock Option Award and Stock Option Award Agreement for the Digimarc Corporation 1999 Stock Incentive Plan (incorporated by reference to Exhibit 99(d)(2) of the Company s Schedule TO, as filed with the Securities and Exchange Commission on February 16, 2001)

Exhibit Number	Document
10.5	Registrant s 1999 Employee Stock Purchase Plan, as amended and restated on February 19, 2004, including forms of agreements thereunder (incorporated by reference to Exhibit 99.1 to the Registrant s Registration Statement on Form S-8 (Commission File No. 333-115074) which became effective on April 30, 2004)
10.6	Lease Agreement, dated as of June 25, 1999, between the Registrant and Southplace Associates LLC (incorporated by reference to Exhibit 10.8 to the Registrant s Registration Statement on Form S-1 (Commission File No. 333-87501) which became effective on December 2, 1999)
10.7	First Amendment to Lease Agreement, dated as of February 17, 2000, between the Registrant and Southplace Associates LLC (incorporated by reference to Exhibit 10.10 to the Registrant s Registration Statement on Form S-1 (Commission File No. 333-32778) which was filed with the Securities and Exchange Commission on March 17, 2000 and withdrawn on July 31, 2000)
10.8	CityPlex Towers Lease Agreement, dated as of January 4, 2000, between the Registrant and Oral Roberts University (incorporated by reference to Exhibit 10.11 to the Registrant s Registration Statement on Form S-1 (Commission File No. 333-32778) which was filed with the Securities and Exchange Commission on March 17, 2000 and withdrawn on July 31, 2000)
10.9	Strategic Investment Agreement, dated as of September 17, 2000, between the Registrant and Macrovision Corporation (incorporated by reference to Exhibit 10.12 to the Registrant s Quarterly Report on Form 10-Q, as filed with the Securities and Exchange Commission on November 14, 2000)
10.10	Strategic Investment Agreement, dated as of September 17, 2000, between the Registrant and Koninklijke Philips Electronics N.V. (incorporated by reference to Exhibit 10.13 to the Registrant s Quarterly Report on Form 10-Q, as filed with the Securities and Exchange Commission on November 14, 2000)
10.11	Registrant s 2000 Non-Officer Employee Stock Incentive Plan, as amended and restated on February 19, 2004 (incorporated by reference to Exhibit 10.2 to the Registrant s Quarterly Report on Form 10-Q, as filed with the Securities and Exchange Commission on May 10, 2004)
10.12	Registrant s 1999 Non-Employee Director Option Program, as amended and restated on March 10, 2004 (incorporated by reference to Exhibit 10.3 to the Registrant s Quarterly Report on Form 10-Q, as filed with the Securities and Exchange Commission on May 10, 2004)
10.13	First Promissory Note, dated July 1, 2002, between Digimarc Corporation and Indraneel Paul (incorporated by reference to Exhibit 10.16 to the Registrant s Annual Report on Form 10-K, as filed with the Securities and Exchange Commission on March 31, 2003)
10.14	Second Promissory Note, dated July 1, 2002, between Digimarc Corporation and Indraneel Paul (incorporated by reference to Exhibit 10.17 to the Registrant s Annual Report on Form 10-K, as filed with the Securities and Exchange Commission on March 31, 2003)
10.15	Employment Agreement, dated as of July 16, 2001, between the Registrant and Bruce Davis (incorporated by reference to Exhibit 10.1 to the Registrant s Quarterly Report on Form 10-Q, as filed with the Securities and Exchange Commission on May 15, 2003)
10.16	Form of Warrant (incorporated by reference to Exhibit 4.1 to the Registrant s Current Report on Form 8-K, as filed with the Securities and Exchange Commission on August 27, 2003)
10.17	Purchase Agreement by and between the Registrant and each of the purchasers whose names are set forth on the signature pages thereof (incorporated by reference to Exhibit 10.1 to the Registrant s Current Report on Form 8-K, as filed with the Securities and Exchange Commission on August 27, 2003)

Exhibit Number	Document
10.18	Form of Notice of Stock Option Award and Stock Option Award Agreement for employees under the Digimarc Corporation 1999 Stock Incentive Plan (incorporated by reference to Exhibit 99(d)(2) of the Company s Schedule TO, as filed with the Securities and Exchange Commission on February 16, 2001)
10.19	Form of Restricted Stock Agreement for the Digimarc Corporation 1999 Stock Incentive Plan (incorporated by reference to Exhibit 10.1 to the Registrant s Current Report on Form 8-K, as filed with the Securities and Exchange Commission on March 1, 2005)
10.20	Form of Stock Option Award Agreement for the 1999 Non-Employee Director Option Program adopted under the Digimarc Corporation 1999 Stock Incentive Plan (incorporated by reference to Exhibit 10.2 to the Registrant s Current Report on Form 8-K, as filed with the Securities and Exchange Commission on March 1, 2005)
10.21	Forms of Notice of Stock Option Award and Stock Option Award Agreement for officers under the Digimarc Corporation 1999 Stock Incentive Plan*
10.22	Full Service Lease, dated March 22, 2004, by and between PS Business Parks, L.P., and the Registrant*
21.1	List of Subsidiaries (incorporated by reference to Exhibit 21.1 to the Registrant s Annual Report on Form 10-K, as filed with the Securities and Exchange Commission on March 31, 2003)
23.1	Consent of KPMG LLP, Independent Registered Public Accounting Firm
24.1	Power of Attorney*
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*

* Previously filed