AVOCENT CORP
Form 10-Q
May 14, 2001

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U.S. 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 March 30, 2001

or

/ / **Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the period from ______ to ______

Commission file number: 000-30575

AVOCENT CORPORATION

(Exact Name of Registrant as Specified in Its Charter)

Delaware (State or Other Jurisdiction of Incorporation or Organization)	**91-2032368** (I.R.S. Employer Identification Number)
4991 Corporate Drive **Huntsville, Alabama** (Address of Principal Executive Offices)	**35805** (Zip Code)

256-430-4000
(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, as amended, during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes /x/ No / /

As of May 7, 2001, the number of outstanding shares of the Registrant's Common Stock was 44,173,609.

AVOCENT CORPORATION
FORM 10-Q
March 30, 2001

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements

AVOCENT CORPORATION

CONDENSED CONSOLIDATED INCOME STATEMENTS

(In thousands, except per share data)

	For the three months ended	
	March 30, 2001	March 31, 2000
	(unaudited)	(unaudited)
Net sales	$ 73,174	$ 28,244
Cost of sales	37,340	14,591
Gross profit	35,834	13,653
Research and development expenses	5,693	1,451
In-process research and development expenses and other acquisition costs	4,570	
Selling, general and administrative expenses	19,641	4,057
Amortization of intangible assets	33,060	

	For the three months ended	
Total operating expenses	62,964	5,508
Income (loss) from operations	(27,130)	8,145
Other income, net	1,300	917
Income (loss) before income taxes	(25,830)	9,062
Provision for income taxes	2,293	3,061
Net income (loss)	$ (28,123)	$ 6,001
Earnings (loss) per share:		
Basic	$ (0.64)	$ 0.26
Diluted	$ (0.64)	$ 0.25
Weighted average shares used in computing earnings (loss) per share:		
Basic	43,982	22,972
Diluted	43,982	24,492

See notes accompanying these condensed consolidated financial statements.

AVOCENT CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands)

	March 30, 2001	December 31, 2000
ASSETS		
Current assets:		
Cash and cash equivalents	$ 55,904	$ 44,106
Investments maturing within one year	49,806	77,372
Accounts receivable, net	60,163	63,532
Income taxes receivable	5,453	4,487
Other receivables		10,800
Inventories, net	52,316	34,458
Other current assets	3,746	3,029
Deferred tax assets	6,933	5,560
Total current assets	234,321	243,344
Investments	5,826	3,891
Property held for lease, net	2,053	2,102
Property and equipment, net	22,712	16,062

	March 30, 2001	December 31, 2000
Intangible assets, net	548,411	549,910
Other assets	732	580
	$ 814,055	$ 815,889
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 8,674	$ 8,869
Accrued wages and commissions	3,896	3,965
Accrued liabilities	13,263	13,400
Income taxes payable	6,603	1,610
Other accrued expenses	121	123
Total current liabilities	32,557	27,967
Deferred tax liability	31,293	27,742
	63,850	55,709
Stockholders' equity:		
Preferred stock, 5,000 and 1,000 shares authorized, no shares issued and outstanding as of March 30, 2001, and December 31, 2000, respectively		
Common stock, $0.001 par value; 200,000 shares authorized, 44,087 and 43,820 shares issued and outstanding as of March 30, 2001 and December 31, 2000, respectively	44	44
Additional paid-in capital	914,432	898,410
Accumulated other comprehensive loss	(2,808)	(2,881)
Deferred compensation	(30,629)	(32,682)
Retained deficit	(130,834)	(102,711)
Total stockholders' equity	750,205	760,180
	$ 814,055	$ 815,889

See notes accompanying these condensed consolidated financial statements.

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AVOCENT CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

	For the three months ended	
	March 30, 2001	March 31, 2000
	(unaudited)	(unaudited)

	For the three months ended	
Cash flows from operating activities:		
Net income (loss)	$ (28,123)	$ 6,001
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation	1,195	192
Amortization of intangible assets	33,060	
Stock-based compensation	4,806	35
Purchased in-process research and development expenses	4,570	
Net loss on sale of investments	17	
Changes in operating assets and liabilities:		
Accounts receivable, net	6,892	4,180
Other receivables	10,800	
Inventories, net	(14,292)	(3,463)
Other assets	572	(45)
Accounts payable	(2,161)	(2,098)
Accrued compensation	(924)	(473)
Other accrued expenses	(1,361)	(134)
Income taxes, current and deferred	1,293	(2,422)
Total adjustments	44,467	(4,228)
Net cash provided by operating activities	16,344	1,773
Cash flows from investing activities:		
Purchase of Equinox Systems Inc., net of cash and investments	(31,725)	
Purchases of property and equipment	(1,198)	(191)
Purchases of investments	(14,571)	(33,820)
Maturities of investments	20,644	27,147
Proceeds from sales of investments	19,654	
Deferred acquisition costs		(1,338)
Net cash used in investing activities	(7,196)	(8,202)
Cash flows from financing activities:		
Proceeds from issuance of short-term debt	45,000	
Repayment of short-term debt	(45,000)	
Proceeds from employee stock plans	2,691	8,479
Net cash provided by financing activities	2,691	8,479
Effect of exchange rate changes on cash and cash equivalents	(41)	
Net increase in cash and cash equivalents	11,798	2,050
Cash and cash equivalents at beginning of period	44,106	15,786
Cash and cash equivalents at end of period	$ 55,904	$ 17,836

See notes accompanying these condensed consolidated financial statements.

AVOCENT CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited, in thousands)

Note 1. Basis of presentation

Avocent Corporation was formed from the merger of Apex Inc. ("Apex") and Cybex Computer Products Corporation ("Cybex") on July 1, 2000 when both Apex and Cybex merged with wholly owned subsidiaries of Avocent. The merger has been accounted for as a purchase of Cybex by Apex. Avocent's condensed consolidated income statement and condensed consolidated statement of cash flows for the three months ended March 31, 2000 include only Apex's historical results. Avocent's condensed consolidated income statement and condensed consolidated statement of cash flows for the three months ended March 30, 2001 include the results of Apex, Cybex, and Equinox, which was acquired January 3, 2001. Avocent's condensed consolidated balance sheet as of March 30, 2001 includes the consolidated financial position of Apex, Cybex, and Equinox. Avocent's condensed consolidated balance sheet as of December 31, 2000 includes the consolidated financial position of Apex and Cybex. Certain reclassifications have been made to the prior year financial statements to conform to the current year presentation.

The accompanying unaudited condensed consolidated financial statements have been prepared in conformity with generally accepted accounting principles and reflect all adjustments consisting of normal recurring adjustments which, in the opinion of management, are necessary for a fair presentation of the results for the periods shown. The results of operations for these periods are not necessarily indicative of the results expected for the full fiscal year or for any future periods. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates and assumptions.

The accompanying unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and the related notes contained in our Annual Report on Form 10-K for the year ended December 31, 2000, which is on file with the Securities and Exchange Commission.

We report our annual results based on years ending December 31. We report our quarterly results for the first three interim periods based on 13 week periods ending on Fridays and for the fourth interim period ending on December 31.

Our financial statements are consolidated and include the accounts of Avocent and its wholly owned subsidiaries. Significant intercompany transactions and balances have been eliminated in consolidation.

Note 2. Inventories

Inventories consisted of the following at:

	March 30, 2001	December 31, 2000
	(unaudited)	
Raw materials	$ 23,847	$ 10,712
Work-in-process	7,290	7,379
Finished goods	21,179	16,367
	$ 52,316	$ 34,458

Note 3. Stock options and deferred compensation

Deferred compensation We recorded $41,165 of deferred compensation related to Cybex employee stock options at the time of the merger. Additionally, we recorded $2,752 of deferred compensation related to the Equinox employee stock options at the time of the acquisition. The deferred compensation is being amortized over the vesting period of the options for which it was recorded.

Stock option exercises Options to purchase 267 shares of our Common Stock were exercised during the quarter ended March 30, 2001.

Note 4. Accumulated other comprehensive loss

We record unrealized gains and losses on our foreign currency translation adjustments and unrealized holding gains or losses on our available-for-sale securities as accumulated other comprehensive income (loss), which is included as a separate component of stockholders' equity. For the three months ended March 30, 2001, total other comprehensive income amounted to $73. As of March 30, 2001, total accumulated other comprehensive loss was ($2,808).

Note 5. Earnings (loss) per share

	For the three months ended	
	March 30, 2001	**March 31, 2000**
Net income (loss)	$ (28,123)	$ 6,001
Weighted average shares used in computing basic earnings (loss) per share	43,982	22,972
Dilutive effect of employee stock options after application of the treasury method		1,520
Weighted average shares used in computing diluted earnings (loss) per share	43,982	24,492

Note 6. Segment Reporting

Our reportable segments are based on our method of internal reporting which is disaggregated operationally. Our three reportable segments, Redmond, Washington, Huntsville, Alabama, and Shannon, Ireland, are evaluated based on gross profit. Selling, general, and administrative costs, as well as research and development, interest income/expense, and provision for taxes, are reported on an entity-wide basis only. The Huntsville and Shannon locations were previously Cybex entities; therefore, the segment reporting presented below includes only financial data for the three months ended March 30, 2001 for these locations.

The accounting policies of the segments are the same as those described in the Summary of Significant Accounting Policies included in our Annual Report to the extent such policies affect the

reported segment information. The operational distributions of our revenues and gross margin for our reportable segments for the three months ended March 30, 2001 and March 31, 2000 are as follows:

	For the three months ended	
	March 30, 2001	**March 31, 2000**
	(unaudited)	**(unaudited)**
Net sales:		
Redmond	$ 20,494	$ 28,244
Huntsville	38,266	
Shannon	17,970	
Less inter-segment	(3,556)	

	For the three months ended	
	$ 73,174	$ 28,244

	For the three months ended	
	March 30, 2001	March 31, 2000
	(unaudited)	(unaudited)
Gross profit:		
Redmond	$ 7,917	$ 13,653
Huntsville	19,516	
Shannon	8,465	
Less inter-segment	(64)	
	$ 35,834	$ 13,653

The operational distribution of our identifiable assets as of March 30, 2001 and December 31, 2000 is as follows:

	March 30, 2001	December 31, 2000
	(unaudited)	
Assets		
Redmond	$ 134,503	$ 161,545
Huntsville	668,592	646,752
Shannon	34,243	33,594
Total identifiable assets	837,338	841,891
Eliminations	(23,283)	(26,002)
Total assets	$ 814,055	$ 815,889

Note 7. Acquisition of Equinox Systems Inc.

On January 3, 2001, we acquired Equinox Systems Inc. ("Equinox") for cash equal to $9.75 for each outstanding share of Equinox capital stock. Equinox, headquartered in Sunrise, Florida, makes products that provide communications port management and remote control capabilities. The products

are distributed through a two-tier distribution channel, a network of value added resellers and original equipment manufacturers.

The acquisition was recorded under the purchase method of accounting, and the purchase price was allocated based on the fair value of the assets acquired and liabilities assumed. In accordance with generally accepted accounting principles, costs allocated to research and development assets with alternative future uses were capitalized and the remaining amounts of purchased in-process research and development were expensed upon the closing of the transaction. A summary of the total purchase consideration is as follows:

Cash paid for outstanding shares	$ 55,607
Outstanding options	10,579

Assumed liabilities and acquisition costs		4,456
Total purchase consideration	$	70,642

The purchase consideration was allocated to the estimated fair values of the assets acquired and liabilities assumed, as follows:

		Purchase Price Allocation	Amortization Life
Tangible assets	$	40,476	
Patents and trademarks		1,680	7 years
In-process research and development		4,570	
Developed technology		6,250	5 years
Assembled workforce		1,800	3 years
Customer base and certification		2,500	3 - 6 years
Deferred tax liability on intangible assets acquired		(5,962)	
Goodwill		19,328	5 years
Total purchase price allocation	$	70,642	

The acquisition was funded through available cash and the issuance of short-term debt. We borrowed a total of $45,000 at the stated rate of 30-day LIBOR plus 1.75% (8.31% at January 31, 2001). All borrowings were repaid during the quarter ended March 30, 2001. On the closing of the Equinox transaction, we acquired $24,295 in cash and short-term investments held by Equinox.

Pro Forma Financial Information The following unaudited pro forma summary combines the results of operations of Apex and Cybex as if the merger had occurred on January 1, 2000 and includes the results of operations of Equinox as if the acquisition had occurred on January 1, 2000. Certain adjustments have been made to reflect the impact of the purchase transaction. These pro forma results have been prepared for comparative purposes only and do not purport to be indicative of what would

have occurred had the acquisition been made at the beginning of the respective years, or of results which may occur in the future.

	Three Months Ended (Unaudited)			
	March 30, 2001		March 31, 2000	
Net sales	$	73,174	$	65,554
Net loss	$	(23,685)	$	(135,065)
Loss per share	$	(0.54)	$	(3.20)

Note 8. Recently Issued Accounting Standards

In June 1999, the Financial Accounting Standards Board issued SFAS No. 137, (subsequently amended by SFAS No. 138) *Accounting for Derivative Instruments and Hedging Activities Deferral of the Effective Date of SFAS No. 133*, which deferred the effective date provisions of SFAS No. 133 for us until the first quarter of 2001. These statements require all derivatives to be measured at fair value and recognized as either assets or liabilities on the balance sheet. Changes in such fair value are required to be recognized immediately in net income (loss) to the extent the derivatives are not effective as hedges. The impact of SFAS No. 133 on the financial statements was not material for the first quarter of 2001.

The Company uses forward contracts to reduce its foreign currency exposure related to the net cash flows from its European operations. The majority of these contracts are short-term contracts (three months or less) and are marked-to-market each quarter and included in trade payables, with the offsetting gain or loss included in other revenues in the accompanying statements of operations. At March 30, 2001, we had two open forward contracts, all maturing in the second quarter of 2001, to purchase $2,200 in foreign currency. The fair value of the contracts at

March 30, 2001 was approximately $2,200.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

THE INFORMATION IN THIS ITEM 2 "MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS" CONTAINS FORWARD-LOOKING STATEMENTS, INCLUDING, WITHOUT LIMITATION, STATEMENTS RELATING TO OUR REVENUES, EXPENSES, MARGINS, LIQUIDITY, INVENTORY, CAPITAL NEEDS, MERGER ACCOUNTING, ACQUISITION AND TRANSACTION COSTS AND ADJUSTMENTS INCLUDING, AMONG OTHER THINGS, WRITE OFF OF IN-PROCESS RESEARCH AND DEVELOPMENT COSTS AND AMORTIZATION OF INTANGIBLE ASSETS. THESE FORWARD-LOOKING STATEMENTS ARE SUBJECT TO CERTAIN RISKS AND UNCERTAINTIES THAT COULD CAUSE ACTUAL RESULTS TO DIFFER MATERIALLY FROM THOSE ANTICIPATED IN THE FORWARD-LOOKING STATEMENTS. FACTORS THAT MIGHT CAUSE SUCH A DIFFERENCE INCLUDE, BUT ARE NOT LIMITED TO, THOSE DISCUSSED IN OUR ANNUAL REPORT ON FORM 10-K, WHICH WAS FILED WITH THE SECURITIES AND EXCHANGE COMMISSION ON MARCH 27, 2001.

Formation of Avocent by Merger of Apex and Cybex

In March 2000, Apex and Cybex entered into a definitive agreement under which they agreed to combine the two companies in a merger resulting in a new company, Avocent Corporation (formerly known as Aegean Sea Inc.). On March 31, 2000, Avocent filed a registration statement on Form S-4, which was declared effective by the Securities and Exchange Commission on June 2, 2000. Apex and Cybex received final approval of the merger by their respective shareholders on June 30, 2000. The merger was effective as of July 1, 2000. Prior to the effective date of the merger, Avocent did not conduct any activities. Avocent is on a calendar year basis with December 31 as its year-end.

The merger has been accounted for as a purchase of Cybex by Apex in accordance with Accounting Principles Board Opinion No. 16, with the purchase price allocated to the assets and liabilities of Cybex based upon their fair values on the date of the transaction. The excess of the purchase price over the fair value of the assets and liabilities has been allocated to the identifiable intangible assets and goodwill. Additionally, $94 million of the purchase price was expensed as in-process research and development upon the completion of the merger. The purchase price allocation was as follows: $111 million of tangible assets, $90 million of identifiable intangible assets, $34 million of deferred tax liability on intangible assets acquired, $522 million of goodwill, $94 million of in-process research and development, and $29 million of assumed liabilities and acquisition costs. The amortization periods are 3 to 7 years for identifiable intangibles and 5 years for goodwill.

Avocent's condensed consolidated income statement and condensed consolidated statement of cash flows for the three months ended March 31, 2000 include only Apex's historical results. Avocent's condensed consolidated income statement and condensed consolidated statement of cash flows for the three months ended March 30, 2001, include the results of Apex, Cybex, and Equinox, acquired January 3, 2001. Avocent's condensed consolidated balance sheet as of March 30, 2001 includes the consolidated financial position of Apex, Cybex, and Equinox. Avocent's condensed consolidated balance sheet as of December 31, 2000 includes the consolidated financial position of Apex and Cybex. Certain reclassifications have been made to the prior year financial statements to conform to the current year presentation.

Apex and Cybex History

Apex operated as a division of Apex Computer Company through January 1993, providing computer maintenance services to Microsoft and selling integrated server cabinets and, to a limited extent, stand-alone switching systems, primarily to Microsoft. In February 1993, the assets of that division were spun off as a dividend to the sole shareholder of Apex Computer Company, who

contributed those assets as Apex's initial capital. Throughout 1993, Apex derived revenue primarily from the provision of computer maintenance services to Microsoft. In May 1994, Apex began selling stand-alone switching systems to Compaq for integration into server cabinets. In June 1994, Apex discontinued its computer maintenance service business and decided to concentrate on sales of stand-alone switching products.

Cybex engaged in the development of software and performed engineering consulting from 1981 to 1984 to finance its research and development efforts for computer-related products. In 1986, Cybex shipped its first computer-related hardware product. In 1987, Cybex shipped its first product that allowed the computer to be extended distances from the keyboard, monitor, and mouse. Subsequently in 1989, Cybex shipped its first stand-alone switching system. Through the effective date of the merger, Cybex derived primarily all of its revenues from switching, extension, and remote access products.

Overview

We design, manufacture, and sell console switching systems, digital connectivity solutions, serial connectivity devices, and extension and remote access products for the computer industry. Data center managers and network administrators have increasingly complex and growing server populations, and our analog, digital, and serial switching solutions and our extension and remote access products help network administrators manage multiple servers from a console containing a single keyboard, video monitor, and mouse, from extended distances or from remote locations. Specifically, our products can provide significant cost reductions including lower initial investment, reduced utility costs, and space savings, as well as more efficient technical support capabilities.

We provide comprehensive "plug and play" switching systems for many network administration, management, and storage problems faced by corporate customers, data centers, and server farms. Our switching solutions include products sold under the Avocent, Apex, Cybex, and Equinox brands including our *AutoView* , *DS1800* , *OutLook®, ViewPoint®,* and *XP®4000 Series* products. Our switching products help facilities managers and network administrators access multiple servers from one or more centralized or remote consoles, consolidate hardware requirements, and provide direct hardwired connections between the switch and the attached servers to facilitate access to those servers, even when the network is down.

A substantial portion of our revenue is derived from sales to a limited number of original equipment server manufacturers, or OEMs, who purchase our switching systems on a private-label or branded basis for integration and sale with the their own products, sales through our reseller and distributor network, and sales to a limited amount of direct customers. We do not have contracts with many of these customers, and in general, they are obligated to purchase products from us only pursuant to binding purchase orders. For the three months ended March 30, 2001, sales to our OEM customers, our reseller and distributor network, and our direct sales were approximately 38%, 57% and 5%, respectively, of our net sales.

With recent industry-wide initiatives to reduce all channel inventories and to shorten lead times, trends with our major customers are, generally, to reduce the number of weeks of forward-committed firm orders. This factor is currently affecting our business with certain OEMs and other server manufacturers, and we believe that it will continue to make our sales more difficult to predict and inventory levels more difficult to manage.

We are currently experiencing increased price competition in the market for all of our products, and we expect that pricing pressures will continue to increase in the future.

Our executive officers have vested in significant amounts of options to purchase shares of our Common Stock and continue to vest in additional shares on a regular (sometimes monthly) basis.

These officers have informed us that they have sold and may sell additional shares of our Common Stock on a regular basis to provide liquidity and diversify their portfolios.

Acquisition of Equinox

On January 3, 2001, we acquired Equinox Systems Inc. ("Equinox") for cash equal to $9.75 for each outstanding share of Equinox capital stock. Equinox, headquartered in Sunrise, Florida, makes products that provide communications port management and remote control capabilities. The products are distributed through a two-tier distribution channel, a network of value added resellers and original equipment manufacturers.

The acquisition was recorded under the purchase method of accounting, and the purchase price was allocated based on the fair value of the assets acquired and liabilities assumed. In accordance with generally accepted accounting principles, costs allocated to research and development assets with alternative future uses were capitalized and the remaining amounts of purchased in-process research and development were expensed upon the closing of the transaction. The purchase price allocation was as follows: $40.5 million of tangible assets, $12.2 million of identifiable intangible assets, $6.0 million of deferred tax liability on intangible assets acquired, $19.3 million of goodwill, and $4.6 million of in-process research and development. The amortization periods are 3 to 7 years for identifiable intangibles and 5 years for goodwill.

Results of Operations

The following table sets forth, for the periods indicated, selected statement of operations data expressed as a percentage of net sales:

	Three Months Ended			
	March 30, 2001	March 31, 2000		
Net sales	100.0%	100.0%		
Cost of sales	51.0	51.7		
Gross profit	49.0	48.3		
Operating expenses:				
Research and development expenses	7.8	5.1		
In-process research and development expenses and other acquisition costs	6.2			
Selling, general and administrative expenses	26.8	14.4		
Amortization of intangible assets	45.2			
Total operating expenses	86.0	19.5		
Income (loss) from operations	(37.0)	28.8		
Other income, net	1.8	3.2		
Income (loss) before income taxes	(35.2)	32.0		
Provision for income taxes	3.1	Customer advances	97	88
Total deferred revenue, current and customer advances	$ 5,883	$ 5,125		

7. LONG-TERM DEFERRED REVENUE

On March 31, 2009, long-term deferred revenue was $17.7 million and included approximately $16.3 million of deferred revenue from Sony Computer Entertainment. On December 31, 2008, long-term deferred revenue was $16.9 million and included approximately $15.4 million from Sony Computer Entertainment.

8. STOCK-BASED COMPENSATION

Stock Options and Awards

The Company s equity incentive program is a long-term retention program that is intended to attract, retain, and provide incentives for talented employees, consultants, officers, and directors and to align stockholder and employee interests. The Company may grant options, stock appreciation rights, restricted stock, restricted stock units (RSU s), performance shares, performance units, and other stock-based or cash-based awards to employees, directors, and consultants. Under these programs, stock options may be granted at prices not less than the fair market value on the date of grant for stock options. These options generally vest over 4 years. RSU s generally vest over 3 years and expire 10 years from the date of grant. Restricted stock generally vests over one year. On March 31, 2009, 3,305,612 shares of common stock were available for grant, and there were 7,325,914 options to purchase shares of common stock outstanding, as well as 287,787 RSU s and restricted stock outstanding.

General Stock Option Information

The following table sets forth the summary of option activity under the Company s stock option plans:

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	Number of Shares
Outstanding at December 31, 2008 (4,055,180 exercisable at a weighted average price of $9.35 per share)	7,009,667
Granted (weighted average fair value of $2.09 per share)	1,195,433
Exercised	(25,307)
Forfeited and Cancelled	(853,879)
Outstanding at March 31, 2009	7,325,914
Exercisable at March 31, 2009	3,980,188

Restricted Stock Units

Restricted stock unit activity for the three months ended March 31, 2009 is as follows:

	Number
Beginning balance at December 31, 2008	34,500
Awarded	246,287
Released	(4,000)
Forfeited	(16,000)
Ending Balance at March 31, 2009	260,787
Expected to Vest (1)	171,362

(1) RSU s expected to vest reflect estimated forfeiture rates.

The aggregate intrinsic value is calculated as the market value of the RSU s as of March 31, 2009.

Restricted Stock

Restricted stock activity for the three months ended March 31, 2009 is as follows:

	Number of Shares	Aggregate Intrinsic Value
Beginning balance at December 31, 2008		
Awarded	27,000	
Released		
Forfeited		
Ending Balance at March 31, 2009	27,000	$ 79,110

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The aggregate intrinsic value is calculated as the market value of the Restricted Stock as of March 31, 2009.

The assumptions used to value option grants and shares under the ESPP are as follows:

	Options		Employee Stock Purchase Plan	
	Three Months Ended March 31,		Three Months Ended March 31,	
	2009	2008	2009	2008
Expected life (in years)	5.5	5.5	0.5	0.5
Interest rate	1.8%	2.5%	0.4%	2.2%
Volatility	69%	62%	109%	73%
Dividend yield				

Total stock-based compensation recognized in the condensed consolidated statements of operations is as follows:

	Three Months Ended March 31,	
	2009	2008
Income Statement Classifications	(In thousands)	
Cost of product sales	$ 62	$ 20
Sales and marketing	117	229
Research and development	448	286
General and administrative	614	409
Total	$ 1,241	$ 944

As of March 31, 2009, there was $13.1 million of unrecognized compensation cost, adjusted for estimated forfeitures, related to non-vested stock options, restricted stock and RSU s granted to the Company s employees and directors. This cost will be recognized over an estimated weighted-average period of approximately 3.3 years for options, 0.93 years for restricted stock and 2.88 years for RSU s. Total unrecognized compensation cost will be adjusted for future changes in estimated forfeitures.

Stock Repurchase Program

On November 1, 2007, the Company announced that its board of directors authorized the repurchase of up to $50 million of the Company s common stock. The Company may repurchase its stock for cash in the open market in accordance with applicable securities laws. The timing of and amount of any stock repurchase will depend on share price, corporate and regulatory requirements, economic and market conditions, and other factors. The stock repurchase authorization has no expiration date, does not require the Company to repurchase a specific number of shares, and may be modified, suspended, or discontinued at any time. During the three months ended March 31, 2009, there were no stock repurchases under this program.

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9. RESTRUCTURING COSTS AND DISCONTINUED OPERATIONS

The Company accounts for restructuring costs and discontinued operations in accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets and SFAS No. 146, Accounting for Costs Associated with Exit of Disposal Activities. The following table sets forth the charges and expenses that are included in the restructuring line on the Company s condensed consolidated Statement of Operations for the three months ended March 31, 2009:

	December 31, 2008	Quarter Ended March 31,			March 31, 2009
	Restructuring Reserve	Add Charges	Deduct Cash Payments	Non-Cash Expenses	Restructuring Reserve
	($ in thousands)				
Medical workforce reductions	$	166			$ 166
Touch workforce reductions	247	481	317	(1)	410
Other	15		3		12
Total	$ 262	$ 647	$ 320	$ (1)	$ 588

On March 2, 2009, the Company announced that it was relocating its Medical business operations from Gaithersburg, Maryland to San Jose, California. The Company had workforce reductions that were recorded as Medical segment restructuring charges for the three months ended March 31, 2009. Workforce reduction costs consisting of severance benefits of $166,000 are included in accrued compensation on the Company s condensed consolidated balance sheet. In addition, the Company expects to record approximately $200,000 of workforce reduction costs relating to the remaining service period of these Medical division employees for the three months ended June 30, 2009, bringing the cumulative total to $366,000. All of the severance benefits are expected to be paid in the second or third quarter of 2009 with the exception of certain COBRA costs that will be paid by the end of 2009. The Company will also incur costs in the remainder of 2009 for temporary housing, the closing down of the Gaithersburg, Maryland facility, and the movement of operations to the San Jose facility.

On November 17, 2008, the Company announced that it would divest its 3D product line which was part of its Touch segment. The Company s 3D product line consisted of a variety of products in the area of 3D digitizing, 3D measurement and inspection, and 3D interaction and included products such as MicroScribe digitizers, the CyberGlove family of products, and a SoftMouse 3D positioning device. In the three months ended March 31, 2009, the company sold its CyberGlove and SoftMouse 3D positioning device product families including inventory, fixed assets, and intangibles and has recorded a gain on sale of discontinued operations of $167,000. Negotiated consideration received for the sales was $900,000 in the form of cash and notes receivable and the proceeds are being recognized when they are received. The Company has abandoned all other 3D operations. Accordingly, the operations of the 3D product line have been classified as discontinued operations, net of income tax, in the condensed consolidated statement of operations. Revenues included in discontinued operations of the 3D product line were $531,000 and $1.2 million for the three months ended March 31, 2009 and March 31, 2008, respectively. The assets sold consisted primarily of intangibles that had no carrying value on the Company s books at the time of sale.

In addition, for the first three months of 2009, there were reorganizations in the Company s Touch segment due to business changes causing workforce reductions that have been recorded as accrued compensation in the company s condensed consolidated balance sheet and restructuring charges in the statement of operations for the three months ended March 31, 2009.

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10. INTEREST INCOME

The Company has accounted for payments from Sony Computer Inc. due under a license entered in with them in 2007 in accordance with APB No. 21. Under APB No. 21, the Company determined the present value of $22.5 million of payments from them due over the three years ended December 31, 2009 to equal $20.2 million. The Company is accounting for the difference of $2.3 million as interest income which is being recognized in the income statement as each quarterly payment installment becomes due.

11. INCOME TAXES

For the three months ended March 31, 2009, the Company recorded an income tax expense of $91,000 on a pre-tax loss from continuing operations of $7.8 million, yielding an effective tax rate of 1.2%. For the three months ended March 31, 2008, the Company recorded an income tax benefit of $1.2 million on a pre-tax loss from continuing operations of $4.1 million, yielding an effective tax rate of (29.3)%. The effective tax rate differs from the statutory rate primarily due to certain permanent items and foreign withholding taxes. The income tax provision or benefit for the three months ended March 31, 2009 and 2008, are as a result of applying the estimated annual effective tax rate to loss from continuing operations before taxes, adjusted for certain discrete items which are fully recognized in the period they occur.

The Company adopted FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109, (FIN 48), regarding accounting for uncertain tax benefits, on January 1, 2007. As of March 31, 2009, the Company has unrecognized tax benefits of approximately $647,000, including interest of $20,000. The total amount of unrecognized tax benefits that would affect the Company s effective tax rate, if recognized, is $219,000. There were no material changes in the amount of unrecognized tax benefits during the quarter ended March 31, 2009. The Company does not expect any material changes to its liability for unrecognized tax benefits during the next twelve months. The Company s policy is to account for interest and penalties related to uncertain tax positions as a component of income tax provision.

Because the Company has net operating loss and credit carryforwards, there are open statutes of limitations in which federal, state, and foreign taxing authorities may examine the Company s tax returns for all years from 1993 through the current period.

During 2008, the Company recorded a valuation allowance for the entire deferred tax asset as a result of uncertainties regarding the realization of the asset balance due to losses in fiscal 2008, the variability of operating results, and near term projected results. In the event that the Company determines the deferred tax assets are realizable, an adjustment to the valuation allowance may increase income in the period such determination is made. The valuation allowance does not impact the Company s ability to utilize the underlying net operating loss carryforwards.

The net tax benefits from employee stock option transactions were approximately $0 and $108,000 during the three months ended March 31, 2009 and March 31, 2008, respectively, and are reflected as an increase to additional paid-in capital. The Company includes only the direct tax effects of employee stock incentive plans in calculating this increase to additional paid-in capital.

12. NET INCOME (LOSS) PER SHARE

The following is a reconciliation of the numerators and denominators used in computing basic and diluted net income (loss) per share (in thousands, except per share amounts):

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	Three Months Ended March 31	
	2009	**2008**
Numerator:		
Loss from continuing operations	$ (7,861)	$ (2,907)
Gains from discontinued operations	402	322
Net loss	$ (7,459)	$ (2,585)
Denominator:		
Shares used in computation, basic and diluted (weighted average common shares outstanding)	27,924	30,478
Basic and diluted net loss per share:		
Continuing operations	$ (0.28)	$ (0.09)
Discontinued operations	0.01	0.01
Total	$ (0.27)	$ (0.08)

As of March 31, 2009 and 2008, the Company had securities outstanding that could potentially dilute basic earnings per share in the future, but these were excluded from the computation of diluted net loss per share in the periods presented since their effect would have been anti-dilutive. These outstanding securities consisted of the following:

	March 31, 2009	March 31, 2008
Outstanding stock options	7,325,914	6,840,918
Restricted Stock and RSU s	287,787	
Warrants	431,243	436,772

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13. COMPREHENSIVE INCOME (LOSS)

The following table sets forth the components of comprehensive income (loss):

	Three Months Ended March 31,	
	2009	2008
	(In thousands)	
Net income (loss)	$ (7,459)	$ (2,585)
Change in unrealized losses on short-term investments	(2)	(7)
Foreign currency translation adjustment	(67)	(12)
Total comprehensive income (loss)	$ (7,528)	$ (2,604)

14. SEGMENT REPORTING, GEOGRAPHIC INFORMATION, AND SIGNIFICANT CUSTOMERS

The Company develops, manufactures, licenses, and supports a wide range of hardware and software technologies that more fully engage users sense of touch when operating digital devices. The Company focuses on the following target application areas: automotive, consumer electronics, entertainment, gaming, and commercial and industrial controls; medical simulation; mobile communications; and three-dimensional design and interaction. The Company manages these application areas under two operating and reportable segments: 1) Touch (previously called Immersion Computing, Entertainment, and Industrial), and 2) Medical. The Company determines its reportable segments in accordance with criteria outlined in SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information.

The Company s chief operating decision maker (CODM) is the Chief Executive Officer. The CODM allocates resources to and assesses the performance of each operating segment using information about its revenue and operating profit before interest and taxes. A description of the types of products and services provided by each operating segment is as follows:

Touch develops and markets touch feedback technologies that enable software and hardware developers to enhance realism and usability in their mobility, computing, entertainment, and industrial applications. Medical develops, manufactures, and markets medical training simulators that recreate realistic healthcare environments.

The following tables display information about the Company s reportable segments:

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	Three Months Ended March 31 2009	2008
	(In thousands)	
Revenues:		
Touch	$ 4,475	$ 3,962
Medical	2,538	3,008
Intersegment eliminations	(35)	(41)
Total	$ 6,978	$ 6,929
Net Income (Loss):		
Touch	$ (4,300)	$ (1,410)
Medical	(3,158)	(1,158)
Intersegment eliminations	(1)	(17)
Total	$ (7,459)	$ (2,585)

	March 31, 2009	December 31, 2008
	(In thousands)	
Total Assets:		
Touch	$ 129,079	$ 129,674
Medical	9,223	10,706
Intersegment eliminations	(31,004)	(27,189)
Total	$ 107,298	$ 113,191

15. CONTINGENCIES

In re Immersion Corporation

The Company is involved in legal proceedings relating to a class action lawsuit filed on November 9, 2001 in the U. S. District Court for the Southern District of New York, *In re Immersion Corporation Initial Public Offering Securities Litigation*, No. Civ. 01-9975 (S.D.N.Y.), related to In re Initial Public Offering Securities Litigation, No. 21 MC 92 (S.D.N.Y.). The named defendants are the Company and three of its current or former officers or directors (the Immersion Defendants), and certain underwriters of its November 12, 1999 initial public offering (IPO). Subsequently, two of the individual defendants stipulated to a dismissal without prejudice.

The operative amended complaint is brought on purported behalf of all persons who purchased the Company s common stock from the date of the Company s IPO through December 6, 2000. It alleges liability under Sections 11 and 15 of the Securities Act of 1933 and Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, on the grounds that the registration statement for the IPO did not disclose that: (1) the underwriters agreed to allow certain customers to purchase shares in the IPO in exchange for

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excess commissions to be paid to the underwriters; and (2) the underwriters arranged for certain customers to purchase additional shares in the aftermarket at predetermined prices. The complaint also appears to allege that false or misleading analyst reports were issued. The complaint does not claim any specific amount of damages.

Similar allegations were made in other lawsuits challenging over 300 other initial public offerings and follow-on offerings conducted in 1999 and 2000. The cases were consolidated for pretrial purposes. On February 19, 2003, the District Court ruled on all defendants motions to dismiss. The motion was denied as to claims under the Securities Act of 1933 in the case involving Immersion as well as in all other cases (except for 10 cases). The motion was denied as to the claim under Section 10(b) as to the Company, on the basis that the complaint alleged that the Company had made acquisition(s) following the IPO. The motion was granted as to the claim under Section 10(b), but denied as to the claim under Section 20(a), as to the remaining individual defendant.

In September 2008, all of the parties to the lawsuits reached a settlement, subject to documentation and approval of the District Court. The Immersion Defendants would not be required to contribute to the settlement. Subsequently, an underwriter defendant filed for bankruptcy and other underwriter defendants were acquired. On April 2, 2009, final documentation evidencing the settlement was presented to the District Court for approval. If the settlement is not approved by the District Court, the Company intends to defend the lawsuit vigorously.

Other Contingencies

From time to time, the Company receives claims from third parties asserting that the Company s technologies, or those of its licensees, infringe on the other parties intellectual property rights. Management believes that these claims are without merit. Additionally, periodically, the Company is involved in routine legal matters and contractual disputes incidental to its normal operations. In management s opinion, the resolution of such matters will not have a material adverse effect on the Company s consolidated financial condition, results of operations, or liquidity.

In the normal course of business, the Company provides indemnifications of varying scope to customers against claims of intellectual property infringement made by third parties arising from the use of the Company s intellectual property, technology, or products. Historically, costs related to these guarantees have not been significant, and the Company is unable to estimate the maximum potential impact of these guarantees on its future results of operations.

As permitted under Delaware law, the Company has agreements whereby it indemnifies its officers and directors for certain events or occurrences while the officer or director is, or was, serving at its request in such capacity. The term of the indemnification period is for the officer s or director s lifetime. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited; however, the Company currently has director and officer insurance coverage that limits its exposure and enables it to recover a portion of any future amounts paid. Management believes the estimated fair value of these indemnification agreements in excess of applicable insurance coverage is indeterminable.

ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This Quarterly Report on Form 10-Q includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. The forward-looking statements involve risks and uncertainties. Forward-looking statements are identified by words such as anticipates, believes, expects, intends, may, will, and other similar expressions. However, these words are only way we identify forward-looking statements. In addition, any statements, which refer to expectations, projections, or other characterizations

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of future events, or circumstances, are forward-looking statements. Actual results could differ materially from those projected in the forward-looking statements as a result of a number of factors, including those set forth below in Management s Discussion and Analysis of Financial Condition and Results of Operations and Risk Factors, those described elsewhere in this report, and those described in our other reports filed with the SEC. We caution you not to place undue reliance on these forward-looking statements, which speak only as of the date of this report, and we undertake no obligation to update these forward-looking statements after the filing of this report. You are urged to review carefully and consider our various disclosures in this report and in our other reports publicly disclosed or filed with the SEC that attempt to advise you of the risks and factors that may affect our business.

OVERVIEW

We are a leading provider of haptic technologies that allow people to use their sense of touch more fully when operating a wide variety of digital devices. To achieve this heightened interactivity, we develop and manufacture or license a wide range of hardware and software technologies and products. While we believe that our technologies are broadly applicable, we are currently focusing our marketing and business development activities on the following target application areas: automotive, consumer electronics, entertainment, gaming, and commercial and industrial controls; medical simulation; and mobile communications. We manage these application areas under two operating and reportable segments: 1) Touch and 2) Medical.

In some markets, such as video console gaming, mobile phones, and automotive controls, we license our technologies to manufacturers who use them in products sold under their own brand names. In other markets, such as medical simulation we sell products manufactured under our own brand name through direct sales to end users, distributors, OEMs, or value-added resellers. From time to time, we also engage in development projects for third parties. In the three months ended March 31, 2009, the Company divested its 3D product line which was part of its Touch segment. It ceased operations of the 3D product line and sold its CyberGlove and SoftMouse 3D positioning device product families. The Company has abandoned all other 3D operations.

Our objective is to drive adoption of our touch technologies across markets and applications to improve the user experience with digital devices and systems. We and our wholly owned subsidiaries hold over 700 issued or pending patents in the U.S. and other countries, covering various aspects of hardware and software technologies.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Our discussion and analysis of our financial condition and results of operations are based upon our condensed consolidated financial statements, which have been prepared in accordance with GAAP. The preparation of these condensed consolidated financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, expenses, and related disclosure of contingent assets and liabilities. On an ongoing basis, we evaluate our estimates and assumptions, including those related to revenue recognition, stock-based compensation, bad debts, inventory reserves, short-term investments, warranty obligations, patents and intangible assets, contingencies, and litigation. We base our estimates and assumptions on historical experience and on various other factors that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates and assumptions.

We believe the following are our most critical accounting policies as they require our significant judgments and estimates in the preparation of our condensed consolidated financial statements:

Revenue Recognition

We recognize revenues in accordance with applicable accounting standards, including SAB No. 104, EITF No. 00-21, SOP No. 81-1 and SOP No. 97-2. Revenue is recognized when persuasive evidence of an arrangement exists, delivery has occurred or service has been rendered, the fee is fixed and determinable,

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and collectability is probable. We derive our revenues from three principal sources: royalty and license fees, product sales, and development contracts.

Royalty and license revenue We recognize royalty and license revenue based on royalty reports or related information received from the licensee as well as time-based licenses of our intellectual property portfolio. Up-front payments under license agreements are deferred and recognized as revenue either based on the royalty reports received or amortized over the license period depending on the nature of the agreement. Advance payments under license agreements that also require us to provide future services to the licensee are generally deferred and recognized over the service period when VSOE related to the value of the services does not exist. These services are not essential to the functionality of the license agreement.

We generally recognize revenue from our licensees under one or a combination of the following license models:

License revenue model	Revenue recognition
Perpetual license of intellectual property portfolio based on per unit royalties, no services contracted.	Based on royalty reports received from licensees. No further obligations to licensee exist.
Time-based license of intellectual property portfolio with up-front payments and/or annual minimum royalty requirements, no services contracted. Licensees have certain rights to updates to the intellectual property portfolio during the contract period.	Based on straight-line amortization of annual minimum/up-front payment recognized over contract period or annual minimum period.
Perpetual license of intellectual property portfolio or technology license along with contract for development work.	Based on proportional performance method over the service period or completed performance method.
License of software or technology, no modification necessary, no services contracted.	Up-front revenue recognition based on SOP No. 97-2 criteria or SAB No. 104, as applicable.

Individual contracts may have characteristics that do not fall within a specific license model or may have characteristics of a combination of license models. Under those circumstances, we recognize revenue in accordance with SAB No. 104, EITF No. 00-21, SOP No. 81-1, and SOP No. 97-2, as amended, to guide the accounting treatment for each individual contract. See also the discussions regarding Multiple element arrangements below. If the information received from our licensees regarding royalties is incorrect or inaccurate, our revenues in future periods may be adversely affected. To date, none of the information we have received from our licensees has caused any material reduction in future period revenues.

Product sales We recognize revenues from product sales when the product is shipped, provided the other revenue recognition criteria are met, including that collection is determined to be probable and no significant obligation remains. We sell our products with warranties ranging from three to sixty months. We record the estimated warranty costs during the quarter the revenue is recognized. Historically, warranty-related costs and related accruals have not been significant. We offer a general right of return on the MicroScribe product line for 14 days after purchase. We recognize revenue at the time of shipment of a

MicroScribe digitizer and provide an accrual for potential returns based on historical experience. We offer no other general right of return on our products.

Development contracts and other revenue Development contracts and other revenue is comprised of professional services (consulting services and/or development contracts), customer support, and extended warranty contracts. Development contract revenues are recognized under the proportional performance accounting method based on physical completion of the work to be performed or completed performance method. Losses on contracts are recognized when determined. Revisions in estimates are reflected in the period in which the conditions become known. Customer support and extended warranty contract revenue is recognized ratably over the contractual period.

Multiple element arrangements We enter into revenue arrangements in which the customer purchases a combination of patent, technology, and/or software licenses, products, professional services, support, and extended warranties (multiple element arrangements). When VSOE of fair value exists for all elements, we allocate revenue to each element based on the relative fair value of each of the elements. If vendor specific objective evidence or other objective evidence of fair value does not exist, the revenue is generally recorded over the term of the contract.

Our revenue recognition policies are significant because our revenues are a key component of our results of operations. In addition, our revenue recognition determines the timing of certain expenses, such as commissions and royalties. Revenue results are difficult to predict, and any shortfall in revenue or delay in recognizing revenue could cause our operating results to vary significantly from quarter to quarter and could result in greater or future operating losses.

Stock-based Compensation

We account for stock-based compensation in accordance with SFAS No. 123R. We accounted for stock-based compensation using the modified-prospective method, under which prior periods are not revised for comparative purposes. Under the fair value recognition provisions of this statement, stock-based compensation cost is measured at the grant date based on the fair value of the award and is recognized as expense on a straight-line basis over the requisite service period, which is the vesting period.

Valuation and amortization method We use the Black-Scholes model, single-option approach to determine the fair value of stock options, and ESPP shares. All share-based payment awards are amortized on a straight-line basis over the requisite service periods of the awards, which are generally the vesting periods. The determination of the fair value of stock-based payment awards on the date of grant using an option-pricing model is affected by our stock price as well as assumptions regarding a number of complex and subjective variables. These variables include actual and projected employee stock option exercise behaviors that impact the expected term and forfeiture rates, our expected stock price volatility over the term of the awards, risk-free interest rate, and expected dividends.

Expected term We estimate the expected term of options granted by calculating the average term from our historical stock option exercise experience. We used the simplified method as prescribed by SAB No. 110 for options granted prior to January 1, 2008.

Expected volatility We estimate the volatility of our common stock taking into consideration our historical stock price movement and our expected future stock price trends based on known or anticipated events.

Risk-free interest rate We base the risk-free interest rate that we use in the option pricing model on U.S. Treasury zero-coupon issues with remaining terms similar to the expected term on the options.

Expected dividend We do not anticipate paying any cash dividends in the foreseeable future and therefore use an expected dividend yield of zero in the option pricing model.

Forfeitures We are required to estimate future forfeitures at the time of grant and revise those estimates in subsequent periods if actual forfeitures differ from those estimates. We record stock-based compensation expense only for those awards that are expected to vest. We estimate our forfeiture rate based on anticipated future trends in pre-vesting options and awards forfeitures and recent historical data.

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If factors change and we employ different assumptions for estimating stock-based compensation expense in future periods, or if we decide to use a different valuation model, the future periods may differ significantly from what we have recorded in the current period and could materially affect our operating results.

The Black-Scholes model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable, characteristics not present in our option grants and ESPP shares. Existing valuation models, including the Black-Scholes and lattice binomial models, may not provide reliable measures of the fair values of our stock-based compensation. Consequently, there is a risk that our estimates of the fair values of our stock-based compensation awards on the grant dates may bear little resemblance to the actual values realized upon the exercise, expiration, early termination, or forfeiture of those stock-based payments in the future. Certain stock-based payments, such as employee stock options, may expire and be worthless or otherwise result in zero intrinsic value as compared to the fair values originally estimated on the grant date and reported in our financial statements. Alternatively, value may be realized from these instruments that are significantly higher than the fair values originally estimated on the grant date and reported in our financial statements. There currently is no market-based mechanism or other practical application to verify the reliability and accuracy of the estimates stemming from these valuation models, nor is there a means to compare and adjust the estimates to actual values.

See Note 8 to the condensed consolidated financial statements for further information regarding the SFAS No. 123R disclosures.

Accounting for Income Taxes

We use the asset and liability method of accounting for income taxes. Under this method, income tax expense is recognized for the amount of taxes payable or refundable for the current year. In addition, deferred tax assets and liabilities are recognized for the expected future tax consequences of temporary differences between the financial reporting and tax bases of assets and liabilities, and for operating losses and tax credit carryforwards. Valuation allowances are established when necessary to reduce deferred tax assets to the amount expected to be realized and are reversed at such time that realization is believed to be more likely than not. Management must make assumptions, judgments, and estimates to determine our current provision for income taxes and also our deferred tax assets and liabilities and any valuation allowance to be recorded against a deferred tax asset.

Our judgments, assumptions, and estimates relative to the current provision for income tax take into account current tax laws, our interpretation of current tax laws, and possible outcomes of current and future audits conducted by foreign and domestic tax authorities. We have established reserves for income taxes to address potential exposures involving tax positions that could be challenged by tax authorities. Although we believe our judgments, assumptions, and estimates are reasonable, changes in tax laws or our interpretation of tax laws and any future tax audits could significantly impact the amounts provided for income taxes in our condensed consolidated financial statements.

Our assumptions, judgments, and estimates relative to the value of a deferred tax asset take into account predictions of the amount and category of future taxable income, such as income from operations or capital gains income. Actual operating results and the underlying amount and category of income in future years could render inaccurate our current assumptions, judgments, and estimates of recoverable net deferred taxes. Any of the assumptions, judgments, and estimates mentioned above could cause our actual income tax obligations to differ from our estimates, thus materially impacting our financial position and results of operations.

Short-term Investments

Our short-term investments consist primarily of highly liquid commercial paper and government agency securities purchased with an original or remaining maturity of greater than 90 days on the date of purchase. We classify all debt securities with readily determinable market values as available-for-sale in accordance with SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities. Even though the stated maturity dates of these debt securities may be one year or more beyond the balance sheet date, we have classified all debt securities as short-term investments in accordance with Accounting

Research Bulletin No. 43, Chapter 3A, Working Capital Current Assets and Current Liabilities, as they are reasonably expected to be realized in cash or sold within one year. These investments are carried at fair market value with unrealized gains and losses considered to be temporary in nature reported as a separate component of other comprehensive income (loss) within stockholders equity.

We follow the guidance provided by FSP 115-1/124-1 and EITF No. 03-01 The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments to assess whether our investments with unrealized loss positions are other than temporarily impaired. Realized gains and losses and declines in value judged to be other than temporary are determined based on the specific identification method and are reported in the condensed consolidated statement of operations. Factors considered in determining whether a loss is temporary include the length of time and extent to which fair value has been less than the cost basis, the financial condition and near-term prospects of the investee, and our intent and ability to hold the investment for a period of time sufficient to allow for any anticipated recovery in market value.

Effective January 1, 2008, we adopted the provisions of SFAS No. 157, which defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements required under other accounting pronouncements. SFAS No. 157 clarifies that fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. SFAS No. 157 also requires that a fair value measurement reflect the assumptions market participants would use in pricing an asset or liability based on the best information available. Assumptions include the risks inherent in a particular valuation technique (such as a pricing model) and/or the risks inherent in the inputs to the model.

SFAS No. 157 establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (level 1 measurements) and the lowest priority to unobservable inputs (level 3 measurements). The three levels of the fair value hierarchy under SFAS No. 157 are described below:

Level 1: Unadjusted quoted prices in active markets that are accessible at the measurement date for identical unrestricted assets or liabilities;

Level 2: Quoted prices in markets that are less active or financial instruments for which all significant inputs are observable, either directly or indirectly;

Level 3: Prices or valuations that require inputs that are both significant to the fair value measurement and unobservable.

A financial instrument s level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement.

In February 2008, the Financial FASB issued FSP No. 157-2 that delays the effective date of SFAS No. 157 for nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually) until fiscal years beginning after November 15, 2008. The delay is intended to allow the FASB and constituents additional time to consider the effect of various implementation issues that have arisen, or that may arise, from the application of SFAS No. 157. We continue to assess the impact that FSP 157-2 may have on our consolidated financial position and results of operations. The Company does not believe that FSP 157-2 will have a material impact on its condensed consolidated financial statements.

Further information about the application of SFAS No. 157 may be found in Note 2 to the condensed consolidated financial statements.

Recovery of Accounts Receivable

We maintain allowances for doubtful accounts for estimated losses resulting from our review and assessment of our customers ability to make required payments. If the financial condition of one or more of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances might be required.

Inventory Reserves

We reduce our inventory value for estimated obsolete and slow moving inventory in an amount equal to the difference between the cost of inventory and the net realizable value based upon assumptions about future demand and market conditions. If actual future demand and market conditions are less favorable than those projected by management, additional inventory write-downs may be required.

Product Return and Warranty Reserves

We provide for estimated costs of future anticipated product returns and warranty obligations based on historical experience when related revenues are recognized, and we defer warranty-related revenue over the related warranty term.

Intangible Assets

We have acquired patents and other intangible assets. In addition, we capitalize the external legal and filing fees associated with patents and trademarks. We assess the recoverability of our intangible assets, and we must make assumptions regarding estimated future cash flows and other factors to determine the fair value of the respective assets that affect our consolidated financial statements. If these estimates or related assumptions change in the future, we may be required to record impairment charges for these assets. We amortize our intangible assets related to patents and trademarks, over their estimated useful lives, generally 10 years. Future changes in the estimated useful life could affect the amount of future period amortization expense that we will incur. During the first three months of 2009, we capitalized costs associated with patents and trademarks of $767,000. Our total amortization expense for the same period for all intangible assets was $376,000.

Restructuring Costs

In connection with our exit activities, we record restructuring charges for employee termination costs and other exit-related costs. These charges are incurred pursuant to formal plans developed by management and accounted for in accordance with SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities . The recognition of restructuring charges requires our management to make judgments and estimates regarding the nature, timing, and amount of costs associated with the planned exit activity, including move related costs and the fair value, less selling costs, of property, plant and equipment to be disposed of. Estimates of future liabilities may change, requiring us to record additional restructuring charges or reduce the amount of liabilities already recorded. At the end of each reporting period, we evaluate the remaining accrued balances to ensure their adequacy, that no excess accruals are retained, and that the utilization of the provisions are for their intended purposes in accordance with developed exit plans. In the event circumstances change and the provision is no longer required, the provision is reversed.

The above listing is not intended to be a comprehensive list of all of our accounting policies. In many cases, the accounting treatment of a particular transaction is specifically dictated by GAAP, with no need for management s judgment in their application. There are also areas in which management s judgment in selecting any available alternative would not produce a materially different result.

RESULTS OF OPERATIONS FOR THE THREE MONTHS ENDED MARCH 31, 2009 AND 2008

The following discussion and analysis includes the Company s results of operations from continuing operations for the three months ended March 2009 and 2008. A separate discussion of the 3D product line under discontinued operations has been presented following our analysis of continuing operations. Accordingly, the sales, gross profit, sales and marketing expense, and income tax provision from our discontinued operations have been aggregated and reported as loss from discontinued operations and are not a component of the aforementioned continuing operations discussion.

Overview

We achieved a 1% increase in revenues from continuing operations during the three months ended March 31, 2009 as compared to the three months ended March 31, 2008. The first three months revenue growth was primarily due to a 9% increase in royalty and license revenues from increased Touch royalty and license fees mainly from customers that sell mobile devices. The revenue increase also included a 3% increase in product sales partially offset by a 44% decrease in development contract revenues. In conjunction with our plan to move our medical operating segment to San Jose and other workforce reductions in our Touch segment, we had restructuring costs relating to workforce reductions of $646,000. We divested our 3D product line and recorded a gain of $235,000 from discontinued operations for the three months ended March 31, 2009 as compared to a gain of $322,000 for the three months ended March 31, 2008. We also had a gain on sale of discontinued operations of $167,000 for the three months ended March 31, 2009. Our net loss was $7.5 million for the three months ended March 31, 2009 compared to a net loss of $2.6 million for the three months ended March 31, 2008.

With our divestiture of the 3D product line, our move of the medical operating segment to San Jose, and other restructuring efforts, we hope to achieve cost reductions in 2009. In 2009, we expect to continue to focus on the execution of plans in our established businesses to seek to increase revenue and make selected investments for product-based solutions for longer-term growth areas. Our success could be limited by several factors, including the current macro-economic climate, the timely release of our new products and our licensees products, continued market acceptance of our products and technology, the introduction of new products by existing or new competitors, and the cost of ongoing litigation. For a further discussion of these and other risk factors, see Part II Item 1A Risk Factors.

REVENUES	**March 31, 2009**	**2008**	**Change**
	($ In thousands)		
Three months ended:			
Royalty and license	$ 3,781	$ 3,461	9%
Product sales	2,751	2,669	3%
Development contracts and other	446	799	(44)%
Total Revenue	$ 6,978	$ 6,929	1%

Three Months Ended March 31, 2009 Compared to Three Months Ended March 31, 2008

Total Revenue Our total revenue from continuing operations for the first three months of 2009 increased by $49,000 or 1% from the first three months of 2008.

Royalty and license revenue Royalty and license revenue is comprised of royalties earned on sales by our TouchSense licensees and license fees charged for our intellectual property portfolio. Royalty and license revenue for the three months ended March 31, 2009 was $3.8 million, an increase of $320,000 or 9% from the three months ended March 31, 2008. The increase in royalty and license revenue was primarily due to an increase in royalty and license revenue from our Touch segment from increased shipments by licensees of mobile devices partially offset by decreased shipments by gaming and automotive licensees. We expect royalty revenue to be a significant component of our revenue as our technology continues to be included in mobile phone handsets and other mobility devices.

Based on our litigation conclusion and new business agreement entered into with Sony Computer Entertainment in March 2007, we are recognizing a minimum of $30.0 million as royalty and license revenue from March 2007 through March 2017, approximately $750,000 per quarter. The revenue from our third-party peripheral licensees included in royalty and license revenue has also generally continued to decline primarily due to i) the reduced sales of past generation video console systems due to the launches of the next-generation console models from Microsoft Xbox 360, Sony PlayStation 3 (PS3), and Nintendo Wii, and ii) the decline in third-party market share of aftermarket game console controllers due to the launch of next-generation peripherals by manufacturers of console systems.

Sony has, to date, not yet broadly licensed third parties to produce peripherals of the PS3 system. To the extent Sony discourages or impedes third-party controller makers from making more PS3 controllers with vibration feedback, our licensing revenue from third-party PS3 peripherals will continue to be severely limited.

For the Microsoft Xbox 360 video console system launched in November 2005, Microsoft has, to date, not broadly licensed third parties to produce game controllers. Because our gaming royalties come mainly from third-party manufacturers, unless Microsoft broadens its licenses to third-party controller makers, particularly with respect to wireless controllers for Xbox 360, our gaming royalty revenue may decline. Additionally, Microsoft is now making touch-enabled wheels covered by its royalty-free, perpetual, irrevocable license to our worldwide portfolio of patents that could compete with our licensees current or future products for which we earn per unit royalties. For the Nintendo Wii video console system launched in December 2006, Nintendo has, to date, not yet broadly licensed third parties to produce game controllers for its Wii game console. Because our gaming royalties come mainly from third-party manufacturers, unless Nintendo broadens its licenses to third-party controller makers, our gaming royalty revenue may decline.

In addition, BMW has begun to remove our technology from certain controller systems, which also caused automotive royalties to decline. We expect that this removal of our technology from certain controller systems will cause our automotive royalty revenue to decline in the future, which may be partially offset by new vehicles from other manufacturers brought to market.

Product sales Product sales for the three months ended March 31, 2009 were $2.8 million, an increase of $82,000 or 3% as compared to the three months ended March 31, 2008. The increase in product sales was primarily due to an increase in medical product sales. Increased medical product sales was mainly due to increased sales of our endovascular and laparoscopy simulators. This increase in product sales was a result of pursuing a product growth strategy for our medical business, which includes leveraging our strategic industry alliances, and expanding international sales. We expect that the current economic downturn may have a negative effect on capital purchases of our products in the near term.

Development contract and other revenue Development contract and other revenue is comprised of revenue on commercial contracts and extended support and warranty contracts. Development contract and other revenue was $446,000 during the three months ended March 31, 2009, a decrease of $353,000 or 44% as compared to the three months ended March 31, 2008. The decrease was mainly attributable to a decrease in medical contract revenue of $535,000 due to the completion of work performed under medical contracts that occurred through the first six months of 2008. Partially offsetting that decrease was increased revenue recognized on Touch development contracts and support of $182,000. We do not currently have any government projects in development. We continue to transition our engineering resources from certain commercial development contract efforts to product development efforts that focus on leveraging our existing sales and channel distribution capabilities.

We categorize our geographic information into four major regions: North America, Europe, Far East, and Rest of the World. In the first three months of 2009, revenue generated in North America, Europe, Far East, and Rest of the World represented 45%, 29%, 24%, and 2%, respectively, compared to 62%, 23%, 11%, and 4%, respectively, for the first three months of 2008. The shift in revenues among regions was mainly due to an increase in royalty revenue and medical product revenue from Europe and the Far East and a decrease in royalty and medical contract revenue in North America and Medical product revenue from the Rest of the World. We partially attribute increased European and Far East revenue to the addition of increased international sales and support personnel in 2008.

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COST OF PRODUCT SALES	March 31, 2009	2008	Change
	($ In thousands)		
Three months ended:			
Cost of product sales	$1,126	$1,683	(33)%
% of total product revenue	41%	63%	

Cost of Product Sales Our cost of product sales (exclusive of amortization of intangibles) consists primarily of materials, labor, and overhead. There is no cost of product sales associated with royalty and license revenue or development contract revenue. Cost of product sales from continuing operations was $1.1 million, a decrease of $557,000 or 33% for the three months ended March 31, 2009 as compared to the three months ended March 31, 2008. The decrease in cost of product sales was primarily due to reduced obsolescence expense of $209,000, reduced direct material costs of $134,000, and reduced overhead costs of $120,000. The decrease in obsolescence expense was mainly due to lower excess and obsolescence write-off from medical, touch, and other parts in 2009. The decrease in direct material costs was mainly the result of a product mix change in medical product sales where we sold a greater percentage of products with higher margins. Overhead costs decreased mainly as a result of reduced salary expense from decreased headcount. Cost of product sales decreased as a percentage of product revenue to 41% in the first three months of 2009 from 63% in the first three months of 2008. This increase is mainly due to the reduced costs and the change in the product sales mix mentioned above.

OPERATING EXPENSES AND OTHER	March 31, 2009	2008	Change
	($ In thousands)		
Three months ended:			
Sales and marketing	$4,760	$3,136	52%
% of total revenue	68%	45%	
Research and development	$3,904	$3,229	21%
% of total revenue	56%	47%	
General and administrative	$4,366	$4,263	2%
% of total revenue	63%	62%	
Amortization of intangibles	$ 376	$ 235	60%
% of total revenue	5%	3%	
Restructuring Costs	$ 646	$	*%
% of total revenue	9%	*%	

* Not meaningful

Sales and Marketing Our sales and marketing expenses are comprised primarily of employee compensation and benefits costs, advertising, public relations, trade shows, brochures, market development funds, travel, and an allocation of facilities costs. Sales and marketing expenses from continuing operations were $4.8 million, an increase of $1.6 million or 52% in the first three months of 2009 compared to the comparable period in 2008. The increase was primarily due to an increase in bad debt expense of $571,000 primarily from one customer that has not paid within terms, increased compensation, benefits, and overhead of $357,000, increased marketing, advertising, and public relations costs of $291,000, increased consulting costs of $220,000 to supplement our sales and marketing staff, and increased sales and marketing travel expense of $171,000. The increased sales and marketing expenses were primarily due to the expansion of our sales and marketing efforts internationally. We are taking steps to reduce our sales and marketing expenses, although we expect to continue to focus our sales and marketing efforts on medical, mobile device, and touchscreen market opportunities to build greater market acceptance for our touch technologies as well as continue to expand our sales and marketing presence internationally.

Research and Development Our research and development expenses are comprised primarily of employee compensation and benefits costs, consulting fees, tooling and supplies, and an allocation of facilities costs. Research and development expenses from continuing operations were $3.9 million, an increase of $675,000 or 21% in the first three months of 2009 compared to the same period in 2008. The increase was primarily due to increased compensation, benefits, and overhead of $627,000. The increased compensation, benefits, and overhead expense was primarily due to increased research and development headcount and increased non-cash stock based compensation charges. We are taking steps to reduce our research and development expenses, yet we believe that continued significant investment in research and development is critical to our future success, and we expect to make significant investments in areas of research and technology development to support future growth.

General and Administrative Our general and administrative expenses are comprised primarily of employee compensation and benefits, legal and professional fees, office supplies, travel, and an allocation of facilities costs. General and administrative expenses from continuing operations were $4.4 million, an increase of $103,000 or 2% in the first three months of 2009 compared to the same period in 2008. The increase was primarily due to increased compensation, benefits, and overhead of $486,000, increased travel of $87,000, increased public company expense of $61,000, and increased supplies and office expenses of $31,000 partially offset by decreased legal and professional fees of $588,000. The increased compensation, benefits, and overhead expense was primarily due to increased general and administrative headcount and increased non-cash stock-based compensation charges. The decreased legal, professional, and license fee expenses were primarily due to decreased litigation costs, mainly Microsoft litigation which was settled in 2008; decreased audit, tax, and accounting fees due to completion of the accounting and valuation for Sony Computer Entertainment litigation conclusion and patent license; resolution of a routine SEC review of our prior periodic filings; and reduction of income tax related issues, partially offset by increased consulting costs. We expect that the dollar amount of general and administrative expenses to continue to be a significant component of our operating expenses, but we are currently taking steps to reduce our general and administrative expenses. We will continue to incur costs related to litigation as we continue to assert our intellectual property and contractual rights and defend lawsuits brought against us.

Amortization of Intangibles Our amortization of intangibles is comprised primarily of patent amortization and other intangible amortization. Amortization of intangibles increased by $141,000 or 60% in the first three months of 2009 compared to the same period in 2008. The increase was primarily attributable to an increase from the cost and number of new patent costs being amortized and a revision to how we amortize our patents partially offset by some intangible assets reaching full amortization.

Restructuring Restructuring costs consist primarily of severance benefits paid in connection with the reduction of workforce due to severance benefits to be paid as the result of a planned reduction of workforce due to the relocation of the Maryland medical business operations to San Jose of $166,000 and severance benefits to be paid as the result of the reduction of workforce due to business changes in our Touch segment of $480,000. There were no restructuring charges incurred in the three months ended March 31, 2008. We expect to record approximately $200,000 of workforce reduction costs relating to the remaining service period of the Maryland business operations employees plus additional costs relating to the move and close down of facilities in the second quarter of 2009.

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Interest and Other Income Interest and other income consist primarily of interest income and dividend income from cash and cash equivalents and short-term investments and gain on sale of short-term investments. Interest and other income decreased by $1.1 million in the first three months of 2009 compared to the same period in 2008. This was primarily the result of decreased interest income due to a reduction in cash equivalents and short-term investments and reduced interest rates on cash, cash equivalents, and short-term investments. We expect that the accretion of interest income from Sony Computer Inc. that was approximately $272,000 in the three months ended March 31, 2009 and will total approximately $1.3 million in 2009 will be completed at the end of 2009.

Provision for Income Taxes We recorded a provision for income taxes for the three months ended March 31, 2009 of $91,000 on pre-tax loss from continuing operations of $7.8 million, yielding an effective tax rate of 1.2%. For the three months ended March 31, 2008, we recorded a benefit for income taxes of $1.2 million on pre-tax loss from continuing operations of $4.1 million, yielding an effective tax rate of (29.3)%. The income tax provision or benefit for the three months ended March 31, 2009 and March 31, 2008 are arrived at as a result of applying the estimated annual effective tax rate to cumulative loss before taxes, plus foreign withholding tax expense, adjusted for certain discrete items which are fully recognized in the period they occur.

Discontinued Operations In the three months ended March 31, 2009, we ceased operations of the 3D product line and sold both our CyberGlove family of products and SoftMouse 3D positioning device family of products and has recorded a gain on sale of discontinued operations of $167,000. Accordingly, the operations of the 3D product line have been classified as discontinued operations in the condensed consolidated statement of operations. Gain from discontinued operations, net of tax, decreased by $87,000 in the three months ended March 31, 2009 compared to the same period in 2008, primarily due to the decrease in activity due to the ceasing of 3D operations in the quarter ended March 31, 2009 resulting in reduced sales volumes and costs and expenses associated with 3D operations during that period.

SEGMENT RESULTS FOR THE THREE MONTHS ENDED MARCH 31, 2009 AND 2008

	Three Months Ended March 31,	
	2009	**2008**
	(In thousands)	
Revenues:		
Touch	$ 4,475	$ 3,962
Medical	2,538	3,008
Intersegment eliminations	(35)	(41)
Total	$ 6,978	$ 6,929
Net Income (Loss):		
Touch	$ (4,300)	$ (1,410)
Medical	(3,158)	(1,158)
Intersegment eliminations	(1)	(17)
Total	$ (7,459)	$ (2,585)

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* Note: Segment information may not be indicative of the financial position or results of operations that would have been achieved had these segments operated as unaffiliated entities.

Touch segment Revenues from the Touch segment were $4.5 million, an increase of $513,000 or 13% in the first three months of 2009 compared to the same period in 2008. Royalty and license revenues increased by $320,000 mainly due to increased shipments by licensees of mobile devices partially offset by decreased shipments by gaming and automotive licensees. Development contract revenue increased by $182,000 primarily due to increased development contracts and support. Net loss for the three months ended March 31, 2009 was $4.3 million, an increase of $2.9 million compared to the same period in 2008. The increase was primarily due to an increase in provision for income taxes of $1.3 million, a decrease in interest and other income of $996,000 mainly due to reduced interest rates and a reduction in cash equivalents and short-term investments, an increase of research and development expenses of $603,000, an increase in restructuring costs of $480,000, an increase in sales and marketing expenses of $417,000 and an increase in amortization expense of $140,000. The increases to the net loss were partially offset by increased gross margin of $850,000 due to increased royalty and license revenue and a decrease in general and administrative expenses of $189,000.

Medical segment Revenues from the Medical segment were $2.5 million, a decrease of $470,000 or 16%, for the first three months of 2009 compared to the same period in 2008. The decrease was primarily due to a reduction of medical development contract revenue due to the completion of work performed under medical contracts that occurred through the first six months of 2008 partially offset by an increase in product sales mainly due to increased sales of our endovascular and laparoscopy simulators. Net loss for the three months ended March 31, 2009 was $3.2 million, an increase of $2.0 million compared to the same period in 2008. The increase was mainly due to increased sales and marketing expenses of $1.2 million as the segment expands international sales and marketing efforts, increased general and administrative expenses of $292,000, a decrease in gross margin of $261,000 primarily due to reduced development contract revenue, and an increase in restructuring costs of $166,000.

LIQUIDITY AND CAPITAL RESOURCES

Our cash, cash equivalents, and short-term investments consist primarily of money market funds and highly liquid commercial paper and government agency securities. All of our short-term investments are classified as available-for-sale under the provisions of SFAS No. 115. The securities are stated at market value, with unrealized gains and losses reported as a component of accumulated other comprehensive income, within stockholders equity.

On March 31, 2009, our cash, cash equivalents, and short-term investments totaled $80.9 million, a decrease of $4.8 million from $85.7 million on December 31, 2008.

In March 2007, we concluded our patent infringement litigation against Sony Computer Entertainment and we received $97.3 million. Furthermore, we entered into a new business agreement under which, we are to receive twelve quarterly installments of $1.875 million for a total of $22.5 million beginning on March 31, 2007 and ending on December 31, 2009. As of March 31, 2009, we had received nine of these installments.

Net cash used in operating activities during the three months ended March 31, 2009 was $3.8 million, a change of $5.5 million from the $1.7 million provided during the three months ended March 31, 2008. Cash used in operations during the three months ended March 31, 2009 was primarily the result of a net loss of $7.5 million, a decrease of $1.4 million due to a change in accrued compensation and other current liabilities, a decrease of $884,000 due to a change in inventories, and a decrease of $469,000 due to a change in accounts payable. These decreases were offset by a $2.2 million increase due to a change in accounts receivable and a $1.6 million increase due to a change in deferred revenue and customer advances. Cash used in operations during the three months ended March 31, 2009 was also impacted by noncash charges and credits of $2.5 million, including $1.2 million of noncash stock-based compensation, an increase of $519,000 to allowance for doubtful accounts, $390,000 in depreciation and amortization, and $376,000 in amortization of intangibles.

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Net cash used in investing activities during the three months ended March 31, 2009 was $24.1 million, compared to the $48.9 million provided by investing activities during the three months ended March 31, 2008, an increase of $73.0 million. Net cash used in investing activities during the period consisted of purchases of short-term investments of $34.0 million; $580,000 used to purchase property and equipment; and a $542,000 increase in intangibles and other assets, primarily due to capitalization of external patent filing and application costs partially offset by maturities or sales of short-term investments of $11.0 million.

Net cash provided by financing activities during the three months ended March 31, 2009 was $204,000 compared to $934,000 provided during the three months ended March 31, 2008, or a $730,000 decrease from the prior year. Net cash provided by financing activities for the period consisted primarily of issuances of common stock and exercises of stock options and warrants in the amount of $204,000.

We believe that our cash and cash equivalents will be sufficient to meet our working capital needs for at least the next twelve months. We will continue to protect and defend our extensive intellectual property portfolio across all business segments. We anticipate that capital expenditures for the year ended December 31, 2009 will total approximately $3.0 million in connection with anticipated maintenance and upgrades to operations and infrastructure. Additionally, if we acquire one or more businesses, patents, or products, our cash or capital requirements could increase substantially. In the event of such an acquisition, or should any unanticipated circumstances arise that significantly increase our capital requirements, we may elect to raise additional capital through debt or equity financing. Any of these events could result in substantial dilution to our stockholders. There is no assurance that such additional capital will be available on terms acceptable to us, if at all.

SUMMARY DISCLOSURES ABOUT CONTRACTUAL OBLIGATIONS AND COMMERCIAL COMMITMENTS

The following table reflects a summary of our contractual cash obligations and other commercial commitments as of December 31, 2008:

Contractual Obligations	**Total**	**2009**	**2010 and 2011**	**2012 and 2013**	**2014**
			(In thousands)		
Operating leases	$ 3,555	$ 928	$ 1,250	$ 1,094	$ 283

As discussed in Note 11 to the condensed consolidated financial statements, effective January 1, 2007, we adopted the provisions of FIN 48. On March 31, 2009, we had a liability for unrecognized tax benefits totaling approximately $647,000, including interest of $20,000. Due to the uncertainties related to these tax matters, we are unable to make a reasonably reliable estimate when cash settlement with a taxing authority will occur. Settlement of such amounts could require the utilization of working capital.

RECENT ACCOUNTING PRONOUNCEMENTS

See Note 1 to the condensed consolidated financial statements for information regarding the effect of new accounting pronouncements on our financial statements.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We are exposed to financial market risks, including changes in interest rates and foreign currency exchange rates. Changes in these factors may cause fluctuations in our earnings and cash flows. We evaluate and manage the exposure to these market risks as follows:

Cash Equivalents and Short-term Investments We have cash equivalents and short-term investments of $78.5 million as of March 31, 2009. These securities are subject to interest rate fluctuations. An increase in interest rates could adversely affect the market value of our cash equivalents and short-term investments.

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A hypothetical 100 basis point increase in interest rates would result in an approximate $289,000 decrease in the fair value of our cash equivalents and short-term investments as of March 31, 2009.

We limit our exposure to interest rate and credit risk by establishing and monitoring clear policies and guidelines for our cash equivalents and short-term investment portfolios. The primary objective of our policies is to preserve principal while at the same time maximizing yields, without significantly increasing risk. Our investment policy limits the maximum weighted average duration of all invested funds to 12 months. Our policy s guidelines also limit exposure to loss by limiting the sums we can invest in any individual security and restricting investment to securities that meet certain defined credit ratings. We do not use derivative financial instruments in our investment portfolio to manage interest rate risk.

Foreign Currency Exchange Rates A substantial majority of our revenue, expense, and capital purchasing activities are transacted in U.S. dollars. However, we do incur certain operating costs for our foreign operations in other currencies but these operations are limited in scope and thus we are not materially exposed to foreign currency fluctuations. Additionally we have some reliance on international and export sales that are subject to the risks of fluctuations in currency exchange rates. Because a substantial majority of our international and export revenues, as well as expenses, are typically denominated in U.S. dollars, a strengthening of the U.S. dollar could cause our products to become relatively more expensive to customers in a particular country, leading to a reduction in sales or profitability in that country. We have no foreign exchange contracts, option contracts, or other foreign currency hedging arrangements.

ITEM 4. CONTROLS AND PROCEDURES

EVALUATION OF DISCLOSURE CONTROLS AND PROCEDURES

Our management evaluated, with the participation of our Chief Executive Officer and our Chief Financial Officer, the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) as of March 31, 2009. Based on this evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that our disclosure controls and procedures were not effective as of March 31, 2009 due to the previously reported material weakness in our internal control over financial reporting with respect to accounting for income taxes that was disclosed in our Annual Report on Form 10-K for our fiscal year ended December 31, 2008.

The material weakness we disclosed was in the area of accounting for income taxes. A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of our annual or interim financial statements will not be prevented or detected on a timely basis.

In connection with our plan to remediate this material weakness, we have engaged in, and are continuing to engage in, substantial efforts to improve our internal control over financial reporting and disclosure controls and procedures related to income tax matters including the following:

Commencing the First Quarter of 2008, we engaged outside consultants to advise us in areas of complex tax accounting and to design and implement controls to ensure proper communication with our personnel to obtain the needed advice and review of tax related accounting and reporting documentation.

Our management, including our Chief Executive Officer and Chief Financial Officer, does not expect that our disclosure controls and procedures or our internal controls will prevent all error and all fraud. A 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 resource constraints, and the benefits of controls must be considered relative to their costs. 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 within Immersion, have been detected.

CHANGES IN INTERNAL CONTROL OVER FINANCIAL REPORTING

There were no changes to our internal control over financial reporting during the quarter ended March 31, 2009 that have materially affected or are reasonably likely to materially affect our internal control over financial reporting.

PART II

OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

In re Immersion Corporation

We are involved in legal proceedings relating to a class action lawsuit filed on November 9, 2001 in the U. S. District Court for the Southern District of New York, *In re Immersion Corporation Initial Public Offering Securities Litigation*, No. Civ. 01-9975 (S.D.N.Y.), related to In re Initial Public Offering Securities Litigation, No. 21 MC 92 (S.D.N.Y.). The named defendants are Immersion and three of our current or former officers or directors (the Immersion Defendants), and certain underwriters of our November 12, 1999 initial public offering (IPO). Subsequently, two of the individual defendants stipulated to a dismissal without prejudice.

The operative amended complaint is brought on purported behalf of all persons who purchased our common stock from the date of our IPO through December 6, 2000. It alleges liability under Sections 11 and 15 of the Securities Act of 1933 and Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, on the grounds that the registration statement for the IPO did not disclose that: (1) the underwriters agreed to allow certain customers to purchase shares in the IPO in exchange for excess commissions to be paid to the underwriters; and (2) the underwriters arranged for certain customers to purchase additional shares in the aftermarket at predetermined prices. The complaint also appears to allege that false or misleading analyst reports were issued. The complaint does not claim any specific amount of damages.

Similar allegations were made in other lawsuits challenging over 300 other initial public offerings and follow-on offerings conducted in 1999 and 2000. The cases were consolidated for pretrial purposes. On February 19, 2003, the District Court ruled on all defendants motions to dismiss. The motion was denied as to claims under the Securities Act of 1933 in the case involving us as well as in all other cases (except for 10 cases). The motion was denied as to the claim under Section 10(b) as to us, on the basis that the complaint alleged that we had made acquisition(s) following the IPO. The motion was granted as to the claim under Section 10(b), but denied as to the claim under Section 20(a), as to the remaining individual defendant.

In September 2008, all of the parties to the lawsuits reached a settlement, subject to documentation and approval of the District Court. The Immersion Defendants would not be required to contribute to the settlement. Subsequently, an underwriter defendant filed for bankruptcy and other underwriter defendants were acquired. On April 2, 2009, final documentation evidencing the settlement was presented to the District Court for approval. If the settlement is not approved by the District Court, we intend to defend the lawsuit vigorously.

Immersion Corporation v. Mentice AB, Mentice SA, Simbionix USA Corp., and Simbionix Ltd.

On April 16, 2008, we announced that our wholly owned subsidiary, Immersion Medical, Inc., filed lawsuits for patent infringement in the United States District Court for the Eastern District of Texas against Mentice AB, Mentice SA, Simbionix USA Corp., and Simbionix Ltd (collectively the Defendants), seeking damages and injunctive relief. On July 11, 2008, Mentice AB and Mentice SA (collectively, Mentice) answered the complaint by denying the material allegations and alleging counterclaims seeking a judicial declaration that the asserted patents were invalid, unenforceable, or not infringed. On July 11, 2008, Simbionix USA Corp. and Simbionix Ltd, (collectively, Simbionix) filed a motion to stay or dismiss the lawsuit, and a motion to transfer venue for convenience to Ohio. On August 7, 2008, we filed our opposition to both motions filed by Simbionix. The court has not ruled on the pending motions. On December 2, 2008, the court held a status conference in which it set a trial date for December 5, 2011 and a claim construction hearing for June 1, 2011. We intend to vigorously prosecute this lawsuit.

ITEM 1A. RISK FACTORS

Company Risks

THE UNCERTAIN GLOBAL ECONOMIC ENVIRONMENT COULD REDUCE OUR REVENUES AND COULD HAVE AN ADVERSE EFFECT ON OUR FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

The current global economic recession could materially hurt our business in a number of ways including, longer sales and renewal cycles, delays in adoption of our products, increased risk of competition for our products, increased risk of inventory obsolescence, higher overhead costs as a percentage of revenue, risk of nonpayment or delayed payment by our customers, delays in signing or failing to sign customer agreements, or signing customer agreements at reduced purchase levels. In addition, our suppliers, customers, potential customers, and business partners are facing similar challenges, which could materially and adversely affect the level of business they conduct with us. The current economic downturn may lead to a reduction in corporate, university, or government budgets for research and development in sectors including the automotive, aerospace, mobility, and medical sectors, which use our products. Sales of our products may be adversely affected by cuts in these research and development budgets. Furthermore, a prolonged tightening of the credit markets could significantly impact our ability to liquidate investments or reduce the rate of return on investments.

WE HAD AN ACCUMULATED DEFICIT OF $75 MILLION AS OF MARCH 31, 2009, HAVE A HISTORY OF LOSSES, EXPECT TO EXPERIENCE LOSSES IN THE FUTURE, AND MAY NOT ACHIEVE OR MAINTAIN PROFITABILITY IN THE FUTURE.

Since 1997, we have incurred losses in all but four quarters. We need to generate significant ongoing revenue to return to profitability. We anticipate that we will continue to incur expenses as we:

- continue to develop our technologies;
- increase our sales and marketing efforts;
- attempt to expand the market for touch-enabled technologies and products and change our business;
- protect and enforce our intellectual property;
- pursue strategic relationships;
- acquire intellectual property or other assets from third-parties; and
- invest in systems and processes to manage our business.

If our revenues grow more slowly than we anticipate or if our operating expenses exceed our expectations, we may not achieve or maintain profitability.

WE HAVE LITTLE OR NO CONTROL OR INFLUENCE ON OUR LICENSEES DESIGN, MANUFACTURING, PROMOTION, DISTRIBUTION, OR PRICING OF THEIR PRODUCTS INCORPORATING OUR TOUCH-ENABLING TECHNOLOGIES, UPON WHICH WE GENERATE ROYALTY REVENUE.

A key part of our business strategy is to license our intellectual property to companies that manufacture and sell products incorporating our touch-enabling technologies. Sales of those products generate royalty and license revenue for us. For the three months ended March 31, 2009 and 2008, 54% and 50%, respectively, of our total revenues were royalty and license revenues. We do not control or influence the design, manufacture, quality control, promotion, distribution, or pricing of products that are manufactured and sold by our licensees, nor can we control consolidation within an industry which could either reduce the number of licensing products available or reduce royalty rates for the combined licensees. In addition, we generally do not have commitments from our licensees that they will continue to use our technologies in current or future products. As a result, products incorporating our technologies may not be brought to market, achieve commercial acceptance, or otherwise generate meaningful royalty revenue for us. For us to generate royalty revenue, licensees that pay us per-unit royalties must manufacture and distribute products incorporating our touch-enabling technologies in a timely fashion and generate consumer demand through marketing and other promotional activities. If our licensees products fail to achieve commercial success or if products are recalled because of quality control problems, our revenues will not grow and could decline.

Peak demand for products that incorporate our technologies, especially in the video console gaming and computer gaming peripherals market, typically occurs in the fourth calendar quarter as a result of increased demand during the year-end holiday season. If our licensees do not ship products incorporating our touch-enabling technologies in a timely fashion or fail to achieve strong sales in the fourth quarter of the calendar year, we may not receive related royalty and license revenue.

WE MAY NOT BE ABLE TO CONTINUE TO DERIVE SIGNIFICANT REVENUES FROM MAKERS OF PERIPHERALS FOR POPULAR VIDEO GAMING PLATFORMS.

A significant portion of our gaming royalty revenues come from third-party peripheral makers who make licensed gaming products designed for use with popular video game console systems from Microsoft, Sony, and Nintendo. Video game console systems are closed, proprietary systems, and video game console system makers typically impose certain requirements or restrictions on third-party peripheral makers who wish to make peripherals that will be compatible with a particular video game console system. If third-party peripheral makers cannot or are not allowed to obtain or satisfy these requirements or restrictions, our gaming royalty revenues could be significantly reduced. Furthermore, should a significant video game console maker choose to omit touch-enabling capabilities from its console system or somehow restrict or impede the ability of third parties to make touch-enabling peripherals, it may very well lead our gaming licensees to stop making products with touch-enabling capabilities, thereby significantly reducing our gaming royalty revenues.

Under the terms of our agreement with Sony, Sony receives a royalty-free license to our worldwide portfolio of patents. This license permits Sony to make, use, and sell hardware, software, and services covered by our patents in its PS1, PS2, and PS3 systems for a fixed license payment. Sony has, to date, not yet broadly licensed third parties to produce peripherals of the PS3 system. To the extent Sony selectively limits its licensing to leading third-party controller makers to make PS3 controllers with vibration feedback, our licensing revenue from third-party PS3 peripherals will be severely limited. Sony continues to sell the PS2, and our third party licensees continue to sell licensed PS2 peripherals. However, sales of PS2 peripherals continue to decline as more consumers switch to the PS3 console system and other next-generation console systems like the Nintendo Wii and Microsoft Xbox 360.

Both the Microsoft Xbox 360 and Nintendo Wii include touch-enabling capabilities. For the Microsoft Xbox 360 video console system launched in November 2005, Microsoft has, to date, not yet broadly licensed third parties to produce peripherals for its Xbox 360 game console. To the extent Microsoft does not fully license third parties, Microsoft s share of all aftermarket Xbox 360 game controller sales will likely remain high or increase, which we expect will limit our gaming royalty revenue. Additionally, Microsoft is now making touch-enabled steering wheel products covered by its royalty-free, perpetual, irrevocable license to our worldwide portfolio of patents that could compete with our licensees current products for which we earn per unit royalties.

BECAUSE WE HAVE A FIXED PAYMENT LICENSE WITH MICROSOFT, OUR ROYALTY REVENUE FROM LICENSING IN THE GAMING MARKET AND OTHER CONSUMER MARKETS HAS DECLINED AND MAY FURTHER DO SO IF MICROSOFT INCREASES ITS VOLUME OF SALES OF TOUCH-ENABLED GAMING PRODUCTS AND CONSUMER PRODUCTS AT THE EXPENSE OF OUR OTHER LICENSEES.

Under the terms of our present agreement with Microsoft, Microsoft receives a royalty-free, perpetual, irrevocable license to our worldwide portfolio of patents. This license permits Microsoft to make, use, and sell hardware, software, and services, excluding specified products, covered by our patents. We will not receive any further revenues or royalties from Microsoft under our current agreement with Microsoft.

Microsoft has a significant share of the market for touch-enabled console gaming computer peripherals and is pursuing other consumer markets such as mobile phones, PDAs, and portable music players. Microsoft has significantly greater financial, sales, and marketing resources, as well as greater name recognition and a larger customer base than some of our other licensees. In the event that Microsoft increases its share of these markets, our royalty revenue from other licensees in these market segments might decline.

WE GENERATE REVENUES FROM TOUCH-ENABLING COMPONENTS THAT ARE SOLD AND INCORPORATED INTO THIRD-PARTY PRODUCTS. WE HAVE LITTLE OR NO CONTROL OR INFLUENCE OVER THE DESIGN, MANUFACTURE, PROMOTION, DISTRIBUTION, OR PRICING OF THOSE THIRD-PARTY PRODUCTS.

Part of our business strategy is to sell components that provide touch feedback capability in products that other companies design, manufacture, and sell. Sales of these components generate product revenue. However, we do not control or influence the design, manufacture, quality control, promotion, distribution, or pricing of products that are manufactured and sold by those customers that buy these components. In addition, we generally do not have commitments from customers that they will continue to use our components in current or future products. As a result, products incorporating our components may not be brought to market, meet quality control standards, or achieve commercial acceptance. If the customers fail to stimulate and capitalize upon market demand for their products that include our components, or if products are recalled because of quality control problems, our revenues will not grow and could decline.

THE TERMS IN OUR AGREEMENTS MAY BE CONSTRUED BY OUR LICENSEES IN A MANNER THAT IS INCONSISTENT WITH THE RIGHTS THAT WE HAVE GRANTED TO OTHER LICENSEES, OR IN A MANNER THAT MAY REQUIRE US TO INCUR SUBSTANTIAL COSTS TO RESOLVE CONFLICTS OVER LICENSE TERMS.

We have entered into, and we expect to continue to enter into, agreements pursuant to which our licensees are granted rights under our technology and intellectual property. These rights may be granted in certain fields of use, or with respect to certain market sectors or product categories, and may include exclusive rights or sublicensing rights. We refer to the license terms and restrictions in our agreements, including, but not limited to, field of use definitions, market sector, and product category definitions, collectively as License Provisions.

Due to the continuing evolution of market sectors, product categories, and licensee business models, and to the compromises inherent in the drafting and negotiation of License Provisions, our licensees may, at some time during the term of their agreements with us, interpret License Provisions in their agreements in a way that is different from our interpretation of such License Provisions, or in a way that is in conflict with the rights that we have granted to other licensees. Such interpretations by our licensees may lead to claims that we have granted rights to one licensee which are inconsistent with the rights that we have granted to another licensee.

In addition, after we enter into an agreement, it is possible that markets and/or products, or legal and/or regulatory environments, will evolve in a manner that we did not foresee or was not foreseeable at the time we entered into the agreement. As a result, in any agreement, we may have granted rights that will preclude or restrict our exploitation of new opportunities that arise after the execution of the agreement.

IF WE ARE UNABLE TO ENTER INTO NEW LICENSING ARRANGEMENTS WITH OUR EXISTING LICENSEES AND WITH ADDITIONAL THIRD-PARTY MANUFACTURERS FOR OUR TOUCH-ENABLING TECHNOLOGIES, OUR ROYALTY REVENUE MAY NOT GROW.

Our revenue growth is significantly dependent on our ability to enter into new licensing arrangements. Our failure to enter into new or renewal of licensing arrangements will cause our operating results to suffer. We face numerous risks in obtaining new licenses on terms consistent with our business objectives and in maintaining, expanding, and supporting our relationships with our current licensees. These risks include:

- the lengthy and expensive process of building a relationship with potential licensees;
- the competition we may face with the internal design teams of existing and potential licensees;

difficulties in persuading product manufacturers to work with us, to rely on us for critical technology, and to disclose to us proprietary product development and other strategies;

difficulties with persuading potential licensees who may have developed their own intellectual property or licensed intellectual property from other parties in areas related to ours to license our technology versus continuing to develop their own or license from other parties;

challenges in demonstrating the compelling value of our technologies in new applications like mobile phones, portable devices, and touchscreens;

difficulties in persuading existing and potential licensees to bear the development costs and risks necessary to incorporate our technologies into their products;

difficulties in obtaining new licensees for yet-to-be commercialized technology because their suppliers may not be ready to meet stringent quality and parts availability requirements;

inability to sign new gaming licenses if the video console makers choose not to license third parties to make peripherals for their new consoles; and

reluctance of content developers, mobile phone manufacturers, and service providers to sign license agreements without a critical mass of other such inter-dependent supporters of the mobile phone industry also having a license, or without enough phones in the market that incorporate our technologies.

OUR RECENTLY-ANNOUNCED CONSOLIDATION OF OUR MEDICAL OPERATIONS MAY NOT BE SUCCESSFUL, AND MAY NEGATIVELY IMPACT OUR BUSINESS

In March 2009, we announced that we are consolidating the operations of our Medical line of business with the rest of our business. As a result of this consolidation, we are moving the operations of our Medical line of business from Maryland to our headquarters in San Jose, California. Consolidations and business restructurings involve numerous risks and uncertainties, including, but not limited to: the potential loss of key employees, customers and business partners; market uncertainty related to our future business plans; the incurrence of unexpected expenses or charges; diversion of management attention from other key areas of our business; negative impacts on employee morale; and other potential dislocations and disruptions to the business. For the three months ended March 31, 2009 and 2008, our Medical line of business represented 36% and 43%, respectively, of our total revenues. Accordingly, if we are unable to manage this consolidation effectively, our overall business and operating results could be materially and adversely affected.

LITIGATION REGARDING INTELLECTUAL PROPERTY RIGHTS COULD BE EXPENSIVE, DISRUPTIVE, AND TIME CONSUMING; COULD RESULT IN THE IMPAIRMENT OR LOSS OF PORTIONS OF OUR INTELLECTUAL PROPERTY; AND COULD ADVERSELY AFFECT OUR BUSINESS.

Intellectual property litigation, whether brought by us or by others against us, has caused us to expend, and may cause us to expend in future periods, significant financial resources as well as divert management s time and efforts. From time to time, we initiate claims against third parties that we believe infringe our intellectual property rights. We intend to enforce our intellectual property rights vigorously and may initiate litigation against parties that we believe are infringing our intellectual property rights if we are unable to resolve matters satisfactorily through negotiation. Litigation brought to protect and enforce our intellectual property rights could be costly, time-consuming, and difficult to pursue in certain venues, and distracting to management and potential customers and could result in the impairment or loss of portions of our intellectual property. In addition, any litigation in which we are accused of infringement may cause product shipment delays, require us to develop non-infringing technologies, or require us to enter into royalty or license agreements even before the issue of infringement has been decided on the merits. If any litigation were not resolved in our favor, we could become subject to substantial damage claims from third parties and indemnification claims from our licensees. We could be enjoined from the continued use of the technologies at issue without a royalty or license agreement. Royalty or license agreements, if required, might not be available on acceptable terms, or at all. If a third party claiming infringement against us prevailed, and we may not be able to develop non-infringing technologies or license the infringed or similar technologies on a timely and cost-effective basis, our expenses could increase and our revenues could decrease.

While we attempt to avoid infringing known proprietary rights of third parties, third parties may hold, or may in the future be issued, patents that could be infringed by our products or technologies. Any of these third parties might make a claim of infringement against us with respect to the products that we manufacture and the technologies that we license. From time to time, we have received letters from companies, several of which have significantly greater financial resources than we do, asserting that some of our technologies, or those of our licensees, infringe their intellectual property rights. Certain of our licensees may receive similar letters from these or other companies from time to time. Such letters or subsequent litigation may influence our licensees decisions whether to ship products incorporating our technologies. In addition, such letters may cause a dispute between our licensees and ourselves over indemnification for the infringement claim. Any of these notices, or additional notices that we or our licensees could receive in the future from these or other companies, could lead to litigation against us, either regarding the infringement claim or the indemnification claim.

We have acquired patents from third parties and also license some technologies from third parties. We must rely upon the owners of the patents or the technologies for information on the origin and ownership of the acquired or licensed technologies. As a result, our exposure to infringement claims may increase. We generally obtain representations as to the origin and ownership of acquired or licensed technologies and indemnification to cover any breach of these representations. However, representations may not be accurate and indemnification may not provide adequate compensation for breach of the representations. Intellectual property claims against our licensees, or us, whether or not they have merit, could be time-consuming to defend, cause product shipment delays, require us to pay damages, harm existing license arrangements, or require us or our licensees to cease utilizing the technologies unless we can enter into licensing agreements. Licensing agreements might not be available on terms acceptable to us or at all. Furthermore, claims by third parties against our licensees could also result in claims by our licensees against us for indemnification.

The legal principles applicable to patents and patent licenses continue to change and evolve. Legislation and judicial decisions that make it easier for patent licensees to challenge the validity, enforceability, or infringement of patents, or make it more difficult for patent licensors to obtain a permanent injunction, obtain enhanced damages for willful infringement, or to obtain or enforce patents, may adversely affect our business and the value of our patent portfolio. Furthermore, our prospects for future revenue growth through our royalty and licensing based businesses could be diminished.

OUR CURRENT LITIGATION UNDERTAKINGS ARE EXPENSIVE, DISRUPTIVE, AND TIME CONSUMING, AND WILL CONTINUE TO BE, UNTIL RESOLVED, AND REGARDLESS OF WHETHER WE ARE ULTIMATELY SUCCESSFUL, COULD ADVERSELY AFFECT OUR BUSINESS.

We are currently a party to various legal proceedings. Due to the inherent uncertainties of litigation, we cannot accurately predict how these cases will ultimately be resolved. We anticipate that the litigation will continue to be costly, and there can be no assurance that we will be successful or able to recover the costs we incur in connection with the litigation. We expense litigation costs as incurred and only accrue for costs that have been incurred but not paid to the vendor as of the financial statement date. Litigation has diverted, and is likely to continue to divert, the efforts and attention of some of our key management and personnel. As a result, until such time as it is resolved, litigation could adversely affect our business. Further, any unfavorable outcome could adversely affect our business. For additional background on this and our other litigation, please see Note 15 to the condensed consolidated financial statements and Item 1. Legal Proceedings of this Part II.

PRODUCT LIABILITY CLAIMS COULD BE TIME-CONSUMING AND COSTLY TO DEFEND AND COULD EXPOSE US TO LOSS.

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Our products or our licensees products may have flaws or other defects that may lead to personal or other injury claims. If products that we or our licensees sell cause personal injury, property injury, financial loss, or other injury to our or our licensees customers, the customers or our licensees may seek damages or other recovery from us. Defending any claims against us, regardless of merit, would be time-consuming, expensive to defend, and distracting to management, and could result in damages and injure our reputation, the reputation of our technology and services, and/or the reputation of our products, or the reputation of our licensees or their products. This damage could limit the market for our and our licensees products and harm our results of operations. In addition, if our business liability insurance coverage proves inadequate or future coverage is unavailable on acceptable terms or at all, our business, operating results, and financial condition could be adversely affected.

In the past, manufacturers of peripheral products including certain gaming products such as joysticks, wheels, or gamepads, have been subject to claims alleging that use of their products has caused or contributed to various types of repetitive stress injuries, including carpal tunnel syndrome. While we have not experienced any product liability claims to date, we could face such claims in the future, which could harm our business and reputation. Although our license agreements typically contain provisions designed to limit our exposure to product liability claims, existing or future laws or unfavorable judicial decisions could limit or invalidate the provisions.

OUR PRODUCTS ARE COMPLEX AND MAY CONTAIN UNDETECTED ERRORS, WHICH COULD HARM OUR REPUTATION AND FUTURE PRODUCT SALES.

Any failure to provide high quality and reliable products, whether caused by our own failure or failures of our suppliers or OEM customers, could damage our reputation and reduce demand for our products. Our products have in the past contained, and may in the future contain, undetected errors or defects. Some errors in our products may only be discovered after a product has been shipped to customers. Any errors or defects discovered in our products after commercial release could result in loss of revenue, loss of customers, and increased service and warranty costs, any of which could adversely affect our business.

THE NATURE OF SOME OF OUR PRODUCTS MAY ALSO SUBJECT US TO EXPORT CONTROL REGULATION BY THE U.S. DEPARTMENT OF STATE AND THE DEPARTMENT OF COMMERCE. VIOLATIONS OF THESE REGULATIONS CAN RESULT IN MONETARY PENALTIES AND DENIAL OF EXPORT PRIVILEGES.

Our sales to customers in some areas outside the United States could be subject to government export regulations or restrictions that prohibit us from selling to customers in some countries or that require us to obtain licenses or approvals to export such products internationally. Delays or denial of the grant of any required license or approval, or changes to the regulations, could make it difficult or impossible to make sales to foreign customers in some countries and could adversely affect our revenue. In addition, we could be subject to fines and penalties for violation of these export regulations if we were found in violation. Such violation could result in penalties, including prohibiting us from exporting our products to one or more countries, and could materially and adversely affect our business.

COMPLIANCE WITH DIRECTIVES THAT RESTRICT THE USE OF CERTAIN MATERIALS MAY INCREASE OUR COSTS AND LIMIT OUR REVENUE OPPORTUNITIES.

Our products and packaging must meet all safety, electrical, labeling, marking, or other requirements of the countries into which we ship products or our resellers sell our products. We have to assess each product and determine whether it complies with the requirements of local regulations or whether they are exempt from meeting the requirements of the regulations. If we determine that a product is not exempt and does not comply with adopted regulations, we will have to make changes to the product or its documentation if we want to sell that product into the region once the regulations become effective. Making such changes may be costly to perform and may have a negative impact on our results of operations. In addition, there can be no assurance that the national enforcement bodies of the regions adopting such regulations will agree with our assessment that certain of our products and documentation comply with or are exempt from the regulations. If products are determined not to be compliant or exempt,

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we will not be able to ship them in the region that adopts such regulations until such time that they are compliant, and this may have a negative impact on our revenue and results of operations.

BECAUSE PERSONAL COMPUTER PERIPHERAL PRODUCTS THAT INCORPORATE OUR TOUCH-ENABLING TECHNOLOGIES CURRENTLY WORK WITH MICROSOFT S OPERATING SYSTEM SOFTWARE, OUR COSTS COULD INCREASE AND OUR REVENUES COULD DECLINE IF MICROSOFT MODIFIES ITS OPERATING SYSTEM SOFTWARE.

Our hardware and software technologies for personal computer peripheral products that incorporate our touch-enabling technologies are currently compatible with Microsoft s Windows 2000, Windows Me, Windows XP, and Windows Vista operating systems, including DirectX, Microsoft s entertainment API. Modifications and new versions of Microsoft s operating system and APIs (including DirectX and Windows 7) may require that we and/or our licensees modify the touch-enabling technologies to be compatible with Microsoft s modifications or new versions, and this could cause delays in the release of products by our licensees. If Microsoft modifies its software products in ways that limit the use of our other licensees products, our costs could increase and our revenues could decline.

In addition, Microsoft announced that its new product, Windows 7, will feature a new multi-touch input function, allowing users to use multiple fingers simultaneously to interact with touch surfaces. Enabling multi-location touch-feedback will require us to innovate hardware and software, enable Windows 7 API s with multi-touch output support, and work with our licensees and third parties to integrate such features. There are feasibility risks with both hardware and software, and there may be potential delays in the revenue growth of haptically-enabled multi touch surfaces.

IF WE ARE UNABLE TO DEVELOP OPEN SOURCE COMPLIANT PRODUCTS, OUR ABILITY TO LICENSE OUR TECHNOLOGIES AND GENERATE REVENUES WOULD BE IMPAIRED.

We have seen, and believe that we will continue to see, an increase in customers requesting that we develop products that will operate in an open source environment. Developing open source compliant products, without imperiling the intellectual property rights upon which our licensing business depends, may prove difficult under certain circumstances, thereby placing us at a competitive disadvantage for new product designs. As a result, our revenues may not grow and could decline.

THE MARKET FOR CERTAIN TOUCH-ENABLING TECHNOLOGIES AND TOUCH-ENABLED PRODUCTS IS AT AN EARLY STAGE AND IF MARKET DEMAND DOES NOT DEVELOP, WE MAY NOT ACHIEVE OR SUSTAIN REVENUE GROWTH.

The market for certain of our touch-enabling technologies and certain of our licensees touch-enabled products is at an early stage. If we and our licensees are unable to develop demand for touch-enabling technologies and touch-enabled products, we may not achieve or sustain revenue growth. We cannot accurately predict the growth of the markets for these technologies and products, the timing of product introductions, or the timing of commercial acceptance of these products.

Even if our touch-enabling technologies and our licensees touch-enabled products are ultimately widely adopted, widespread adoption may take a long time to occur. The timing and amount of royalties and product sales that we receive will depend on whether the products marketed achieve widespread adoption and, if so, how rapidly that adoption occurs.

We expect that we will need to pursue extensive and expensive marketing and sales efforts to educate prospective licensees, component customers, and end users about the uses and benefits of our technologies and to persuade software developers to create software that utilizes our technologies. Negative product reviews or publicity about our company, our products, our licensees products, haptic features, or haptic technology in general could have a negative impact on market adoption, our revenue, and/or our ability to license our technologies in the future.

IF WE FAIL TO PROTECT AND ENFORCE OUR INTELLECTUAL PROPERTY RIGHTS, OUR ABILITY TO LICENSE OUR TECHNOLOGIES AND GENERATE REVENUES WOULD BE IMPAIRED.

Our business depends on generating revenues by licensing our intellectual property rights and by selling products that incorporate our technologies. We rely on our significant patent portfolio to protect our proprietary rights. If we are not able to protect and enforce those rights, our ability to obtain future licenses or maintain current licenses and royalty revenue could be impaired. In addition, if a court or the patent office were to limit the scope, declare unenforceable, or invalidate any of our patents, current licensees may refuse to make royalty payments, or they may choose to challenge one or more of our patents. It is also possible that:

- our pending patent applications may not result in the issuance of patents;
- our patents may not be broad enough to protect our proprietary rights; and
- effective patent protection may not be available in every country in which we or our licensees do business.

We also rely on licenses, confidentiality agreements, other contractual agreements, and copyright, trademark, and trade secret laws to establish and protect our proprietary rights. It is possible that:

- laws and contractual restrictions may not be sufficient to prevent misappropriation of our technologies or deter others from developing similar technologies; and
- policing unauthorized use of our patented technologies, trademarks, and other proprietary rights would be difficult, expensive, and time-consuming, within and particularly outside of the United States of America.

CERTAIN TERMS OR RIGHTS GRANTED IN OUR LICENSE AGREEMENTS OR OUR DEVELOPMENT CONTRACTS MAY LIMIT OUR FUTURE REVENUE OPPORTUNITIES.

While it is not our general practice to sign license agreements that provide exclusive rights for a period of time with respect to a technology, field of use, and/or geography, or to accept similar limitations in product development contracts, we have entered into such agreements and may in the future. Although additional compensation or other benefits may be part of the agreement, the compensation or benefits may not adequately compensate us for the limitations or restrictions we have agreed to as that particular market develops. Over the life of the exclusivity period, especially in markets that grow larger or faster than anticipated, our revenue may be limited and less than what we could have achieved in the market with several licensees or additional products available to sell to a specific set of customers.

IF WE FAIL TO DEVELOP NEW OR ENHANCED TECHNOLOGIES FOR NEW APPLICATIONS AND PLATFORMS, WE MAY NOT BE ABLE TO CREATE A MARKET FOR OUR TECHNOLOGIES OR OUR TECHNOLOGIES MAY BECOME OBSOLETE, AND OUR ABILITY TO GROW AND OUR RESULTS OF OPERATIONS MIGHT BE HARMED.

Our initiatives to develop new and enhanced technologies and to commercialize these technologies for new applications and new platforms may not be successful or timely. Any new or enhanced technologies may not be favorably received by consumers and could damage our reputation or our brand. Expanding our technologies could also require significant additional expenses and strain our management, financial, and operational resources. Moreover, technology products generally have relatively short product life cycles and our current products may become obsolete in the future. Our ability to generate revenues will be harmed if:

- we fail to develop new technologies or products;
- the technologies we develop infringe on third-party patents or other third-party rights;
- our new technologies fail to gain market acceptance; or

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our current products become obsolete or no longer meet new regulatory requirements.

Our ability to achieve revenue growth also depends on our continuing ability to improve and reduce the cost of our technologies and to introduce these technologies to the marketplace in a timely manner. If our development efforts are not successful or are significantly delayed, companies may not incorporate our technologies into their products and our revenue growth may be impaired.

WE HAVE LIMITED ENGINEERING, CUSTOMER SERVICE, TECHNICAL SUPPORT, QUALITY ASSURANCE AND MANUFACTURING RESOURCES TO DESIGN AND FULFILL FAVORABLE PRODUCT DELIVERY SCHEDULES AND SUFFICIENT LEVELS OF QUALITY IN SUPPORT OF OUR DIFFERENT PRODUCT AREAS. PRODUCTS AND SERVICES MAY NOT BE DELIVERED IN A TIMELY WAY, WITH SUFFICIENT LEVELS OF QUALITY, OR AT ALL, WHICH MAY REDUCE OUR REVENUE.

Engineering, customer service, technical support, quality assurance, and manufacturing resources are deployed against a variety of different projects and programs to provide sufficient levels of quality necessary for channels and customers. Success in various markets may depend on timely deliveries and overall levels of sustained quality and customer service. Failure to provide favorable product and program deliverables and quality and customer service levels, or provide them at all, may disrupt channels and customers, harm our brand, and reduce our revenues.

THE HIGHER COST OF PRODUCTS INCORPORATING OUR TOUCH-ENABLING TECHNOLOGIES MAY INHIBIT OR PREVENT THEIR WIDESPREAD ADOPTION.

Personal computer and console gaming peripherals, mobile devices, touchscreens, and automotive and industrial controls incorporating our touch-enabling technologies can be more expensive than similar competitive products that are not touch-enabled. Although major manufacturers, such as ALPS Electric Co., BMW, LG Electronics, Logitech, Microsoft, Nokia, Samsung, and Sony have licensed our technologies, the greater expense of development and production of products containing our touch-enabling technologies, together with the higher price to the end customer, may be a significant barrier to their widespread adoption and sale.

THIRD-PARTY VALIDATION STUDIES MAY NOT DEMONSTRATE ALL THE BENEFITS OF OUR MEDICAL TRAINING SIMULATORS, WHICH COULD AFFECT CUSTOMER MOTIVATION TO BUY.

In medical training, validation studies are generally used to confirm the usefulness of new techniques, devices, and training methods. For medical training simulators, several levels of validation are generally tested: content, concurrent, construct, and predictive. A validation study performed by a third party, such as a hospital, a teaching institution, or even an individual healthcare professional, could result in showing little or no benefit for one or more types of validation for our medical training simulators. Such validation study results published in medical journals could impact the willingness of customers to buy our training simulators, especially new simulators that have not previously been validated. In addition, customers may be reluctant to purchase these products if no studies have been published or until a favorable study has been published, which would negatively impact our revenues from sales of these products.

MEDICAL LICENSING AND CERTIFICATION AUTHORITIES MAY NOT RECOMMEND OR REQUIRE USE OF OUR TECHNOLOGIES FOR TRAINING AND/OR TESTING PURPOSES AND CERTAIN LEGISLATION THAT MAY ENCOURAGE THE USE OF SIMULATORS MAY NOT BECOME LAW, SIGNIFICANTLY SLOWING OR INHIBITING THE MARKET PENETRATION OF OUR MEDICAL SIMULATION TECHNOLOGIES.

Several key medical certification bodies, including the American Board of Internal Medicine (ABIM), the American Board of Surgery (ABS), and the American College of Cardiology (ACC), have great influence in recommending particular medical methodologies, including medical training and testing methodologies, for use by medical professionals. In the event that the ABIM and the ACC, as well as other, similar bodies, do not endorse medical simulation products in general, or our products in particular, as a training and/or testing tool, and in addition in the event that the H.R. 855 Enhancing

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Simulation Act of 2009 does not pass into law, market penetration for our products in the medical market could be significantly and adversely affected.

WE HAVE LIMITED DISTRIBUTION CHANNELS AND RESOURCES TO MARKET AND SELL OUR PRODUCTS, AND IF WE ARE UNSUCCESSFUL IN MARKETING AND SELLING THESE PRODUCTS, WE MAY NOT ACHIEVE OR SUSTAIN PRODUCT REVENUE GROWTH.

We have limited resources for marketing and selling our products, either directly or through distributors. To achieve our business objectives, we must build a balanced mixture of sales through a direct sales channel and through qualified distribution channels. The success of our efforts to sell products will depend upon our ability to retain and develop a qualified sales force and effective distribution channels. We may not be successful in attracting and retaining the personnel necessary to sell and market our products. A number of our distributors are small, specialized companies and may not have sufficient capital or human resources to support the complexities of selling and supporting our products. In addition, many of our distributors do not have exclusive relationships with us and may not devote sufficient time and attention to selling our products. There can be no assurance that our direct selling efforts will be effective, distributors or OEMs will market our products successfully or, if our relationships with distributors or OEMs terminate, that we will be able to establish relationships with other distributors or OEMs on satisfactory terms, if at all. Any disruption in the distribution, sales, or marketing network for our products could have a material adverse effect on our product revenues.

IT IS DIFFICULT FOR US TO PREDICT THE SALES VOLUME OF OUR DISTRIBUTION CHANNELS, WHICH MAKES IT DIFFICULT FOR US TO FORECAST OUR BUSINESS.

The sales volumes for our limited distribution channels are volatile and hard to predict. We consider forecasts in determining our component needs and our inventory requirements. If the business in these limited distribution channels fails to meet expectations, or if we fail to accurately forecast our customers product demands, we may have inadequate or excess inventory of our products or components or assets that are not realizable, which could adversely affect our operating results.

THE MARKETS IN WHICH WE PARTICIPATE OR MAY TARGET IN THE FUTURE ARE INTENSELY COMPETITIVE, AND IF WE DO NOT COMPETE EFFECTIVELY, OUR OPERATING RESULTS COULD BE HARMED.

Our target markets are rapidly evolving and highly competitive. Many of our competitors and potential competitors are larger and have greater name recognition, much longer operating histories, larger marketing budgets, and significantly greater resources than we do, and with the introduction of new technologies and market entrants, we expect competition to intensify in the future. We believe that competition in these markets will continue to be intense and that competitive pressures will drive the price of our products and our licensees products downward. These price reductions, if not offset by increases in unit sales or productivity, will cause our revenues to decline. If we fail to compete effectively, our business will be harmed. Some of our principal competitors offer their products or services at a lower price, which has resulted in pricing pressures. If we are unable to achieve our target pricing levels, our operating results would be negatively impacted. In addition, pricing pressures and increased competition generally could result in reduced sales, reduced margins, losses, or the failure of our application suite to achieve or maintain more widespread market acceptance, any of which could harm our business.

In the medical simulation market, we face competition from Simbionix USA Corporation, Mentice Corporation, Medical Education Technologies, Inc., and Medical Simulation Corporation. In the mobility and touchscreen markets, we face competition from internal design teams of existing and potential OEM customers. As a result of their licenses to our patent portfolios, we could face competition from Microsoft and Sony.

Our licensees or other third parties may also seek to develop products using our intellectual property or develop alternative designs that attempt to circumvent our intellectual property or that they believe do not require a license under our intellectual property. These potential competitors may have significantly greater financial, technical, and marketing resources than we do, and the costs associated with asserting our intellectual property rights against such products and such potential competitors could be significant.

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Moreover, if such alternative designs were determined by a court not to require a license under our intellectual property rights, competition from such unlicensed products could limit or reduce our revenues.

Additionally, if haptic technology gains market acceptance, more research by universities and/or corporations or other parties may be performed potentially leading to strong intellectual property positions by third parties in certain areas of haptics or the launch of haptics products before we commercialize our own technology.

Many of our current and potential competitors, including Microsoft, are able to devote greater resources to the development, promotion, and sale of their products and services. In addition, many of our competitors have established marketing relationships or access to larger customer bases, distributors, and other business partners. As a result, our competitors might be able to respond more quickly and effectively than we can to new or changing opportunities, technologies, standards, or customer requirements. Further, some potential customers, particularly large enterprises, may elect to develop their own internal solutions. For all of these reasons, we may not be able to compete successfully against our current and future competitors.

WINNING BUSINESS IS SUBJECT TO A COMPETITIVE SELECTION PROCESS THAT CAN BE LENGTHY AND REQUIRES US TO INCUR SIGNIFICANT EXPENSE, AND WE MAY NOT BE SELECTED.

Our primary focus is on winning competitive bid selection processes, known as design wins, so that haptics will be included in our customers equipment. These selection processes can be lengthy and can require us to incur significant design and development expenditures. We may not win the competitive selection process and may never generate any revenue despite incurring significant design and development expenditures. Because we typically focus on only a few customers in a product area, the loss of a design win can sometimes result in our failure to get haptics added to new generation products. This can result in lost sales and could hurt our position in future competitive selection processes because we may not be perceived as being a technology leader.

After winning a product design for one of our customers, we may still experience delays in generating revenue from our products as a result of the lengthy development and design cycle. In addition, a delay or cancellation of a customer s plans could significantly adversely affect our financial results, as we may have incurred significant expense and generated no revenue. Finally, if our customers fail to successfully market and sell their equipment it could materially adversely affect our business, financial condition, and results of operations as the demand for our products falls.

AUTOMOBILES INCORPORATING OUR TOUCH-ENABLING TECHNOLOGIES ARE SUBJECT TO LENGTHY PRODUCT DEVELOPMENT PERIODS, MAKING IT DIFFICULT TO PREDICT WHEN AND WHETHER WE WILL RECEIVE AUTOMOTIVE ROYALTIES.

The product development process for automobiles is very lengthy, sometimes longer than four years. We may not earn royalty revenue on our automotive technologies unless and until automobiles featuring our technologies are shipped to customers, which may not occur until several years after we enter into an agreement with an automobile manufacturer or a supplier to an automobile manufacturer. Throughout the product development process, we face the risk that an automobile manufacturer or supplier may delay the incorporation of, or choose not to incorporate, our technologies into its automobiles, making it difficult for us to predict the automotive royalties we may receive, if any. After the product launches, our royalties still depend on market acceptance of the vehicle or the option packages if our technology is an option (for example, a navigation unit), which is likely to be determined by many factors beyond our control.

WE HAVE EXPERIENCED SIGNIFICANT CHANGE IN OUR BUSINESS, AND WE CANNOT ASSURE YOU THAT THESE CHANGES WILL RESULT IN INCREASED REVENUE OR PROFITABILITY.

Our business has undergone significant changes in recent periods, including the divestiture of our 3D business, new management, consolidation of our touch, gaming, and mobility businesses, personnel

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changes, and focus on additional target markets. These changes have required significant investments of cash and other resources, as well as management s time and attention and have placed significant strains on our managerial, financial, engineering, or other resources. We cannot assure you that these efforts will result in growing our business successfully or in increased operating performance.

OUR INTERNATIONAL EXPANSION EFFORTS SUBJECT US TO ADDITIONAL RISKS AND COSTS.

We intend to expand international activities. International operations are subject to a number of difficulties and special costs, including:

- compliance with multiple, conflicting and changing governmental laws and regulations;
- laws and business practices favoring local competitors;
- foreign exchange and currency risks;
- difficulty in collecting accounts receivable or longer payment cycles;
- import and export restrictions and tariffs;
- difficulties staffing and managing foreign operations;
- difficulties and expense in enforcing intellectual property rights;
- business risks, including fluctuations in demand for our products and the cost and effort to conduct international operations and travel abroad to promote international distribution and overall global economic conditions;
- multiple conflicting tax laws and regulations; and
- political and economic instability.

Our international operations could also increase our exposure to international laws and regulations. If we cannot comply with foreign laws and regulations, which are often complex and subject to variation and unexpected changes, we could incur unexpected costs and potential litigation. For example, the governments of foreign countries might attempt to regulate our products and services or levy sales or other taxes relating to our activities. In addition, foreign countries may impose tariffs, duties, price controls, or other restrictions on foreign currencies or trade barriers, any of which could make it more difficult for us to conduct our business.

CERTAIN MEMBERS OF OUR EXECUTIVE MANAGEMENT TEAM ARE RELATIVELY NEW AND IF THERE ARE DIFFICULTIES WITH THIS LEADERSHIP TRANSITION IT COULD IMPEDE THE EXECUTION OF OUR BUSINESS STRATEGY.

Various members of our executive management team joined us in 2008 and early 2009. Our success will depend to a significant extent on their ability to implement a successful strategy, to successfully lead and motivate our employees, and to work effectively with other members of our executive management team and board of directors. If this leadership transition is not successful, our ability to execute our business strategy would be impeded.

WE MIGHT BE UNABLE TO RETAIN OR RECRUIT NECESSARY PERSONNEL, WHICH COULD SLOW THE DEVELOPMENT AND DEPLOYMENT OF OUR TECHNOLOGIES.

Our ability to develop and deploy our technologies and to sustain our revenue growth depends upon the continued service of our management and other key personnel, many of whom would be difficult to replace. Management and other key employees may voluntarily terminate their employment with us at any time upon short notice. The loss of management or key personnel could delay product development cycles or otherwise harm our business.

We believe that our future success will also depend largely on our ability to attract, integrate, and retain sales, support, marketing, and research and development personnel. Competition for such personnel is intense, and we may not be successful in attracting, integrating, and retaining such personnel. Given the protracted nature of if, how, and when we collect royalties on new design contracts, it may be difficult to craft compensation plans that will attract and retain the level of salesmanship needed to secure these contracts. Our equity award program is a long-term retention program that is intended to attract, retain, and provide incentives for talented employees, officers and directors, and to align stockholder and employee interests. Additionally some of our executive officers and key employees hold stock options with exercise prices above the current market price of our common stock. Each of these factors may impair our ability to retain the services of our executive officers and key employees. Our technologies are complex and we rely upon the continued service of our existing personnel to support licensees, enhance existing technologies, and develop new technologies.

IF OUR FACILITIES WERE TO EXPERIENCE CATASTROPHIC LOSS, OUR OPERATIONS WOULD BE SERIOUSLY HARMED.

Our facilities could be subject to a catastrophic loss such as fire, flood, earthquake, power outage, or terrorist activity. A substantial portion of our research and development activities, manufacturing, our corporate headquarters, and other critical business operations are located near major earthquake faults in San Jose, California, an area with a history of seismic events. An earthquake at or near our facilities could disrupt our operations, delay production and shipments of our products or technologies, and result in large expenses to repair and replace the facility. Our existing insurance may not be adequate for all possible losses. In addition, California has experienced problems with its power supply in recent years. As a result, we have experienced utility cost increases and may experience unexpected interruptions in our power supply that could have a material adverse effect on our sales, results of operations, and financial condition.

Investment Risks

OUR QUARTERLY REVENUES AND OPERATING RESULTS ARE VOLATILE, AND IF OUR FUTURE RESULTS ARE BELOW THE EXPECTATIONS OF PUBLIC MARKET ANALYSTS OR INVESTORS, THE PRICE OF OUR COMMON STOCK IS LIKELY TO DECLINE.

Our revenues and operating results are likely to vary significantly from quarter to quarter due to a number of factors, many of which are outside of our control and any of which could cause the price of our common stock to decline.

These factors include:

- the establishment or loss of licensing relationships;
- the timing and recognition of payments under fixed and/or up-front license agreements;
- the timing of work performed under development agreements;
- the timing of our expenses, including costs related to litigation, stock-based awards, acquisitions of technologies, or businesses, dispositions and restructurings;
- the timing of introductions and market acceptance of new products and product enhancements by us, our licensees, our competitors, or their competitors;

our ability to develop and improve our technologies;

our ability to attract, integrate, and retain qualified personnel;

seasonality in the demand for our products or our licensees products; and

our ability to build or ship products on a timely basis.

OUR STOCK PRICE MAY FLUCTUATE REGARDLESS OF OUR PERFORMANCE.

The stock market has experienced extreme volatility that often has been unrelated or disproportionate to the performance of particular companies. These market fluctuations may cause our stock price to decline regardless of our performance. The market price of our common stock has been, and in the future could be, significantly affected by factors such as: actual or anticipated fluctuations in operating results; announcements of technical innovations; announcements regarding litigation in which we are involved; changes by game console manufacturers to not include touch-enabling capabilities in their products; new products or new contracts; sales or the perception in the market of possible sales of large number of shares of our common stock by insiders or others; stock repurchase activity; changes in securities analysts recommendations; changing circumstances regarding competitors or their customers; governmental regulatory action; developments with respect to patents or proprietary rights; inclusion in or exclusion from various stock indices; and general market conditions. In the past, following periods of volatility in the market price of a company s securities, securities class action litigation has been initiated against that company.

PROVISIONS IN OUR CHARTER DOCUMENTS AND DELAWARE LAW COULD PREVENT OR DELAY A CHANGE IN CONTROL, WHICH COULD REDUCE THE MARKET PRICE OF OUR COMMON STOCK.

Provisions in our certificate of incorporation and bylaws may have the effect of delaying or preventing a change of control or changes in our board of directors or management, including the following:

our board of directors is classified into three classes of directors with staggered three-year terms;

only our chairperson of the board of directors, a majority of our board of directors, or 10% or greater stockholders are authorized to call a special meeting of stockholders;

our stockholders can only take action at a meeting of stockholders and not by written consent;

vacancies on our board of directors can be filled only by our board of directors and not by our stockholders;

our restated certificate of incorporation authorizes undesignated preferred stock, the terms of which may be established and shares of which may be issued without stockholder approval; and

advance notice procedures apply for stockholders to nominate candidates for election as directors or to bring matters before an annual meeting of stockholders.

In addition, certain provisions of Delaware law may discourage, delay, or prevent someone from acquiring or merging with us. These provisions could limit the price that investors might be willing to pay in the future for shares.

WE MAY ENGAGE IN ACQUISITIONS THAT COULD DILUTE STOCKHOLDERS INTERESTS, DIVERT MANAGEMENT ATTENTION, OR CAUSE INTEGRATION PROBLEMS.

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As part of our business strategy, we have in the past and may in the future, acquire businesses or intellectual property that we feel could complement our business, enhance our technical capabilities, or increase our intellectual property portfolio. The pursuit of potential acquisitions may divert the attention of management and cause us to incur various expenses in identifying, investigating, and pursuing suitable acquisitions, whether or not they are consummated.

If we consummate acquisitions through the issuance of our securities, our stockholders could suffer significant dilution. Acquisitions could also create risks for us, including:

- unanticipated costs associated with the acquisitions;
- use of substantial portions of our available cash to consummate the acquisitions;
- diversion of management s attention from other business concerns;
- difficulties in assimilation of acquired personnel or operations;
- failure to realize the anticipated benefits of acquired intellectual property or other assets;
- charges associated with amortization of acquired assets or potential charges for write-down of assets associated with unsuccessful acquisitions;
- potential intellectual property infringement claims related to newly-acquired product lines; and
- potential costs associated with failed acquisition efforts.

Any acquisitions, even if successfully completed, might not generate significant additional revenue or provide any benefit to our business.

FAILURE TO MAINTAIN EFFECTIVE INTERNAL CONTROLS IN ACCORDANCE WITH SECTION 404 OF THE SARBANES-OXLEY ACT COULD HAVE A MATERIAL ADVERSE EFFECT ON OUR BUSINESS AND STOCK PRICE.

The Sarbanes-Oxley Act of 2002 requires, among other things, that we establish and maintain internal control over financial reporting and disclosure controls and procedures. We must perform system and process evaluation and testing of our internal control over financial reporting to allow management to report on the effectiveness of our internal control over financial reporting, as required by Section 404 of the Sarbanes-Oxley Act. Our independent registered public accounting firm is also required to report on our internal control over financing reporting. Our and our auditor s testing may reveal deficiencies in our internal control over financial reporting that are deemed to be material weaknesses and render our internal control over financial reporting ineffective. We have incurred, and we expect to continue to incur, substantial accounting and auditing expense and expend significant management time in complying with the requirements of Section 404. If we are not able to comply with the requirements of Section 404 in a timely manner, or if we or our independent registered public accounting firm identify deficiencies in our internal control over financial reporting that are deemed to be material weaknesses, the market price of our stock could decline and we could be subject to investigations or sanctions by the SEC, the NASDAQ Stock Market, NASDAQ, or other regulatory authorities, or become subject to litigation. To the extent any material weaknesses in our internal control over financial reporting are identified in the future, we could be required to expend significant management time and financial resources to correct such material weaknesses or to respond to any resulting regulatory investigations or proceedings.

WE HAVE DETERMINED THAT OUR INTERNAL CONTROL OVER FINANCIAL REPORTING IS CURRENTLY INEFFECTIVE.

As discussed in Part I, Item 4, *Controls and Procedures*, our management team, under the supervision and with the participation of our Chief Financial Officer and Chief Executive Officer, conducted an

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evaluation of our internal controls as of March 31, 2009. Management concluded that we had a material weakness in internal controls over financial reporting related to income taxes. We have subsequently initiated actions that are intended to improve our accounting for income taxes and the related internal controls. Any continuation of this material weakness in our internal controls over the accounting for income taxes could impair our ability to report our financial position and results of operations accurately and in a timely manner.

AS OUR BUSINESS GROWS, SUCH GROWTH MAY PLACE A SIGNIFICANT STRAIN ON OUR MANAGEMENT AND OPERATIONS AND, AS A RESULT, OUR BUSINESS MAY SUFFER.

We plan to continue expanding our business, and any significant growth could place a significant strain on our management systems, infrastructure, and other resources. We recently transitioned the preparation of all of our internal reporting to upgraded management information systems and are in the process of implementing this system for all of our subsidiaries. If we encounter problems with the implementation of these systems, we may have difficulties preparing or tracking internal information, which could adversely affect our financial results. We will need to continue to invest the necessary capital to upgrade and improve our operational, financial, and management reporting systems. If our management fails to manage our growth effectively, we could experience increased costs, declines in product quality, or customer satisfaction, which could harm our business.

ITEM 6. EXHIBITS

The following exhibits are filed herewith:

Exhibit Number	**Description**
10.37	Form of 2009 Executive Incentive Plan
10.38	Amended and Restated Retention and Ownership Agreement dated April 20, 2009 between Immersion Corporation and Clent Richardson
10.39	Amended and Restated Retention and Ownership Agreement dated April 23, 2009 between Immersion Corporation and Stephen Ambler
31.1	Certification of Clent Richardson, President and Chief Executive Officer, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Stephen Ambler, Chief Financial Officer, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Clent Richardson, President and Chief Executive Officer, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Stephen Ambler, Chief Financial Officer, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
99.01	Form of Restricted Stock Agreement
99.02	Form of Notice of Grant of Restricted Stock

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SIGNATURES

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

Date: May 6, 2009

IMMERSION CORPORATION

By /s/ Stephen Ambler
Stephen Ambler
Chief Financial Officer

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