IMMERSION CORP
Form 10-Q
November 07, 2008

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(MARK ONE)

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

For the quarterly period ended September 30, 2008

OR

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

For the transition period from __________ to __________

Commission file number 000-27969

IMMERSION CORPORATION

(Exact name of registrant as specified in its charter)

Delaware	**94-3180138**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*

801 Fox Lane, San Jose, California 95131

(Address of principal executive offices)(Zip Code)

(408) 467-1900

(Registrant s telephone number, including area code)

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

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No þ

Number of shares of common stock outstanding at October 31, 2008: 27,895,336

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PART I
FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS
IMMERSION CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except share and per share amounts)
(Unaudited)

	September 30, 2008	December 31, 2007
ASSETS		
Current assets:		
Cash and cash equivalents	$ 102,083	$ 86,493
Short-term investments	16,976	51,619
Accounts receivable (net of allowances for doubtful accounts of: September 30, 2008 $353 and December 31, 2007 $85)	5,276	5,494
Inventories, net	4,892	3,674
Deferred income taxes	211	3,351
Prepaid expenses and other current assets	4,830	3,036
Total current assets	134,268	153,667
Property and equipment, net	3,202	2,112
Deferred income tax assets, net		4,031
Intangibles, net and other assets	10,062	8,558
Total assets	$ 147,532	$ 168,368
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 2,213	$ 1,657
Accrued compensation	3,041	1,828
Other current liabilities	25,184	2,629
Deferred revenue and customer advances (Note 6)	4,653	4,478
Total current liabilities	35,091	10,592
Long-term deferred revenue, less current portion	16,546	14,269
Deferred income tax liabilities	211	
Other long-term liabilities	651	1,720
Total liabilities	52,499	26,581
Contingencies (Note 14)		
Stockholders equity:		
Common stock and additional paid-in capital $0.001 par value; 100,000,000 shares authorized; shares issued: September 30, 2008 30,641,899 and December 31, 2007 30,389,850; shares outstanding: September 30, 2008 28,815,336 and December 31, 2007 30,389,850	164,720	160,147

Warrants	1,731	1,731
Accumulated other comprehensive income	135	137
Accumulated deficit	(58,202)	(20,228)
Treasury stock at cost: September 30, 2008 1,826,563 shares and December 31, 2007 0 shares	(13,351)	
Total stockholders equity	95,033	141,787
Total liabilities and stockholders equity	$ 147,532	$ 168,368

See accompanying Notes to Condensed Consolidated Financial Statements.

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IMMERSION CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share amounts)
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	**2007**	**2008**	**2007** (As restated, see Note 15)
Revenues:				
Royalty and license	$ 4,761	$ 2,904	$ 11,393	$ 7,862
Product sales	4,755	5,420	13,992	14,299
Development contracts and other	565	1,479	2,164	2,651
Total revenues	10,081	9,803	27,549	24,812
Costs and expenses:				
Cost of product sales (exclusive of amortization of intangibles shown separately below)	2,951	2,563	7,607	6,533
Sales and marketing	4,296	2,825	11,996	8,558
Research and development	3,155	2,482	9,239	7,538
General and administrative	4,774	2,781	14,121	9,162
Amortization of intangibles	179	243	584	739
Litigation settlement, conclusions, and patent license	20,750		20,750	(134,900)
Total costs and expenses	36,105	10,894	64,297	(102,370)
Operating income (loss)	(26,024)	(1,091)	(36,748)	127,182
Interest and other income	988	1,856	3,404	4,037
Interest expense		(211)		(1,024)
Income (loss) before provision for income taxes	(25,036)	554	(33,344)	130,195
Provision for income taxes	(7,262)	(61)	(4,630)	(13,688)
Net income (loss)	$ (32,298)	$ 493	$ (37,974)	$ 116,507
Basic net income (loss) per share	$ (1.10)	$ 0.02	$ (1.26)	$ 4.35
Shares used in calculating basic net income (loss) per share	29,448	28,630	30,092	26,768
Diluted net income (loss) per share	$ (1.10)	$ 0.02	$ (1.26)	$ 3.73
Shares used in calculating diluted net income (loss) per share	29,448	31,399	30,092	31,315

See accompanying Notes to Condensed Consolidated Financial Statements.

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IMMERSION CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007 (As restated, see Note 15)
Cash flows from operating activities:		
Net income (loss)	$ (37,974)	$ 116,507
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	844	661
Amortization of intangibles	584	739
Stock-based compensation	2,968	1,942
Excess tax benefits from stock-based compensation	(194)	(10,579)
Realized gain on short-term investments	(81)	
Allowance for doubtful accounts	269	(53)
Interest expense accretion on 5% Convertible Debenture		535
Fair value adjustment of Put Option and Registration Rights		(15)
Loss on disposal of equipment		28
Changes in operating assets and liabilities:		
Accounts receivable	(61)	(51)
Inventories	(1,136)	(412)
Deferred income taxes	7,382	(5,610)
Prepaid expenses and other current assets	(1,795)	397
Other assets	12	
Accounts payable	609	(2,255)
Accrued compensation and other current liabilities	23,207	699
Income taxes payable	(170)	12,498
Deferred revenue and customer advances	2,453	(29,624)
Other long-term liabilities	(1,069)	657
Net cash provided by (used in) operating activities	(4,152)	86,064
Cash flows provided by (used in) investing activities:		
Purchases of short-term investments	(44,221)	(31,777)
Maturities of short-term investments	78,978	
Intangibles and other assets	(2,219)	(1,444)
Purchases of property and equipment	(1,821)	(1,169)
Net cash provided by (used in) investing activities	30,717	(34,390)
Cash flows provided by (used in) financing activities:		
Issuance of common stock under employee stock purchase plan	330	317
Exercise of stock options and warrants	1,168	10,817
Excess tax benefits from stock-based compensation	194	10,579

Payments on long-term debt		(1,400)
Purchases of treasury stock	(12,643)	
Net cash provided by (used in) financing activities	(10,951)	20,313
Effect of exchange rates on cash and cash equivalents	(24)	1,460
Net increase in cash and cash equivalents	15,590	73,447
Cash and cash equivalents:		
Beginning of the period	86,493	32,012
End of the period	$ 102,083	$ 105,459
Supplemental disclosure of cash flow information:		
Cash paid (received) for taxes	$ (731)	$ 6,032
Cash paid for interest	$	$ 572
Non-cash investing and financing activities:		
Amounts accrued for property and equipment, and intangibles	$ 848	$
Amounts accrued for purchase of treasury stock	$ 709	$

See accompanying Notes to Condensed Consolidated Financial Statements.

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IMMERSION CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2008
(Unaudited)

1. SIGNIFICANT ACCOUNTING POLICIES

Description of Business

Immersion Corporation (the Company) was incorporated in 1993 in California and reincorporated in Delaware in 1999 and develops, manufactures, licenses, and supports a wide range of hardware and software technologies and products that enhance digital devices with touch interaction.

Principles of Consolidation and Basis of Presentation

The condensed consolidated financial statements include the accounts of Immersion Corporation and its majority-owned subsidiaries. All intercompany accounts, transactions, and balances have been eliminated in consolidation.

The accompanying condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial information and with the instructions for Form 10-Q and Article 10 of Regulation S-X and, therefore, do not include all information and footnotes necessary for a complete presentation of the financial position, results of operations, and cash flows, in conformity with accounting principles generally accepted in the United States of America. These condensed consolidated financial statements should be read in conjunction with the Company s audited consolidated financial statements included in the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 2007. In the opinion of management, all adjustments consisting of only normal and recurring items necessary for the fair presentation of the financial position and results of operations for the interim period have been included.

The results of operations for the interim periods ended September 30, 2008 are not necessarily indicative of the results to be expected for the full year.

Short-term Investments

The Company s 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. The Company classifies all debt securities with readily determinable market values as available-for-sale in accordance with Statement of Financial Accounting Standards (SFAS) No. 115, Accounting for Certain Investments in Debt and Equity Securities (SFAS No. 115). Even though the stated maturity dates of these debt securities may be one year or more beyond the balance sheet date, the Company has 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 during the normal operating cycle of the Company. 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.

The Company follows the guidance provided by Financial Accounting Standards Board (FASB) Staff Position (FSP) 115-1/124-1 and Emerging Issues Task Force (EITF) No. 03-01, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments (EITF No. 03-01), to assess whether the Company s 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

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cost basis, the financial condition and near-term prospects of the investee , and the Company s 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, the Company adopted the provisions of SFAS No. 157 Fair Value Measurements (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 not 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 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. The Company continues to assess the impact that FSP 157-2 may have on its consolidated financial position and results of operations.

Further information about the application of SFAS No. 157 may be found in Note 2 below.

Revenue Recognition

The Company recognizes revenues in accordance with applicable accounting standards, including Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) No. 104, Revenue Recognition (SAB No. 104), EITF No. 00-21, Accounting for Revenue Arrangements with Multiple Deliverables (EITF No. 00-21), Statement of Position (SOP) 81-1 Accounting for Performance for Construction-Type and Certain Production-Type contracts (SOP 81-1), and SOP 97-2, Software Revenue Recognition (SOP 97-2), as amended. Revenue is recognized when persuasive evidence of an arrangement exists, delivery has occurred or service has been rendered, the fee is fixed and determinable, and collectability is probable. The Company derives its revenues from three principal sources: royalty and license fees, product sales, and development contracts.

Royalty and license revenue The Company recognizes royalty and license revenue based on royalty reports or related information received from the licensee as well as time-based licenses of its 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 the Company to provide future services to the licensee are deferred and recognized over the service period when vendor-specific objective evidence (VSOE) related to the value of the services does not exist.

The Company generally recognizes revenue from its licensees under one or a combination of the following 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 cost-to-cost percentage-of-completion accounting method over the service period or completed contract method. Obligation to licensee exists until development work is complete.
License of software or technology, no modification necessary, no services contracted.	Up-front revenue recognition based on SOP 97-2 criteria or EITF No. 00-21, 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, the Company recognizes revenue in accordance with SAB No. 104, EITF No. 00-21, SOP 81-1, and SOP 97-2, as amended, to guide the accounting treatment for each individual contract. See also the discussion regarding Multiple element arrangements below. If the information received from the Company s licensees regarding royalties is incorrect or inaccurate, the Company s revenues in future periods may be adversely affected. To date, none of the information the Company has received from its licensees has caused any material adjustment to period revenues.

Product sales The Company recognizes 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. The Company sells the majority of its products with warranties ranging from three to sixty months. The Company records the estimated warranty costs during the quarter the revenue is recognized. Historically, warranty-related costs and related accruals have not been significant. The Company offers a general right of return on the MicroScribe® product line for 14 days after purchase. The Company recognizes revenue at the time of shipment of a MicroScribe digitizer and provides an accrual for potential returns based on historical experience. The Company offers no other general right of return on its 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 cost-to-cost percentage-of-completion accounting method based on physical completion of the work to be performed or completed contract 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 The Company enters 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, the Company allocates revenue to each element based on the relative fair value of each of the elements. The price charged when the element is sold separately generally determines the fair value or VSOE.

The Company s revenue recognition policies are significant because the Company s revenues are a key component of its results of operations. In addition, the Company s revenue recognition policies determine the timing of certain expenses, such as commissions and royalties.

Recent Accounting Pronouncements

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (SFAS No. 159). The new Statement allows entities to choose, at specified election dates, to measure eligible financial assets and liabilities at fair value in situations in which they are not otherwise required to be measured at fair value. If a company elects the fair value option for an eligible item, changes in that item s fair value in subsequent reporting periods must be recognized in current earnings. SFAS No. 159 also establishes presentation and disclosure requirements designed to draw comparison between entities that elect different measurement attributes for similar assets and liabilities. SFAS No. 159 was effective on January 1, 2008. The Company did not elect the fair value option for any of its financial instruments, therefore the adoption of SFAS No. 159 did not impact the condensed consolidated financial statements.

In April 2008, the FASB issued FSP No. FAS 142-3, Determination of the Useful Life of Intangible Assets (FSP No. FAS 142-3). FSP No. FAS 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under Statement of SFAS No. 142, Goodwill and Other Intangible Assets. FSP No. FAS 142-3 is effective for fiscal years beginning after December 15, 2008. The Company is currently assessing the impact that FSP No. FAS 142-3 will have on its results of operations, financial position, or cash flows.

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2. FAIR VALUE DISCLOSURES

Short-term Investments

	September 30, 2008			
	Amortized Cost	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Fair Value
		(In thousands)		
U.S. government agency securities	$ 16,934	$ 42	$	$ 16,976

	December 31, 2007			
	Amortized Cost	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Fair Value
		(In thousands)		
Corporate commercial paper	$ 41,740	$	$ (34)	$ 41,706
U.S. government agency securities	9,871	42		9,913
Total	$ 51,611	$ 42	$ (34)	$ 51,619

The contractual maturities of the Company s available-for-sale securities on September 30, 2008 and December 31, 2007 were all due in one year or less.

Cash Equivalents and Short-term Investments

The financial assets of the Company measured at fair value on a recurring basis are cash equivalents and short-term investments. The Company s cash equivalents and short-term investments are generally classified within Level 1 or Level 2 of the fair value hierarchy because they are valued using quoted market prices, broker or dealer quotations, or alternative pricing sources with reasonable levels of price transparency.

The types of instruments valued based on quoted market prices in active markets include most U.S. government agency securities and most money market securities. Such instruments are generally classified within Level 1 of the fair value hierarchy.

The types of instruments valued based on quoted prices in markets that are less active, broker or dealer quotations, or alternative pricing sources with reasonable levels of price transparency include most investment-grade corporate commercial paper. Such instruments are generally classified within Level 2 of the fair value hierarchy.

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The following table sets forth the Company s cash equivalents and short-term investments which are measured at fair value on a recurring basis by level within the fair value hierarchy as of September 30, 2008. As required by SFAS No. 157, these are classified based on the lowest level of input that is significant to the fair value measurement.

	Fair value measurement using			Assets at
	Level 1	Level 2	Level 3	fair value
		(In thousands)		
Corporate commercial paper	$	$ 19,961	$	$ 19,961
U.S. Government agency securities	28,869			28,869
Money market accounts	67,146			67,146
Total	$ 96,015	$ 19,961	$	$ 115,976

The above table excludes $3.1 million of cash.

3. INVENTORIES

	September 30, 2008	December 31, 2007
	(In thousands)	
Raw materials and subassemblies	$ 3,768	$ 2,843
Work in process	364	179
Finished goods	760	652
Inventories, net	$ 4,892	$ 3,674

4. PROPERTY AND EQUIPMENT

	September 30, 2008	December 31, 2007
	(In thousands)	
Computer equipment and purchased software	$ 4,262	$ 3,195
Machinery and equipment	2,982	2,532
Furniture and fixtures	1,229	1,212
Leasehold improvements	1,248	1,267
Total	9,721	8,206
Less accumulated depreciation	(6,519)	(6,094)
Property and equipment, net	$ 3,202	$ 2,112

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5. INTANGIBLES AND OTHER ASSETS

	September 30, 2008	December 31, 2007
	(In thousands)	
Patents and technology	$ 16,955	$ 15,105
Accumulated amortization of patents and technology	(7,298)	(6,714)
Intangibles, net	9,657	8,391
Other assets	405	167
Intangibles and other assets, net	$ 10,062	$ 8,558

The estimated annual amortization expense for intangible assets as of September 30, 2008 is $724,000 in 2008, $709,000 in 2009, $1.1 million in 2010, $1.1 million in 2011, $1.0 million in 2012, and $5.6 million in total for all years thereafter.

6. COMPONENTS OF OTHER CURRENT LIABILITIES AND DEFERRED REVENUE AND CUSTOMER ADVANCES

	September 30, 2008	December 31, 2007
	(In thousands)	
Accrued legal	$ 367	$ 417
Income taxes payable	255	534
Other current liabilities	3,812	1,678
Amount due to Microsoft Corporation (Note 9)	20,750	
Total other current liabilities	$ 25,184	$ 2,629
Deferred revenue, current portion	$ 4,574	$ 4,352
Customer advances	79	126
Total current deferred revenue, and customer advances	$ 4,653	$ 4,478

7. LONG-TERM DEFERRED REVENUE

On September 30, 2008, long-term deferred revenue was $16.5 million and included approximately $14.5 million of deferred revenue from Sony Computer Entertainment. On December 31, 2007, long-term deferred revenue was $14.3 million and included approximately $11.7 million from Sony Computer Entertainment. See Note 9 for further discussion.

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. Essentially all of the Company s employees participate in the equity incentive program. 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. Since inception, the Company has approved programs to purchase up to 19,377,974 shares of its common stock. Under these programs, stock options may be granted at prices not less than the fair market value on the date of grant for incentive stock options and not less than 85% of fair market value on the date of grant for nonstatutory 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. On September 30, 2008, 2,386,648 shares of common stock were available for grant, and there were 7,251,470 options to purchase shares of common stock outstanding, as well as 20,500 RSU s outstanding.

On June 6, 2007, the Company s stockholders approved the Immersion Corporation 2007 Equity Incentive Plan (the 2007 Plan). The 2007 Plan replaced the Company s 1997 Stock Option Plan (the 1997 Plan). Effective June 6, 2007, the 1997 Plan was terminated. Under the 2007 Plan, the Company may grant stock options, stock appreciation rights, restricted stock, RSU s, performance shares, performance units, and other stock-based or cash-based awards to employees and consultants. The 2007 Plan also authorizes the grant of awards of stock options, stock appreciation rights, restricted stock, and restricted stock units to non-employee members of the Company s Board of Directors and deferred compensation awards to officers, directors, and certain management or highly compensated employees. The 2007 Plan authorizes the issuance of 2,303,232 shares of the Company s common stock, and up to an additional 1,000,000 shares subject to awards that remain outstanding under the 1997 Plan as of June 6, 2007 and which subsequently terminate without having been exercised or which are forfeited to the Company.

On April 30, 2008, the Company s Board of Directors approved the issuance of equity awards under the Immersion Corporation 2008 Employment Inducement Award Plan (the 2008 Plan). Under the 2008 Plan, the Company may issue awards in the form of stock options, stock appreciation rights, restricted stock purchase rights, restricted stock bonuses, restricted stock units (RSU s), performance shares, performance units, deferred compensation awards, and other cash and stock awards. Such awards may be granted to new employees who had not previously been a director, and former employees or directors whose period of service was followed by a bona-fide period of non-employment.

Employee Stock Purchase Plan

The Company has an Employee Stock Purchase Plan (ESPP). Under the ESPP, eligible employees may purchase common stock through payroll deductions at a purchase price of 85% of the lower of the fair market value of the Company s stock at the beginning of the offering period or the purchase date. Participants may not purchase more than 2,000 shares in a six-month offering period or purchase stock having a value greater than $25,000 in any calendar year as measured at the beginning of the offering period. A total of 500,000 shares of common stock are reserved for the issuance under the ESPP plus an automatic annual increase on January 1, 2001 and on each January 1 thereafter through January 1, 2010 by an amount equal to the lesser of 500,000 shares per year or a number of shares determined by the Board of Directors. As of September 30, 2008, 397,813 shares had been purchased since the inception of the ESPP. Under SFAS No. 123R, Share-Based Payment, (SFAS No. 123R), the ESPP is considered a compensatory plan and the Company is required to recognize compensation cost related to the fair value of common stock purchased under the ESPP.

The Company did not modify its ESPP in the nine months ended September 30, 2008.

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General Stock Option Information

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

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (In years)	Aggregate Intrinsic Value
Outstanding at December 31, 2007 (3,774,245 exercisable at a weighted average price of $9.11 per share)	6,014,370	$ 9.11		
Granted (weighted average fair value of $5.02 per share)	2,179,925	8.76		
Exercised	(204,891)	5.71		
Forfeited and Cancelled	(737,934)	8.84		
Outstanding at September 30, 2008	7,251,470	$ 9.13	5.68	$1.87 million
Exercisable at September 30, 2008	4,265,859	$ 9.14	3.51	$1.85 million

The expected to vest share balance as of September 30, 2008 is 6,112,543.

The aggregate intrinsic value is calculated as the difference between the exercise price of the underlying awards and the quoted price of the Company s common stock for the options that were in-the-money at September 30, 2008. The aggregate intrinsic value of options exercised under the Company s stock option plans, determined as of the date of option exercise, was approximately $700,000 for the nine months ended September 30, 2008.

Additional information regarding options outstanding as of September 30, 2008 is as follows:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
$ 1.20 - $ 6.02	728,823	5.03	$ 3.26	642,198	$ 2.95
6.03 - 6.79	730,204	4.56	6.35	591,711	6.34
6.81 - 6.98	748,524	5.77	6.96	541,680	6.96
7.00 - 7.53	725,096	6.42	7.16	500,329	7.06
7.60 - 8.61	953,766	7.28	8.47	185,045	8.11
8.67 - 9.01	788,778	3.22	8.99	570,155	8.98
9.04 - 9.24	821,794	5.81	9.09	455,241	9.13
9.47 - 10.00	881,790	7.94	9.84	167,790	10.00
10.13 - 31.88	835,009	4.63	19.12	574,024	21.05
33.50 - 43.25	37,686	1.54	39.95	37,686	39.95

$ 1.20 - $43.25	7,251,470	5.68	$ 9.13	4,265,859	$ 9.14

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Restricted Stock Units

Restricted stock unit activity for the nine months ended September 30, 2008 is as follows:

	Number of Shares	Weighted Average Grant Date Fair Value	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value
Outstanding at December 31, 2007				
Granted	20,500	$ 5.58		
Vested				
Forfeited				
Outstanding at September 30, 2008	20,500	$ 5.58	1.91	$ 119,310
Expected to Vest	15,726	$ 5.58	1.91	$ 92,523

The aggregate intrinsic value is calculated as the difference between the exercise price of the underlying awards, and the quoted price of the Company s stock for the restricted stock units that were in-the-money as of September 30, 2008.

Stock-based Compensation

Valuation and amortization method The Company uses the Black-Scholes-Merton option pricing model (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 the Company s 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, the Company s expected stock price volatility over the term of the awards, risk-free interest rate, and expected dividends.

Expected term The Company estimates the expected term of options granted by calculating the average term from the Company s historical stock option exercise experience. The expected term of ESPP shares is the length of the offering period. The Company used the simplified method as prescribed by SAB No. 107 for options granted prior to December 31, 2007.

Expected volatility The Company estimates the volatility of its common stock taking into consideration its historical stock price movement, the volatility of stock prices of companies of similar size with similar businesses, if any, and its expected future stock price trends based on known or anticipated events.

Risk-free interest rate The Company bases the risk-free interest rate that it uses 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 The Company does not anticipate paying any cash dividends in the foreseeable future and therefore uses an expected dividend yield of zero in the option-pricing model.

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Forfeitures The Company is required to estimate future forfeitures at the time of grant and revise those estimates in subsequent periods if actual forfeitures differ from those estimates. The Company uses historical data to estimate pre-vesting option forfeitures and records stock-based compensation expense only for those awards that are expected to vest.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
Options	**2008**	**2007**	**2008**	**2007**
Expected term (in years)	5.5	6.25	5.5	6.25
Volatility	64%	60%	62%	60%
Interest rate	3.1%	4.4%	2.9%	4.6%
Dividend yield				

	Three Months Ended September 30,		Nine Months Ended September 30,	
Employee Stock Purchase Plan	**2008**	**2007**	**2008**	**2007**
Expected term (in years)	0.5	0.5	0.5	0.5
Volatility	83%	58%	80%	50%
Interest rate	1.9%	5.0%	2.0%	5.1%
Dividend yield				

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	**2007**	**2008**	**2007**
Income Statement Classifications	**(In thousands)**		**(In thousands)**	
Cost of product sales	$ 42	$ 32	$ 114	$ 78
Sales and marketing	286	297	864	674
Research and development	211	152	680	467
General and administrative	501	218	1,310	723
Total	$ 1,040	$ 699	$ 2,968	$ 1,942

SFAS No. 123R requires the benefits of tax deductions in excess of recognized compensation expense to be reported as a financing cash flow, rather than as an operating cash flow. For the three months and nine months ended September 30, 2008, the Company recorded $18,000 and $194,000, respectively, of excess tax benefits from stock-based compensation. For the three months and nine months ended September 30, 2007, the Company recorded $1.3 million and $10.6 million, respectively, of excess tax benefits from stock-based compensation.

The Company has calculated an additional paid-in capital (APIC) pool pursuant to the provisions of SFAS No. 123R. The APIC pool represents the excess tax benefits related to stock-based compensation that are available to absorb future tax deficiencies. The Company includes only those excess tax benefits that have been realized in accordance with SFAS No. 109, Accounting for Income Taxes. If the amount of future tax deficiencies is greater than the available APIC pool, the Company will record the excess as income tax expense in its condensed consolidated statements of operations.

As of September 30, 2008, there was $11.0 million of unrecognized compensation cost, adjusted for estimated forfeitures, related to non-vested stock options and RSUs granted to the Company s employees and directors. This cost will be recognized over an estimated weighted-average period of approximately 2.98 years for options and 2.91 years for RSUs. Total unrecognized compensation cost will be adjusted for future changes in estimated forfeitures.

Warrants

On December 23, 2004, in conjunction with 5% Convertible Debentures, the Company issued an aggregate of 426,951 warrants to purchase shares of its common stock at an exercise price of $7.0265. The warrants may be exercised at any time prior to 5:00 p.m. Eastern time, on December 23, 2009. Any warrants not exercised prior to such time will expire.

Stock Repurchase Program

On November 1, 2007, the Company announced 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 September 30, 2008, the Company repurchased 1.1 million shares for $7.2 million at an average cost of $6.50 through open market repurchases. During the nine months ended September 30, 2008, the Company repurchased 1.8 million shares for $13.4 million at an average cost of $7.31 through open market repurchases. This amount is classified as treasury stock on the Company s condensed consolidated balance sheet.

9. LITIGATION CONCLUSIONS AND PATENT LICENSE

In 2003, the Company executed a series of agreements with Microsoft that provided for settlement of its lawsuit against Microsoft as well as various licensing, sublicensing, and equity and financing arrangements. Under the terms of these agreements, in the event that the Company elected to settle the action in the United States District Court for the Northern District of California entitled *Immersion Corporation v. Sony Computer Entertainment of America, Inc., Sony Computer Entertainment Inc. and Microsoft Corporation*, Case No. C02-00710 CW (WDB), as such action pertains to Sony Computer Entertainment, and grant certain rights, the Company would be obligated to pay Microsoft a minimum of $15.0 million for amounts up to $100.0 million received from Sony Computer Entertainment, plus 25% of amounts over $100.0 million up to $150.0 million, and 17.5% of amounts over $150.0 million. The Company determined that the conclusion of its litigation with Sony Computer Entertainment did not trigger any payment obligations under its Microsoft agreements. Accordingly, the liability of $15.0 million that was in the financial statements at December 31, 2006 was extinguished, and the Company accounted for this sum during 2007 as litigation conclusions and patent license income. However, on June 18, 2007, Microsoft filed a complaint against the Company in the U.S. District Court for the Western District of Washington alleging one claim for breach of a contract. Microsoft alleged that the Company breached a Sublicense Agreement executed in connection with the parties settlement in 2003 of the Company s claims of patent infringement against Microsoft. The complaint alleged that Microsoft was entitled to payments that Microsoft contends are due under the Sublicense Agreement as a result of Sony Computer

Entertainment s satisfaction of the judgment in the Company s lawsuit against Sony Computer Entertainment and payment of other sums to the Company. In a letter sent to the Company dated May 1, 2007, Microsoft stated that it believed the Company owed Microsoft at least $27.5 million, an amount that was subsequently increased to $35.6 million. Although the company disputed Microsoft s allegations, on August 25, 2008 the parties agreed to settle all claims. The Company had made no offers to settle prior to August 25, 2008. Under the terms of the settlement, the Company paid Microsoft $20.8 million in October 2008.

In March 2007, the Company s patent infringement litigation with Sony Computer Entertainment concluded. Sony Computer Entertainment satisfied the judgment against it from the United States District Court for the Northern District of California, which included damages, pre-judgment interest, costs and interest totaling $97.3 million, along with compulsory license fees already paid to the Company of $30.6 million and interest earned on these fees of $1.8 million. As of March 19, 2007, the Company and Sony Computer Entertainment entered into an agreement whereby the Company granted Sony Computer Entertainment and certain of its affiliates a worldwide, non-transferable, non-exclusive license under the Company s patents that have issued, may issue, or claim a priority date before March 2017 for the going forward use, development, manufacture, sale, lease, importation, and distribution of Sony Computer Entertainment s current and past PlayStation and related products. The license does not cover adult, foundry, medical, automotive, industrial, mobility, or gambling products. Subject to the terms of the agreement, the Company also granted Sony Computer Entertainment and certain of its affiliates certain other licenses (relating to PlayStation games, backward compatibility of future consoles, and the use of their licensed products with certain third party products), an option to obtain licenses in the future with respect to future gaming products and certain releases and covenants not to sue. Sony Computer Entertainment granted the Company certain covenants not to sue and agreed to pay the Company 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, and may pay the Company certain other fees and royalty amounts. In total, the Company will receive a minimum of $152.2 million through the conclusion of the litigation and the business agreement. In accordance with the guidance from EITF No. 00-21, the Company has allocated the present value of the total payments, equal to $149.9 million, between each element based on their relative fair values. Under this allocation, the Company recorded $119.9 million as litigation conclusions and patent license income, and the remaining $30.0 million is allocated to deferred license revenue to the extent payment is received in advance of revenue recognition. Such deferred revenue was $17.5 million at September 30, 2008. The Company recorded $749,000 and $2.2 million as revenue for the three-month and nine-month periods ended September 30, 2008, respectively. The Company recorded $749,000 and $1.6 million as revenue for the three-month and nine-month periods ended September 30, 2007, respectively. On September 30, 2008, the Company had recorded $4.6 million of the $30.0 million as revenue and will record the remaining $25.4 million as revenue, on a straight-line basis, over the remaining capture period of the patents licensed, ending March 19, 2017. The Company has accounted for future payments in accordance with Accounting Principles Board Opinion No. 21 (ABP No. 21). Under APB No. 21, the Company determined the present value of the $22.5 million future payments to equal $20.2 million. The Company is accounting for the difference of $2.3 million as interest income as each $1.875 million quarterly payment installment becomes due. This amount is accrued at September 30, 2008 in Other current liabilities.

On October 20, 2004, Internet Services LLC (ISLLC) filed claims against the Company in its lawsuit against Sony Computer Entertainment in the U.S. District Court for the Northern District of California, alleging that the Company breached a contract with ISLLC by suing Sony Computer Entertainment for patent infringement relating to haptically-enabled software whose topics or images are allegedly age-restricted, for judicial apportionment of damages between ISLLC and the Company of the damages awarded by the jury, and for a judicial declaration with respect to ISLLC s rights and duties under agreements with the Company. On December 29, 2004, the District Court issued an order dismissing ISLLC s claims against Sony Computer Entertainment with prejudice and dismissing ISLLC s claims against the Company without prejudice to ISLLC. On January 12, 2005, ISLLC filed Amended Cross-Claims and Counterclaims against the Company that contained similar claims. On March 24, 2005, the District Court again dismissed certain of these claims with prejudice and dismissed the other claims without prejudice.

On February 8, 2006, ISLLC filed a lawsuit against the Company in the Superior Court of Santa Clara County. ISLLC s complaint sought a share of the damages awarded to the Company in the Sony litigation and of the Microsoft settlement proceeds, and generally restated the claims already adjudicated by the District Court. On March 16, 2006, the Company answered the complaint, cross claimed for declaratory relief, breach of contract by ISLLC, and for rescission of the contract, and removed the lawsuit to federal court. The case was assigned to Judge Wilken in the U.S. District Court for the Northern District of California as a case related to the previous proceedings involving Sony Computer Entertainment and ISLLC. On May 10, 2007, ISLLC filed a motion in the District Court to remand its latest action to the Superior Court, or in the alternative, for leave to file an amended complaint. The Company opposed ISLLC s motion, and cross-moved for judgment on the pleadings. On June 26, 2007, the District Court ruled on the motions, denying ISLLC s motion to remand or for leave to file an amended complaint, and granting in part the Company s motion for judgment on the pleadings. The District Court also dismissed one of ISLLC s claims. However, on May 16, 2008, the District Court entered an order granting the Company s motion for summary judgment on all of ISLLC s claims, as well as the Company s counterclaim for declaratory relief. As a result, the only claims remaining in the action were the Company s counterclaims against ISLLC. On August 22, 2008, the Company settled its counterclaims against ISLLC and amended the terms of its existing business agreement with ISLLC. For the three months and nine months ended September 30, 2008, the Company recognized $1.1 million in royalty and license revenue as of result of this settlement with ISLLC.

10. INCOME TAXES

For the three months and nine months ended September 30, 2008, the Company recorded income tax provisions of $7.3 million and $4.6 million on income (loss) before taxes of $(25.0) million and $(33.3) million, yielding effective tax rates of (29.0)% and (13.9)%, respectively. For the three months and nine months ended September 30, 2007, the Company recorded income tax provisions for income taxes of $(61,000) and $(13.7) million, on income (loss) before taxes of $554,000 and $130.2 million, yielding effective tax rates of 11.0% and 10.5%. The income tax provision for the three and nine months ended September 30, 2008 arises because the Company recorded a full valuation allowance on deferred tax assets of $7.3 million. Accordingly, the charge differs from the expected benefit derived by applying the applicable United States federal statutory rate before taxes. The income tax provision for the three and nine months ended September 30, 2007, are as a result of applying the estimated annual effective tax rate to cumulative income (loss) before taxes, adjusted for certain discrete items which are fully recognized in the period they occur.

The Company adopted FIN 48, regarding accounting for uncertain tax benefits, on January 1, 2007. As of September 30, 2008, the Company has unrecognized tax benefits of approximately $651,000, including interest of $24,000 which, if recognized, would result in a reduction of the Company s effective tax rate. Future changes in the unrecognized tax benefit will have an impact on the effective tax rate. There were no material changes in the amount of unrecognized tax benefits during the quarter ended September 30, 2008. 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 the income tax provision.

The Company is subject to taxation in the United States and various states and foreign jurisdictions. The tax years 1993-2007 remain open to examination by the federal and most state tax authorities due to net operating loss and credit carryforwards. The Company s foreign operations in Canada are open to audit under statute of limitation for the years ending December 31, 1998 through 2007. During June 2008, the Internal Revenue Service concluded the examination of calendar year 2004 with no changes.

In the quarter ended September 30, 2008, the Company had 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 realizability of the deferred tax asset, 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, which expire from 2018 to 2028.

The Company s income taxes payable for federal and state purposes have been reduced by the tax benefits from employee stock options. The net tax benefits from employee stock option transactions were approximately $0 and $108,000 during the three and nine months ended September 30, 2008, respectively, and are reflected as increases to additional paid-in capital. The net tax benefits from employee stock option transactions were approximately $1.4 million and $13.2 million during the three months and nine months ended September 30, 2007, respectively. The Company includes only the direct tax effects of employee stock incentive plans in calculating these increases to additional paid-in capital.

The Emergency Economic Stabilization Act of 2008, which contains the Tax Extenders and Alternative Minimum Tax Relief Act of 2008 , was enacted on October 3, 2008 by the U.S. government. Under the Act, the research credit was retroactively extended for amounts paid or incurred after December 31, 2007 and before January 1, 2010. The effects of the change in the tax law will be recognized in the Company s fourth quarter, which is the quarter in which the law was enacted. The Company is currently in the process of analyzing the impact of the new law.

11. 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):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	**2007**	**2008**	**2007** (Restated)
Numerator:				
Net income (loss) used in computing basic net income (loss) per share	$ (32,298)	$ 493	$ (37,974)	$ 116,507
Interest on 5% Convertible Debentures				348
Net income (loss) used in computing diluted net income (loss) per share	$ (32,298)	$ 493	$ (37,974)	$ 116,855
Denominator:				
Shares used in computation of basic net income (loss) per share (weighted average common shares outstanding)	29,448	28,630	30,092	26,768
Dilutive potential common shares:				
Stock options		2,523		1,937
Warrants		246		322
5% Convertible Debentures				2,288
Shares used in computation of diluted net income (loss) per share	29,448	31,399	30,092	31,315
Basic net income (loss) per share	$ (1.10)	$ 0.02	$ (1.26)	$ 4.35
Diluted net income (loss) per share	$ (1.10)	$ 0.02	$ (1.26)	$ 3.73

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As of the three and nine months ended September 30, 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:

Outstanding stock options	7,251,470
Restricted Stock Units	20,500
Warrants	436,772

For the three months and nine months ended September 30, 2007, options and warrants to purchase approximately 383,034 and 1.3 million shares of common stock, respectively, with exercise prices greater than the average fair market value of the Company s stock of $15.57 and $11.54 respectively were not included in the calculation because the effect would have been anti-dilutive. Additionally for the three months ended September 30, 2007, securities representing the conversion of the 5% Convertible Debentures of 1,189,751 were excluded from the calculation because the effect would have been anti-dilutive.

12. COMPREHENSIVE INCOME (LOSS)

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
	(In thousands)		(In thousands)	
				(Restated)
Net income (loss)	$ (32,298)	$ 493	$ (37,974)	$ 116,507
Change in unrealized losses on short-term investments	42		13	(25)
Foreign currency translation adjustment	5	46	(15)	79

13. 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) Immersion Computing, Entertainment, and Industrial, and 2) Immersion 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 net income (loss). A description of the types of products and services provided by each operating segment is as follows:

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
	(In thousands)		(In thousands)	
				(restated)
Revenues:				
Immersion Computing, Entertainment, and Industrial	$ 6,909	$ 4,578	$ 17,109	$ 12,810
Immersion Medical	3,221	5,240	10,530	12,044
Intersegment eliminations	(49)	(15)	(90)	(42)
Total	$ 10,081	$ 9,803	$ 27,549	$ 24,812
Net Income (Loss):				
Immersion Computing, Entertainment, and Industrial	$ (29,977)	$ (810)	$ (34,032)	$ 116,037
Immersion Medical	(2,282)	1,305	(3,897)	466
Intersegment eliminations	(39)	(2)	(45)	4
Total	$ (32,298)	$ 493	$ (37,974)	$ 116,507

	September 30, 2008	December 31, 2007
	(In thousands)	
Total Assets:		
Immersion Computing, Entertainment, and Industrial	$ 162,378	$ 181,860
Immersion Medical	7,913	6,552
Intersegment eliminations	(22,759)	(20,044)
Total	$ 147,532	$ 168,368

Intersegment eliminations represent eliminations for intercompany sales and cost of sales and intercompany receivables and payables between Immersion Computing, Entertainment, and Industrial and Immersion Medical segments.

The Company operates primarily in the United States and in Canada where it operates through its wholly owned subsidiary, Immersion Canada, Inc. Segment assets and expenses relating to the Company s corporate operations are not allocated but are included in Immersion Computing, Entertainment, and

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Industrial as that is how they are considered for management evaluation purposes. As a result, the 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. Management measures the performance of each segment based on several metrics, including net income (loss). These results are used, in part, to evaluate the performance of, and allocate resources to, each of the segments.

Revenue by Product Lines Information regarding revenue from external customers by product lines is as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
	(In thousands)		(In thousands)	
Revenues:				
Consumer, Computing, and Entertainment	$ 4,684	$ 2,567	$ 10,648	$ 6,057
3D	1,204	1,035	3,522	3,123
Touch Interface Products	972	961	2,849	3,588
Subtotal Immersion Computing, Entertainment, and Industrial	6,860	4,563	17,019	12,768
Immersion Medical	3,221	5,240	10,530	12,044
Total	$ 10,081	$ 9,803	$ 27,549	$ 24,812

Revenue by Region The following is a summary of revenues by geographic areas. Revenues are broken out geographically by the ship-to location of the customer. Geographic revenue as a percentage of total revenue was as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
North America	56%	73%	58%	67%
Europe	18%	19%	20%	18%
Far East	26%	7%	19%	12%
Rest of the world	0%	1%	3%	3%
Total	100%	100%	100%	100%

The Company derived approximately 56% and 73% of its total revenues from the United States of America for the three months ended September 30, 2008 and 2007, respectively. The Company derived 12% of its total revenues from Korea for the three months ended September 30, 2008. The Company derived 55% and 66% of its total revenues from the United States of America for the nine months ended September 30, 2008 and 2007, respectively. Revenues from other countries represented less than 10% individually for the periods presented.

The majority of the Company s long-lived assets are located in the United States of America. Long-lived assets include net property and equipment and long-term investments and other assets. Long-lived assets that were outside the United States of America constituted less than 10% of the total on September 30, 2008 and December 31, 2007.

Significant Customers Customers comprising 10% or greater of the Company s net revenues are summarized as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	**2007**	**2008**	**2007**
Customer A	10%	*%	*%	*%
Customer B	10%	*%	*%	*%
Customer C	*%	12%	*%	12%
Customer D	*%	14%	*%	11%
Customer E	*%	*%	*%	*%
Total	20%	26%	0%	23%

Customer B, C, and E accounted for 10%, 11%, and 18%, respectively, of the Company s accounts receivable on September 30, 2008. Customer D accounted for 24% of the Company s accounts receivable on December 31, 2007. No other customer accounted for more than 10% of the Company s accounts receivable on September 30, 2008 or on December 31, 2007.

14. 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 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.

The Company and most of the issuer defendants had settled with the plaintiffs. In this settlement, plaintiffs would have dismissed and released all claims against the Immersion Defendants in exchange for a contingent payment by the insurance companies collectively responsible for insuring the issuers in all of the IPO cases, and for the assignment or surrender of certain claims the Company may have against the underwriters. The Immersion Defendants would not have been required to make any cash payments in the settlement, unless the pro rata amount paid by the insurers in the settlement exceeded the amount of the insurance coverage, a circumstance that the Company believed was remote. In September 2005, the District Court granted preliminary approval of the settlement. The District Court held a hearing to consider final approval of the settlement on April 24, 2006, and took the matter under submission. Subsequently, the U.S. Court of Appeals for the Second Circuit vacated the class certification of plaintiffs claims against the underwriters in six cases designated as focus or test cases. *Miles v. Merrill Lynch & Co. (In re Initial Public Offering Securities Litigation)*, 471 F.3d 24 (2d Cir. 2006). Thereafter, the District Court ordered a stay of all proceedings in all of the lawsuits pending the outcome of plaintiffs petition to the Second Circuit for rehearing en banc and resolution of the class certification issue. On April 6, 2007, the Second Circuit denied plaintiffs petition for rehearing, but clarified that the plaintiffs may seek to certify a more limited class in the District Court. Accordingly, the parties withdrew the prior settlement, and plaintiffs filed an amended complaint in attempt to comply with the Second Circuit s ruling. On March 26, 2008, the District Court denied in part and granted in part the motions to dismiss the focus cases on substantially the same grounds as set forth in its prior opinion.

During the three months ended September 30, 2008, the terms of a settlement have been reached between all of the parties to all of the lawsuits, under which the Company will not be required to pay any cash. The settlement is subject to completion of documentation and court approval, neither of which can be assured. The Company has not accrued for any loss on this matter, and believes the possibility of loss to be remote.

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.

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15. RESTATEMENT OF PREVIOUSLY ISSUED QUARTERLY RESULTS OF OPERATIONS (UNAUDITED)

Subsequent to the filing of Form 10-Q for the nine months ended September 30, 2007, the Company determined that there were errors in its accounting for income taxes for the release of deferred income tax valuation allowance related to stock option deductions for prior years and the utilization of an incorrect effective state tax rate. The Company restated its previously reported provision for income taxes of $7.1 million to $13.7 million and previously reported net income of $123.1 million to $116.5 million. The impact on the condensed consolidated statements of operations and condensed consolidated cash flows is presented below:

	Nine Months Ended September 30, 2007		
	As Previously Reported	Adjustments	As Restated
	(In thousands except per share amounts)		
Total revenues	$ 24,812	$	$ 24,812
Income before provision for income taxes	$ 130,195	$	$ 130,195
Provision for income taxes	(7,093)	(6,595)	(13,688)
Net income	$ 123,102	$ (6,595)	$ 116,507
Basic net income per share	$ 4.60	$ (0.25)	$ 4.35
Shares used in calculating basic net income per share	26,768		26,768
Diluted net income per share	$ 3.93	$ (0.20)	$ 3.73
Shares used in calculating diluted net income per share	31,408	(93)	31,315
Changes to cash flows from operating activities:			
Net income	$ 123,102	$ (6,595)	$ 116,507
Excess tax benefits from stock-based compensation	(3,215)	(7,364)	(10,579)
Deferred income taxes	(5,351)	(259)	(5,610)
Income taxes payable	6,271	6,227	12,498
Other long-term liabilities	30	627	657
Net cash provided by operating activities	93,428	(7,364)	86,064
Changes to cash flows from financing activities:			
Excess tax benefits from stock-based compensation	$ 3,215	$ 7,364	$ 10,579
Net cash provided by financing activities	12,949	7,364	20,313

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 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; mobile communications; and three-dimensional design and interaction. We manage these application areas under two operating and reportable segments: 1) Immersion Computing, Entertainment, and Industrial and 2) Immersion 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 and 3D design and interaction, 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.

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 more than 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, Revenue Recognition, EITF No.
00-21, Accounting for Revenue Arrangements with Multiple Deliverables, AICPA SOP 81-1 Accounting for Performance for Construction-Type and Certain Production-Type contracts, and AICPA SOP 97-2, Software Revenue Recognition, as amended. Revenue is recognized when persuasive evidence of an arrangement exists, delivery has occurred or service

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has been rendered, the fee is fixed and determinable, 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 deferred and recognized over the service period when VSOE related to the value of the services does not exist.

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 cost-to-cost percentage-of-completion accounting method over the service period or completed contract method. Obligation to licensee exists until development work is complete.
License of software or technology, no modification necessary, no services contracted.	Up-front revenue recognition based on SOP 97-2 criteria or EITF No. 00-21, 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 81-1, and SOP 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 cost-to-cost percentage-of-completion accounting method based on physical completion of the work to be performed or completed contract 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 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 elected 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, 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. 107 for options granted prior to December 31, 2007.

Expected volatility We estimate the volatility of our common stock taking into consideration our historical stock price movement, the volatility of stock prices of companies of similar size with similar businesses, if any, 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 use historical data to estimate pre-vesting option forfeitures and record stock-based compensation expense only for those awards that are expected to vest. Changes in estimated forfeitures will be recognized through a cumulative catchup adjustment in the period of change and will also impact the amount of compensation expense to be recognized in future periods.

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. 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 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.

Litigation Conclusions and Patent License

In March 2007, we announced the conclusion of our patent infringement litigation against Sony Computer Entertainment at the U.S. Court of Appeals for the Federal Circuit. Sony Computer Entertainment satisfied the U.S. District Court for the Northern District of California judgment against it. As of March 19, 2007, we entered into a new business agreement with Sony Computer Entertainment. We determined that the conclusion of our litigation with Sony Computer Entertainment did not trigger any payment obligations under our Microsoft agreements. However, on June 18, 2007, Microsoft filed a complaint against us in the United States District Court for the Western District of Washington alleging breach of our Sublicense Agreement dated July 25, 2003 and seeks damages, specific performance, declaratory judgment, and attorneys fees and costs. At a court ordered mediation meeting on December 11, 2007, Microsoft indicated they believe the amount owed to be $35.6 million. On August 25, 2008, the parties agreed to settle Microsoft s breach of contract claim as well as our counterclaim. The settlement arrangement provided that we pay Microsoft $20.8 million, which we paid in October 2008, and the case was dismissed.

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. 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 during our normal operating cycle. 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 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 not 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. The Company continues to assess the impact that FSP 157-2 may have on our consolidated financial position and results of operations.

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. To date such estimated losses have been within our expectations.

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 condensed 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, once they issue, 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 three months and nine months ended September 30, 2008, we capitalized costs associated with patents and trademarks of $674,000 and $1.9 million, respectively. Our total amortization expense for the same periods for all intangible assets was $179,000, and $584,000, respectively.

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 AND NINE MONTHS ENDED SEPTEMBER 30, 2008 AND 2007

The following Management s Discussion and Analysis gives effect to the restatement discussed in Note 15 to the condensed consolidated financial statements.

Overview

We achieved a 3% increase in revenues during the three months ended September 30, 2008 as compared to the three months ended September 30, 2007. The third quarter revenue growth was primarily due to a 64% increase in royalty and license revenues mainly from increased gaming and mobility royalty and license fees. The revenue increase was partially offset by a 12% decrease in product sales and a 62%

decrease in development contract revenues. We achieved an 11% increase in revenues during the nine months ended September 30, 2008 as compared to the nine months ended September 30, 2007. The first nine months revenue growth was primarily due to a 45% increase in royalty and license revenues mainly from increased gaming and mobility royalty and license fees, partially offset by a 2% decrease in product sales and an 18% decrease in development contract revenues. Our net loss was $32.3 million for the three months ended September 30, 2008 compared to net income of $493,000 for the three months ended September 30, 2007. Our net loss was $38.0 million for the nine months ended September 30, 2008 compared to net income of $116.5 million for the nine months ended September 30, 2007. In the third quarter of 2008 and throughout the first nine months of 2008, we continued to invest in research, development, sales, and marketing across all our key business segments. In August 2008, we settled our litigation with Microsoft and we agreed to make a one time payment to Microsoft in the amount of $20.8 million which was recorded in the third quarter of 2008 and paid in October 2008. In March 2007, we concluded our patent infringement litigation against Sony Computer Entertainment and recognized a gain of $119.9 million of litigation conclusions and patent license in the first nine months of 2007. During the three months ended September 30, 2008, the Company assessed the realizability of the deferred tax asset and determined the amount was no longer realizable and recorded a $7.3 million charge to income tax expense.

For the remainder of 2008, we expect to continue to focus on the execution of sales and marketing plans in our established businesses to increase revenue and make selected investments in product and technology development and sales and marketing for longer-term growth areas. Our success could be limited by several factors, including the timely release of our new products or 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	**September 30, 2008**	**2007**	**Change**
	($ In thousands)		
Three months ended:			
Royalty and license	$ 4,761	$ 2,904	64%
Product sales	4,755	5,420	(12)%
Development contracts and other	565	1,479	(62)%
Total Revenue	$ 10,081	$ 9,803	3%
Nine months ended:			
Royalty and license	$ 11,393	$ 7,862	45%
Product sales	13,992	14,299	(2)%
Development contracts and other	2,164	2,651	(18)%
Total Revenue	$ 27,549	$ 24,812	11%

Three Months Ended September 30, 2008 Compared to Three Months Ended September 30, 2007

Total Revenue Our total revenue for the third quarter of 2008 increased by $278,000 or 3% from the third quarter of 2007.

Royalty and license revenue Royalty and license revenue is comprised of royalties earned on sales by our VibeTonz and TouchSense licensees and license fees charged for our intellectual property portfolio. Royalty and license revenue for the three months ended September 30, 2008 was $4.8 million, an increase of $1.9 million or 64% from the three months ended September 30, 2007. The increase in royalty and license revenue was due to an increase in gaming royalties of $1.4 million and an increase in mobile device license and royalty revenue of $491,000.

The increase in gaming royalties for the third quarter of 2008 compared to the similar period in 2007 was partly due to the increase in sales of new steering wheel products from Logitech. Revenues from gaming also included previously deferred revenues from ISLLC totaling $1.1 million which was recognized after we concluded our litigation with them. Although the revenue from our third-party peripheral licensees has 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), 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, we are seeing the decline begin to stabilize, as manifested by the release of new steering wheel products from Logitech for the PlayStation 3.

Sony announced on May 8, 2006 that the vibration feature that is currently available on PlayStation (PS1) and PlayStation 2 (PS2) console systems would be removed from the new PlayStation 3 (PS3) console system. The PS3 console system was launched in late 2006 in the United States and Japan without native vibration or any force feedback capability of any kind. In the first quarter of 2007, Sony released an update to the PS3 console system that offered limited vibration and force feedback support for some older PS1 and PS2 games and controllers. In September 2007, Sony announced that it would fully restore vibration feedback features for the PS3 console system. The new PS3 DualShock 3 controllers with vibration feedback were released in Japan in November 2007 as standalone products sold separately from the PS3 console system. In April 2008, Sony released the PS3 DualShock 3 controller in the U.S. and released a version in Europe in July of 2008. While a very limited number of third party PS3 vibration and force feedback products have been announced recently, including various steering wheel models from Logitech, we do not know to what extent Sony will foster the market for other third-party PS3 gaming peripherals with vibration feedback. 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.

Based on our litigation conclusion and new business agreement entered into with Sony Computer Entertainment in March 2007 (see Note 9 to the condensed consolidated financial statements for more discussion), we will recognize a minimum of $30.0 million as royalty and license revenue from March 2007 through March 2017, approximately $750,000 per quarter. 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.

Mobile device license and royalty revenue increased due to the shipment of additional VibeTonz enabled phones by our existing licensees. We expect mobility device and royalty revenue to be a significant component of our revenue as our technology is included in mobile phone handsets.

Product sales Product sales for the three months ended September 30, 2008 were $4.8 million, a decrease of $665,000 or 12% as compared to the three months ended September 30, 2007. The decrease in product sales was primarily due to a decrease in medical product sales of $863,000 partially offset by an increase in 3D product sales of $183,000. Decreased medical product sales was mainly due to reduced sales of our endovascular, endoscopy, and Virtual IV simulator platforms partially offset by increases in our laparoscopy and arthroscopy simulators. This decrease in product sales was primarily a result of orders that

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did not repeat of endovascular devices during the three months ending September 30, 2007 along with a decrease in sales of our endoscopy simulators as a result of decreased government related orders. These decreases were partially offset by continued expansion of international sales for all of our simulation platforms including increased sales of laparoscopy simulators driven by our increased emphasis on the laparoscopy platform and modules as well as the launch of an arthroscopy simulator in the three months ending September 30, 2008. Increased 3D product sales was primarily due to increased sales of our MicroScribe, CyberForce®, and CyberGrasp® products.

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 $565,000 during the three months ended September 30, 2008, a decrease of $914,000 or 62% as compared to the three months ended September 30, 2007. The decrease was mainly attributable to a decrease in medical contract revenue of $1.2 million due to the completion of work performed under medical contracts in 2007 not repeated in 2008. The decrease was also due to the ongoing transition of our medical engineering resources from certain commercial development contract efforts to product development efforts that focus on leveraging our existing sales and channel distribution capabilities. Partially offsetting that decrease was increased revenue recognized on mobile device development contracts and support of $157,000 and increased Touch Interface Product contract revenue of $67,000.

We categorize our geographic information into four major regions: North America, Europe, Far East, and Rest of the World. In the third quarter of 2008, revenue generated in North America, Europe, Far East, and Rest of the World represented 56%, 18%, 26%, and 0%, respectively, compared to 73%, 19%, 7%, and 1%, respectively, for the third quarter of 2007. The shift in revenues among regions was mainly due to an increase in mobile device royalty and contract revenue and medical product revenue from the Far East and a decrease in medical contract and product revenue in North America partially offset by an increase in gaming license and royalty revenue in North America.

Nine Months Ended September 30, 2008 Compared to Nine Months Ended September 30, 2007

Total Revenue Our total revenue for the first nine months of 2008 increased by $2.7 million or 11% from the first nine months of 2007.

Royalty and license revenue Royalty and license revenue for the nine months ended September 30, 2008 was $11.4 million, an increase of $3.5 million or 45% from the nine months ended September 30, 2007. The increase in royalty and license revenue was primarily due to an increase in mobile device license and royalty revenue of $2.1 million and an increase in gaming royalties of $2.0 million offset by a decrease in touch interface product royalties of $588,000.

Mobile device license and royalty revenue increased primarily due to the increase in the shipment of VibeTonz enabled phones by LG Electronics which began in the second quarter of 2007, the signing of a new license contract with mobile device manufacturer Nokia at the end of the second quarter of 2007, and the shipment of additional VibeTonz enabled phones by our licensees in 2008. The increase in gaming royalties was mainly due to the increase in sales of new steering wheel products from Logitech and previously deferred revenues from ISLLC. There was also an increase in royalty and license revenue from first-party gaming licensee Sony Computer Entertainment. In addition, touch interface product royalties decreased mainly due to the recognition of certain automotive royalty payments in the second quarter of 2007 that did not recur.

Product sales Product sales for the nine months ended September 30, 2008 were $14.0 million, a decrease of $307,000 or 2% as compared to the nine months ended September 30, 2007. The decrease in product sales was primarily due to decreased medical product sales of $911,000 partially offset by an increase in 3D product sales of $394,000 and an increase in touch interface products of $210,000. The decrease in medical product sales was mainly due to reduced sales of our endovascular and Virtual IV simulator platforms partially offset by increases in our laparoscopy, endoscopy, and arthroscopy simulators. This decrease in medical product sales was primarily a result of orders of endovascular devices during the

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nine months ending September 30, 2007 that were not repeated. This decrease was partially offset by continued expansion of international sales for all of our simulation platforms as well as the launch of an arthroscopy simulator. 3D product sales increased due to additional sales of our CyberForce, CyberGrasp, and MicroScribe products. Touch interface products increased due to additional sales of touchscreen and touch panel components, rotary modules, and commercial gaming products.

Development contract and other revenue Development contract and other revenue was $2.2 million during the nine months ended September 30, 2008, a decrease of $487,000 or 18% as compared to the nine months ended September 30, 2007. The decrease was mainly attributable to a decrease in medical contract revenue of $602,000 due to the completion of work performed under medical contracts in the first six months of 2008, and decreased touch interface product contract revenue of $362,000 primarily due to contracts being completed. Partially offsetting this, there was increased revenue recognized on mobile device development contracts and support of $441,000.

In the first nine months of 2008, revenue generated in North America, Europe, Far East, and Rest of the World represented 58%, 20%, 19%, and 3%, respectively, compared to 67%, 18%, 12%, and 3%, respectively, for the first nine months of 2007. The shift in revenues among regions was mainly due to an increase in mobile device royalty and contract revenue and medical product revenue from the Far East, an increase in revenue from mobile device license and contract revenue from Europe, and a decrease in medical contract and product revenue in North America partially offset by an increase in gaming license and royalty revenue in North America. We partially attribute increased European and Far East Revenue to the addition of increased international sales and support personnel in 2008.

COST OF PRODUCT SALES	**September 30, 2008**	**2007**	**Change**
	($ In thousands)		
Three months ended:			
Cost of product sales	$2,951	$2,563	15%
% of total product revenue	62%	47%	
Nine months ended:			
Cost of product sales	$7,607	$6,533	16%
% of total product revenue	54%	46%	

Cost of Product Sales Our cost of product sales consists primarily of materials, labor, and overhead. There is no cost of product sales associated with royalty revenue or development contract revenue. Cost of product sales was $3.0 million, an increase of $388,000 or 15% for the three months ended September 30, 2008 as compared to the three months ended September 30, 2007. The increase in cost of product sales was primarily due to increased material costs of $145,000, increased provision for warranty and repair costs of $147,000, and increased royalties of $97,000. The increase in direct material costs was mainly the result of a product mix change for medical product sales. Provision for warranty and repair costs increased primarily due to a defective component which we will be replacing on one of our laparoscopic products. Royalty costs increased due to increased sales of certain medical products with higher royalty costs. Cost of product sales increased as a percentage of product revenue to 62% in the first three months of 2008 from 47% in the first three months of 2007. This increase is mainly due to the change in the product sales mix mentioned above.

Cost of product sales was $7.6 million, an increase of $1.1 million or 16% for the nine months ended September 30, 2008 as compared to the nine months ended September 30, 2007. The increase in cost of product sales was primarily due to an increase of overhead costs of $432,000, increased direct material costs of $199,000, increased provision for warranty and repair costs of $125,000, increased royalties of $110,000, and an increase in excess and obsolete inventory provisions of $108,000. Overhead costs increased, in part, as a result of increased salary expense primarily due to the costs of programs to improve quality processes within our manufacturing operations which we anticipate will continue throughout 2008. The increase in direct material costs was mainly a result of a higher percentage of sales from products with higher costs. Royalty costs increased due to increased sales of certain medical products with higher royalty costs. Cost of product sales increased as a percentage of product revenue to 54% in the first nine months of 2008 from 46% in the first nine months of 2007. This increase is mainly due to the increased overhead costs mentioned above as well as a sales decrease of certain products with lower costs in the product sales mix.

OPERATING EXPENSES AND OTHER	September 30, 2008	September 30, 2007	Change
	($ In thousands)		
Three months ended:			
Sales and marketing	$ 4,296	$ 2,825	52%
% of total revenue	43%	29%	
Research and development	$ 3,155	$ 2,482	27%
% of total revenue	31%	25%	
General and administrative	$ 4,774	$ 2,781	72%
% of total revenue	47%	28%	
Amortization of intangibles	$ 179	$ 243	(26)%
% of total revenue	2%	2%	
Litigation settlements, conclusions, and patent license	$20,750	$	*%
% of total revenue	*%	*%	
Nine months ended:			
Sales and marketing	$11,996	$ 8,558	40%
% of total revenue	44%	34%	
Research and development	$ 9,239	$ 7,538	23%
% of total revenue	34%	30%	
General and administrative	$14,121	$ 9,162	54%
% of total revenue	51%	37%	
Amortization of intangibles	$ 584	$ 739	(21)%
% of total revenue	2%	3%	
Litigation settlements, conclusions, and patent license	$20,750	$(134,900)	*%
% of total revenue	*%	*%	

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 were $4.3 million, an increase of $1.5 million or 52% in the third quarter of 2008 compared to the comparable period in 2007. The increase was primarily due to increased compensation, benefits, and overhead of $533,000, an increase in bad debt expense of $241,000 primarily from one customer that has not paid within terms, increased consulting costs of $210,000 to supplement our sales and marketing staff, increased sales and marketing travel expense of $162,000, increased recruiting costs of $142,000, increased marketing, advertising, and public relations costs of $93,000, and increased office expenses of $81,000. The increased sales and marketing expenses were primarily due to an increase in sales and marketing headcount and the expansion of our sales and marketing efforts internationally. 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. We will continue to invest in sales and marketing in future periods to exploit market opportunities for our technology.

Sales and marketing expenses were $12.0 million, an increase of $3.4 million or 40% in the first nine months of 2008 compared to the same period in 2007. The increase was primarily due to increased compensation, benefits, and overhead of $1.5 million, increased marketing, advertising, and public relations costs of 507,000, increased sales and marketing travel expense of $358,000, an increase in bad debt expense of $325,000, increased consulting costs of $302,000 to supplement our sales and marketing staff, and increased employee recruiting costs of $279,000. The increased sales and marketing expenses were primarily due to an increase in sales and marketing headcount and the expanding of our sales and marketing efforts internationally. In addition, the increased compensation, benefits, and overhead expense was mainly due to an increase in sales and marketing headcount, increased compensation for sales and marketing personnel, and increased non-cash stock based compensation charges, partially offset by decreased variable compensation.

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 were $3.2 million, an increase of $673,000 or 27% in the third quarter of 2008 compared to the same period in 2007. The increase was primarily due to increased compensation, benefits, and overhead of $472,000, an increase in lab and prototyping expenses of $120,000, and an increase in professional consulting expense of $44,000 to supplement our engineering staff. The increased compensation, benefits, and overhead expense was primarily due to increased research and development headcount, increased compensation for research and development personnel, and increased non-cash stock based compensation charges. We believe that continued significant investment in research and development is critical to our future success, and we expect to make investments in areas of research and technology development to support future growth.

Research and development expenses were $9.2 million, an increase of $1.7 million or 23% in the first nine months of 2008 compared to the same period in 2007. The increase was primarily due to increased compensation, benefits, and overhead of $1.2 million, an increase in professional consulting expense of $244,000 to supplement our engineering staff, and an increase in prototyping expenses of $183,000. The increased compensation, benefits, and overhead expense was primarily due to increased research and development headcount, increased compensation for research and development personnel, and increased non-cash stock based compensation charges.

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 were $4.8 million, an increase of $2.0 million or 72% in the third quarter of 2008 compared to the same period in 2007. The increase was primarily due to increased legal, professional, and license fee expense of $1.2 million and increased compensation, benefits, and overhead of $735,000. The increased legal, professional, and license fee expenses were primarily due to increased litigation costs, mainly Microsoft litigation; increased consulting costs; and increased recruiting costs. The increased compensation, benefits, and overhead expense was primarily due to increased general and administrative headcount, increased compensation for general and administrative personnel, and increased non-cash stock-based compensation charges. We expect that the dollar amount of general and administrative expenses to continue to be a significant component of our operating expenses.

General and administrative expenses were $14.1 million, an increase of $5.0 million or 54% in the first nine months of 2008 compared to the same period in 2007. The increase was primarily due to increased legal, professional, and license fee expense of $2.4 million and increased compensation, benefits, and overhead of $2.3 million. The increased legal, professional, and license fee expenses were primarily due to increased litigation costs, mainly Sony litigation; increased consulting costs; and increased recruiting costs. The increased compensation, benefits, and overhead expense was primarily due to increased general and administrative headcount, increased compensation for general and administrative personnel, and increased non-cash stock-based compensation charges.

Amortization of Intangibles Our amortization of intangibles is comprised primarily of patent amortization and other intangible amortization. Amortization of intangibles decreased by $64,000 or 26% in the third quarter of 2008 compared to the same period in 2007. Amortization of intangibles decreased by $155,000 or 21% in the first nine months of 2008 compared to the same period in 2007. The decrease was primarily attributable to some intangible assets reaching full amortization partially offset by an increase from the cost and number of new patents being amortized.

Litigation Settlements, Conclusions, and Patent License Litigation settlements, conclusions, and patent license was $20.8 million, an increase of $20.8 million in the third quarter of 2008 compared to the same period in 2007, all of which related to our settlement with Microsoft. Litigation settlements, conclusions, and patent license was $20.8 million of expense in the first nine months of 2008, compared to income of $134.9 million for the same period in 2007, an increase of $155.7 million. For the same period in 2007, the $134.9 million is comprised of $119.9 million related to Sony Computer Entertainment and $15.0 million related to the release of the Microsoft long-term customer advance.

In March 2007, we concluded our patent infringement litigation against Sony Computer Entertainment at the U.S. Court of Appeals for the Federal Circuit. In satisfaction of the Amended Judgment, we received funds totaling $97.3 million, inclusive of the award for past damages, pre-judgment interest and costs, and post-judgment interest. Additionally, we retained $32.4 million of compulsory license fees and interest thereon previously paid to us by Sony Computer Entertainment pursuant to court orders. As of March 19, 2007, both parties entered into an agreement whereby we granted Sony Computer Entertainment and certain of its affiliates a worldwide, non-transferable, non-exclusive license under our patents that have issued, may issue, or claim a priority date before March 2017 for the going forward use, development, manufacture, sale, lease, importation, and distribution of its current and past PlayStation and related products. The license does not cover adult, foundry, medical, automotive, industrial, mobility, or gambling products. Subject to the terms of the agreement, we also granted Sony Computer Entertainment and certain of its affiliates certain other licenses (relating to PlayStation games, backward compatibility of future consoles, and the use of their licensed products with certain third party products), an option to obtain licenses in the future with respect to future gaming products and certain releases and covenants not to sue. Sony Computer Entertainment granted us certain covenants not to sue and agreed to pay us 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, and may pay us certain other fees and royalty amounts. In total, we will receive a minimum of $152.2 million through the conclusion of the litigation and the separate patent license. In accordance with the guidance from EITF No. 00-21, we allocated the present value of the total payments, equal to $149.9 million, between each element based on their relative fair values. Under this allocation, we recorded $119.9 million as litigation conclusions and patent license income and the remaining $30.0 million was allocated to deferred license revenue. We recorded $749,000 as revenue for each of the three months ended September 30, 2008 and 2007. We recorded $2.2 million and $1.6 million as revenue for the nine months ended September 30, 2008 and 2007, respectively. At September 30, 2008, we had recorded $4.6 million of the $30.0 million as revenue and will record the remaining $25.4 million as revenue, on a straight-line basis, over the remaining capture period of the patents licensed, ending March 19, 2017. We have accounted for future payments in accordance with APB No. 21. Under APB No. 21, we determined the present value of the $22.5 million future payments to equal $20.2 million. We are accounting for the difference of $2.3 million as interest income as each $1.875 million quarterly payment installment becomes due.

Under the terms of a series of agreements that we entered into with Microsoft in 2003, in the event we had elected to settle the action in the United States District Court for the Northern District of California entitled *Immersion Corporation v. Sony Computer Entertainment of America, Inc., Sony Computer*

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Entertainment Inc. and Microsoft Corporation, Case No. C02-00710 CW (WDB), as such action pertains to Sony Computer Entertainment, and grant certain rights, we would be obligated to pay Microsoft a minimum of $15.0 million for amounts up to $100.0 million received from Sony Computer Entertainment, plus 25% of amounts over $100.0 million up to $150.0 million, and 17.5% of amounts over $150.0 million. The patent infringement litigation with Sony Computer Entertainment was concluded in March 2007 at the U.S. Court of Appeals for the Federal Circuit without settlement. We determined that the conclusion of our litigation with Sony Computer Entertainment did not trigger any payment obligations under our Microsoft agreements. Accordingly, the liability of $15.0 million that was in the financial statements at December 31, 2006 was extinguished, and we accounted for this sum during 2007 as litigation conclusions and patent license income. However, on June 18, 2007, Microsoft filed a complaint against us in the U.S. District Court for the Western District of Washington alleging one claim for breach of a contract. In a letter sent to us dated May 1, 2007, Microsoft stated that it believed we owed Microsoft at least $27.5 million, an amount that was subsequently increased to $35.6 million. Although we disputed Microsoft s allegations, on August 25, 2008 the parties agreed to settle all claims. The Company had made no offers to settle prior to August 25, 2008. Under the terms of the settlement, we paid Microsoft $20.8 million in October 2008.

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. Interest and other income decreased by $868,000 in the third quarter of 2008 compared to the same period in 2007. 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.

Interest and other income decreased by $633,000 in the first nine months of 2008 compared to the same period in 2007. 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 partially offset by gain on the sale of short-term investments.

Interest Expense Interest expense consisted primarily of interest and accretion expense on our 5% Convertible Debentures. Interest expense decreased by $211,000 in the third quarter of 2008 compared to the same period in 2007 due to the conversion and redemption of our 5% Convertible Debentures during the third quarter of 2007. Interest expense decreased by $1.0 million in the first nine months of 2008 compared to the same period in 2007 due to the conversion and redemption of our 5% Convertible Debentures during the third quarter of 2007.

Provision for Income Taxes We recorded a provision for income taxes for the quarter ended September 30, 2008 of $7.3 million, yielding an effective tax rate of (29.0)%. For the three months ended September 30, 2007, we recorded a provision for income taxes of $61,000 on pre-tax income of $554,000, yielding an effective tax rate of 11.0%.

The provision for income taxes for the three months ended September 30, 2008, is reflective of the recording of a full valuation allowance against our entire deferred tax asset balance in the period due to losses in fiscal 2008, the variability of operating results, and near term projected results. Accordingly, the effective tax rate differs from the statutory rate. The income tax provision for the three months ended September 30, 2007 was arrived at as a result of applying the estimated annual effective tax rate to cumulative loss before taxes, adjusted for certain discrete items that are fully recognized in the period they occur.

Based on the first nine months of 2008 pre-tax loss of $33.3 million and future projections, we recorded a provision for income taxes for the nine months ended September 30, 2008 of $4.6 million, yielding an effective tax rate of (13.9)%. For the first nine months of 2007, we recorded a provision for income taxes of $13.7 million on a pre-tax profit of $130.2 million, yielding an effective tax rate of 10.5%.

The provision for income taxes for the nine months ended September 30, 2008, is reflective of the recording of a full valuation allowance against our entire deferred tax asset balance in the period due to losses in fiscal 2008, the variability of operating results, and near term projected results. Accordingly, the effective tax rate differs from the statutory rate. The provision for income taxes for the nine months ended September 30, 2007, which were previously fully reserved, is primarily reflective of federal and state tax expense as a result of our pre-tax income of $130.2 million mainly due to the litigation conclusions and patent license from Sony Computer Entertainment, see Note 9 to the condensed consolidated financial statements. For the nine months ended September 30, 2007, the effective tax rate differs from the statutory rate primarily due to the significant reduction in our valuation allowance against deferred tax assets and we used the majority of our net operating loss carryforwards against taxable income.

SEGMENT RESULTS FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2008 AND 2007

	Three Months Ended September 30,		**Nine Months Ended September 30,**	
	2008	**2007**	**2008**	**2007**
	(In thousands)		**(In thousands)**	
Revenues:				
Immersion Computing, Entertainment, and Industrial	$ 6,909	$ 4,578	$ 17,109	$ 12,810
Immersion Medical	3,221	5,240	10,530	12,044
Intersegment eliminations	(49)	(15)	(90)	(42)
Total	$ 10,081	$ 9,803	$ 27,549	$ 24,812
Net Income (Loss):				
Immersion Computing, Entertainment, and Industrial	$ (29,977)	$ (810)	$ (34,032)	$ 116,037
Immersion Medical	(2,282)	1,305	(3,897)	466
Intersegment eliminations	(39)	(2)	(45)	4
Total	$ (32,298)	$ 493	$ (37,974)	$ 116,507

* Segment assets and expenses relating to our corporate operations are not allocated but are included in Immersion Computing, Entertainment, and Industrial as that is how they are considered for management evaluation purposes. As a result the 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.

Immersion Computing, Entertainment, and Industrial segment Revenues from the Immersion Computing, Entertainment, and Industrial segment were $6.9 million, an increase of $2.3 million or 51% in the third quarter of 2008 compared to the same period in 2007. Royalty and license revenues increased by $1.9 million mainly due to an increase in gaming royalties of $1.4 million, and an increase in mobile device license and royalty revenue of $491,000 due to the shipment of additional VibeTonz enabled phones by our licensees. The increase in gaming royalties was mainly due to the increase in sales of new steering wheel products from Logitech and previously deferred revenues from ISLLC totaling $1.1 million. Product sales increased by $233,000 primarily due to increased 3D product sales, mainly MicroScribe, Cyberforce, and Cybergrasp products. Development Contract revenue increased by $241,000 primarily due to increased revenue recognized on mobile device development contracts and increased Touch interface product contract revenue. Net loss for the three months ended September 30, 2008 was $30.0 million, an increase of $29.2 million compared to the same period in 2007. The increase was primarily due to the Microsoft litigation settlement of $20.8 million, an increase in provision for income taxes of $7.2 million, an increase in general and administrative expenses of $1.6 million, a decrease in interest and other income of $867,000 mainly due to reduced interest rates, an increase in sales and marketing expenses of $737,000, and an increase of research and development expenses of $592,000. The increases to the net loss were partially offset by increased gross margin of $2.3 million mainly from increased royalty and license revenue and a decrease in interest expense of $211,000 due to the conversion and redemption of our 5% Convertible Debentures.

Revenues from the Immersion Computing, Entertainment, and Industrial segment were $17.1 million, an increase of $4.3 million or 34% in the first nine months of 2008 compared to the same period in 2007. Royalty and license revenues increased by $3.5 million, mainly due to an increase in mobile device license and royalty revenue primarily due to the shipment of additional VibeTonz enabled phones, and an increase in gaming royalties mainly due to the increase in sales of new steering wheel products from Logitech and previously deferred revenues from ISLLC offset by a decrease in touch interface product royalties mainly due to the recognition of certain automotive royalty payments in the second quarter of 2007 that did not recur. Product sales increased by $653,000 primarily due to increased 3D product sales mainly from increased sales of our CyberForce, CyberGrasp, and MicroScribe products and an increase in product sales from touch interface products, mainly due to increased sales of touchscreen and touch panel components and increased sales of commercial gaming products. Development contract revenue increased by $115,000 primarily due to increased revenue on mobile device development contracts and support partially offset by reduced touch interface product contract revenue. Net loss for the nine months ended September 30, 2008 was $34.0 million, an increase of $150.0 million compared to the same period in 2007. The increase was primarily due to increased litigation settlements, conclusions, and patent license income of $134.9 million ($119.9 million from Sony Computer Entertainment and $15.0 million related to the release of the Microsoft long-term customer advance) occurring in the first nine months of 2007 and the Microsoft settlement expense in the first nine months of 2008 of $20.8 million; an increase in general and administrative expenses of $4.3 million; an increase in sales and marketing expenses of $2.1 million; and an increase of research and development expenses of $1.3 million. The increase to the net loss was partially offset by a decreased provision for income taxes of $9.0 million; increased gross margin of $3.6 million mainly from increased sales; and a decrease in interest expense of $1.0 million due to the conversion and redemption of our 5% Convertible Debentures.

Immersion Medical segment Revenues from Immersion Medical were $3.2 million, a decrease of $2.0 million or 39%, for the third quarter of 2008 compared to the same period in 2007. The decrease was primarily due to a decrease of $1.2 million in medical development contract revenue due to work completed under medical contracts in 2007, and a decrease in product sales of $863,000 mainly due to reduced sales of our endovascular, endoscopy, and Virtual IV simulator platforms partially offset by increases in our laparoscopy and arthroscopy simulators. Net loss for the three months ended September 30, 2008 was $2.3 million, an increase of $3.6 million compared to the same period in 2007. The increase was mainly due to increased sales and marketing expenses of $734,000 as the segment expands international sales and marketing efforts, increased general and administrative expenses of $369,000, and a decrease in gross margin of $2.4 million primarily due to reduced sales and a higher proportion of sales of lower margin products.

Revenues from Immersion Medical were $10.5 million, a decrease of $1.5 million or 13%, for the first nine months of 2008 compared to the same period in 2007. The decrease was primarily due to a decrease in product sales of $911,000 and a decrease of $602,000 in medical development contract revenue. Net loss for the nine months ended September 30, 2008 was $3.9 million, an increase of $4.4 million compared to the same period in 2007. The increase was mainly due to a decrease in gross margin of $1.9 million primarily due to decreased sales, increased sales and marketing expenses of $1.4 million as the segment expands international sales and marketing efforts, increased general and administrative expenses of $699,000, and increased research and development expenses of $408,000.

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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, Accounting for Certain Investments in Debt and Equity Securities. 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 September 30, 2008, our cash, cash equivalents, and short-term investments totaled $119.1 million, a decrease of $19.0 million from $138.1 million on December 31, 2007.

In March 2007, we concluded our patent infringement litigation against Sony Computer Entertainment at the U.S. Court of Appeals for the Federal Circuit. In satisfaction of the Amended Judgment, we received funds totaling $97.3 million, inclusive of the award for past damages, pre-judgment interest and costs, and post-judgment interest. Additionally, we retained $32.4 million of compulsory license fees and interest thereon previously paid to us by Sony Computer Entertainment pursuant to court orders. Furthermore, we entered into a new business agreement. Under the new business agreement, 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 September 30, 2008, we had received seven of these installments.

On June 18, 2007, Microsoft filed a complaint against us in the U.S. District Court for the Western District of Washington alleging one claim for breach of a contract. After conducting discovery and filing various motions, on August 25, 2008 the parties agreed to settle all claims. The Company had made no offers to settle prior to August 25, 2008. Under the terms of the settlement, we paid Microsoft $20.8 million in October 2008.

Net cash used in operating activities during the nine months ended September 30, 2008 was $4.2 million, a change of $90.3 million from the $86.1 million provided during the nine months ended September 30, 2007. Cash used in operations during the nine months ended September 30, 2008 was primarily the result of a net loss of $38.0 million, a decrease of $1.8 million due to a change in prepaid expenses and other current assets, a decrease of $1.1 million due to a change in inventories, a decrease of $1.1 million due to a change in other long-term liabilities, and a decrease of $170,000 due to a change in income taxes payable. These decreases were offset by an increase of $23.2 million due to a change in accrued compensation and other current liabilities primarily due to the Microsoft settlement of $20.8 million, an increase of $7.4 million due to a change in deferred income taxes, a $2.5 million increase due to a change in deferred revenue and customer advances, and an increase of $609,000 due to a change in accounts payable. Cash provided by operations during the nine months ended September 30, 2008 was also impacted by noncash charges and credits of $4.4 million, including $3.0 million of noncash stock-based compensation, $844,000 in depreciation and amortization, $584,000 in amortization of intangibles, an increase to allowance for doubtful accounts of $269,000, partially offset by a credit of $194,000 from excess tax benefits from stock-based compensation, and an $81,000 realized gain on sales of short-term investments.

Net cash provided from investing activities during the nine months ended September 30, 2008 was $30.7 million, compared to the $34.4 million used in investing activities during the nine months ended September 30, 2007, an increase of $65.1 million. Net cash provided by investing activities during the period consisted of an increase in maturities or sales of short-term investments of $79.0 million, partially offset by purchases of short-term investments of $44.2 million; a $2.2 million increase in intangibles and other assets, primarily due to capitalization of external patent filing and application costs; and $1.8 million used to purchase property and equipment.

Net cash used in financing activities during the nine months ended September 30, 2008 was $11.0 million compared to $20.3 million provided during the nine months ended September 30, 2007, or a $31.3 million decrease from the prior year. Net cash used in financing activities for the period consisted primarily of purchases of treasury stock of $12.6 million, partially offset by issuances of common stock and exercises of stock options and warrants in the amount of $1.5 million, and an increase of $194,000 from excess tax benefits from tax deductible stock-based compensation.

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 have continuing litigation and we will continue to protect and defend our

extensive intellectual property portfolio across all business segments which could require ongoing use of our working capital. We anticipate that capital expenditures for the year ended December 31, 2008 will total approximately $2.5 million in connection with anticipated maintenance and upgrades to operations and infrastructure. On November 1, 2007, we announced that our Board of Directors authorized the repurchase of up to $50 million of our common stock. During the nine months ended September 30, 2008, we repurchased 1.8 million shares for $13.4 million at an average net cost of $7.31 through open market repurchases. Additionally, if we acquire one or more businesses, patents, or products, or invest in other companies, 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. Although we expect to be able to raise additional capital if necessary, 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, 2007:

Contractual Obligations	Total	2008	2009 and 2010	2011 and 2012
		(In thousands)		
Operating leases	$ 2,300	$ 1,100	$ 1,191	$ 9

As discussed in Note 10 to the condensed consolidated financial statements, effective January 1, 2007, we adopted the provisions of FIN48. On September 30, 2008, we had a liability for unrecognized tax benefits totaling approximately $651,000, including interest of $24,000. 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 $116.0 million as of September 30, 2008. 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. A hypothetical 100 basis point increase in interest rates would result in an approximate $137,000 decrease in the fair value of our cash equivalents and short-term investments as of September 30, 2008.

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 September 30, 2008. 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 September 30, 2008 due to a material weakness in our internal control over financial reporting with respect to accounting for income taxes that was initially determined and disclosed in our Annual Report on Form 10-K for our fiscal year ended December 31, 2007.

The material weakness we disclosed was in the area of accounting for income taxes. Our review and monitoring of the accuracy of the components of the deferred income tax valuation allowances and related stock option deductions, and the review and monitoring of the effective state income tax rate utilized in the determination of state income taxes were not effective in identifying errors in these calculations. This resulted in material adjustments to the previously reported quarterly unaudited financial results as of March 31, 2007 and the cumulative loss amounts for quarterly unaudited financial results as of June 30, 2007, and September 30, 2007. 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:

1. We initiated a search to hire appropriate personnel to enable us to properly account for and disclose income taxes; to design and implement controls to ensure that the rationale for positions taken on certain tax matters will be adequately documented and appropriately communicated to all internal and external members of our tax team; and design and implement controls over the adjustment of the income tax accounts based on the preparation and filing of income tax returns.

2. We engaged outside consultants to advise us in complex tax accounting areas, to enhance our preparation and review of tax accounting and disclosure and to assist us in the design and implementation of controls over the accounting for income taxes and other tax related matters.

We believe that these corrective steps, once fully implemented, will sufficiently remediate the material weaknesses described above.

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

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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 September 30, 2008 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.

We and most of the issuer defendants had settled with the plaintiffs. In this settlement, plaintiffs would have dismissed and released all claims against the Immersion Defendants in exchange for a contingent payment by the insurance companies collectively responsible for insuring the issuers in all of the IPO cases, and for the assignment or surrender of certain claims we may have against the underwriters. The Immersion Defendants would not have been required to make any cash payments in the settlement, unless the pro rata amount paid by the insurers in the settlement exceeded the amount of the insurance coverage, a circumstance that we believed was remote. In September 2005, the District Court granted preliminary approval of the settlement. The District Court held a hearing to consider final approval of the settlement on April 24, 2006 and took the matter under submission. Subsequently, the Second Circuit vacated the class certification of plaintiffs claims against the underwriters in six cases designated as focus or test cases.

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Miles v. Merrill Lynch & Co. (In re Initial Public Offering Securities Litigation, 471 F.3d 24 (2d Cir. 2006). Thereafter, the District Court ordered a stay of all proceedings in all of the lawsuits pending the outcome of plaintiffs petition to the U.S. Court of Appeals for the Second Circuit for rehearing en banc and resolution of the class certification issue. On April 6, 2007, the Second Circuit denied plaintiffs petition for rehearing, but clarified that the plaintiffs may seek to certify a more limited class in the District Court. Accordingly, the parties withdrew the prior settlement, and plaintiffs filed an amended complaint in attempt to comply with the Second Circuit s ruling. On March 26, 2008, the District Court denied in part and granted in part the motions to dismiss the focus cases on substantially the same grounds as set forth in its prior opinion.

During the three months ended September 30, 2008, the terms of a settlement have been reached between all of the parties to all of the lawsuits, under which we will not be required to pay any cash. The settlement is subject to completion of documentation and court approval, neither of which can be assured.

Internet Services LLC Litigation

On October 20, 2004, ISLLC filed claims against us in its lawsuit against Sony Computer Entertainment in the U.S. District Court for the Northern District of California, alleging that we breached a contract with ISLLC by suing Sony Computer Entertainment for patent infringement relating to haptically-enabled software whose topics or images are allegedly age-restricted, for judicial apportionment of damages between ISLLC and us of the damages awarded by the jury, and for a judicial declaration with respect to ISLLC s rights and duties under agreements with us. On December 29, 2004, the District Court issued an order dismissing ISLLC s claims against Sony Computer Entertainment with prejudice and dismissing ISLLC s claims against us without prejudice to ISLLC. On January 12, 2005, ISLLC filed Amended Cross-Claims and Counterclaims against us that contained similar claims. On March 24, 2005, the District Court again dismissed certain of these claims with prejudice and dismissed the other claims without prejudice.

On February 8, 2006, ISLLC filed a lawsuit against us in the Superior Court of Santa Clara County. ISLLC s complaint sought a share of the damages awarded to us in the Sony litigation and of the Microsoft settlement proceeds, and generally restated the claims already adjudicated by the District Court. On March 16, 2006, we answered the complaint, cross claimed for declaratory relief, breach of contract by ISLLC, and for rescission of the contract, and removed the lawsuit to federal court. The case was assigned to Judge Wilken in the U.S. District Court for the Northern District of California as a case related to the previous proceedings involving Sony Computer Entertainment and ISLLC. On May 10, 2007, ISLLC filed a motion in the District Court to remand its latest action to the Superior Court or in the alternative for leave to file an amended complaint. We opposed ISLLC s motion, and cross-moved for judgment on the pleadings.. On June 26, 2007, the District Court ruled on the motions, denying ISLLC s motion to remand or for leave to file an amended complaint, and granting in part our motion for judgment on the pleadings. The District Court also dismissed one of ISLLC s claims. However, on May 16, 2008, the District Court entered an order granting our motion for summary judgment on all of ISLLC s claims, as well as our counterclaim for declaratory relief. As a result, the only claims remaining in the action were our counterclaims against ISLLC. On August 22, 2008, we settled our counterclaims against ISLLC and amended the terms of our existing business agreement with ISLLC.

Microsoft Corporation v. Immersion Corporation

On June 18, 2007, Microsoft filed a complaint against us in the U.S. District Court for the Western District of Washington alleging one claim for breach of a contract. Microsoft alleged that we breached a Sublicense Agreement executed in connection with the parties settlement in 2003 of our claims of patent infringement against Microsoft in *Immersion Corporation v. Microsoft Corporation, Sony Computer Entertainment Inc. and Sony Computer Entertainment America, Inc., United States District Court for the Northern District of California, Case No. 02-0710-CW).* The complaint alleged that Microsoft was entitled to payments that Microsoft contends are due under the Sublicense Agreement as a result of Sony Computer Entertainment s satisfaction of the judgment in our lawsuit against Sony Computer Entertainment and payment of other sums to us. In a letter sent to us dated May 1, 2007, Microsoft stated that it believed we owed Microsoft at least $27.5 million, an amount that was subsequently increased to $35.6 million. Although we disputed Microsoft s allegations, on August 25, 2008 the parties agreed to settle all claims. The Company had made no offers to settle prior to August 25, 2008. Under the terms of the settlement, we paid Microsoft $20.8 million in October 2008.

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). 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 in the alternative, a motion to transfer venue for convenience to Ohio. On August 7, 2008, we filed our opposition to both motions filed by Simbionix. On October 14, 2008, a status conference was set up for December 2, 2008 to assign a claim construction hearing date and a trial setting. In addition, discovery orders are due December 16, 2008.

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.

Many economists are now predicting that the United States economy, and possibly the global economy, may enter into a prolonged recession or depression as a result of the deterioration in the credit markets and related financial crisis, as well as a variety of other factors. A downturn in the United States or global economy could 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, delays in signing or failing to sign customer agreements, or signing customer agreements at reduced purchase levels. Furthermore, a prolonged tightening of the credit market could significantly impact our ability to access capital or liquidate investments, or could reduce the rate of return on investments. Any of these effects could have a material adverse effect across all of our businesses on our revenues, financial condition and results of operations.

WE HAD AN ACCUMULATED DEFICIT OF $58 MILLION AS OF SEPTEMBER 30, 2008, HAVE A HISTORY OF LOSSES, MAY 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 recent quarters. We need to generate significant ongoing revenue to maintain profitability. We anticipate that our expenses will increase in the foreseeable future as we:

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

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

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.

We attempt to avoid infringing known proprietary rights of third parties. However, 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 us 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.

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WE ARE SUBJECT TO THE RISK OF ADDITIONAL LITIGATION IN CONNECTION WITH THE RESTATEMENT OF OUR CONDENSED CONSOLIDATED FINANCIAL STATEMENTS AND THE POTENTIAL LIABILITY FROM ANY SUCH LITIGATION COULD MATERIALLY AND ADVERSELY AFFECT OUR BUSINESS.

We announced that we restated our condensed consolidated financial statements for the quarterly periods ended March 31, 2007, June 30, 2007, and September 30, 2007. We have restated the condensed consolidated financial statements for the nine months ended September 30, 2007 in this report. See Note 15 to the condensed consolidated statements. As a result of the restatement of our condensed consolidated financial statements, we could become subject to purported class action, derivative, or other securities litigation. As of the date hereof, we are not aware of any such litigation having been commenced against us related to these matters, but we cannot predict whether any such litigation will be commenced or, if it is, the outcome of any such litigation. The initiation of any such securities litigation may harm our business and financial condition.

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 involved in legal proceedings relating to a class action lawsuit filed on November 9, 2001, related to In re Initial Public Offering Securities Litigation. The named defendants are Immersion and three of our current or former officers or directors and certain underwriters of our November 12, 1999 IPO. Subsequently, two of the individual defendants stipulated to a dismissal without prejudice. We and most of the issuer defendants had settled with the plaintiffs. However, the settlement offer had subsequently been withdrawn. During the three months ended September 30, 2008, the terms of a new settlement have now been reached between all of the parties to all of the lawsuits, under which we will not be required to pay any cash. The settlement is subject to completion of documentation and court approval, neither of which can be assured.

Our wholly owned subsidiary, Immersion Medical, Inc., filed lawsuits for patent infringement against Mentice AB, Mentice SA, Simbionix USA Corp., and Simbionix Ltd in the United States District Court for the Eastern District of Texas.

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 litigation, please see Note 14 to the condensed consolidated financial statements in Part I and the section titled Item 1. Legal Proceedings of this Part II.

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

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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.

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

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. Any claims against us 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 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. We have not experienced any product liability claims to date. 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.

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. While we believe that we maintain insurance sufficient to cover most long-term potential losses at our facilities, 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.

Industry and Technology Risks

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 September 30, 2008 and 2007, 47% and 30%, respectively, of our total revenues were royalty and license revenues. For the nine months ended September 30, 2008 and 2007, 41% and 32%, respectively, of our total revenues were royalty and license revenues. However, 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, meet quality control standards, achieve commercial acceptance, or 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. Products incorporating our touch-enabling technologies are generally more difficult to design and manufacture, which may cause product introduction delays or quality control problems. If our licensees fail to stimulate and capitalize upon market demand for products that generate royalties for us, or if products are recalled because of quality control problems, our revenues will not grow and could decline. Alternatively, if a product that incorporates our touch-enabling technologies achieves widespread market acceptance, the product manufacturer may elect to stop paying us, attempt to design around our intellectual property, challenge our intellectual property, or stop making it rather than pay us royalties based on sales of the product.

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.

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. These requirements and restrictions could be in the form of hardware technical specifications, software technical specifications, security specifications or other security mechanisms, component vendor specifications, licensing fees and/or terms and conditions, or other forms. 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. The PS3 console system was launched in late 2006 in the United States and Japan without force feedback capability. Sony has since released new PS3 controllers with vibration feedback. We do not know to what extent Sony will allow third-party peripheral makers to make licensed PS3 gaming products with vibration feedback to interface with the PS3 console. To the extent Sony selectively limits their licensing to leading third-party controller makers to make PS3 controllers with vibration feedback, our licensing revenue from third-party PS3 peripherals will continue to 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 their 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.

TOUCH INTERFACE PRODUCT ROYALTIES WILL BE REDUCED IF BMW WERE TO REMOVE OUR TECHNOLOGY FROM ITS DRIVER CONTROL SYSTEMS.

Our largest royalty stream from touch interface products is currently from BMW for its iDrive controller and driver control systems. BMW has begun to remove our technology from the iDrive controller from one model. The removal of our technology from driver control systems in other models that it is included in or if our technology is not incorporated in BMW vehicles may cause our business may suffer.

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

On July 1, 2006, the European Union s RoHS Directive became effective. This Directive eliminates most uses of lead, cadmium, hexavalent-chromium, mercury, and certain fire retardants in electronics placed on the market after the effective date. Since the introduction of the European Union s RoHS Directive, other regions of the world have announced or implemented similar regulations. In order to sell products into regions that adopt these or similar regulations, we have to assess each product and determine whether they comply with the requirements of the 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, 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.

In addition, our products or packaging may not meet all safety, electrical, labeling, marking, or other requirements of all countries into which we ship products or our resellers sell our products. We attempt to comply with all known laws and regulations governing product sales into the countries we ship products. However, if products are determined not to be compliant or exempt, we will not be able to ship them in the region that has such regulations until such time that they are compliant, and this may have a negative impact on our revenue and results of operations. There is also the possibility of fines and legal costs as well as costs associated with a product recall if products or packaging are found not to meet the requirements.

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 on the hardware and software sides, 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 both on the hardware and software sides, and 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.

REDUCED SPENDING BY CORPORATE, UNIVERSITY, OR GOVERNMENT RESEARCH AND DEVELOPMENT DEPARTMENTS MAY ADVERSELY AFFECT SALES OF OUR PRODUCTS.

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.

COMPETITION BETWEEN OUR PRODUCTS AND OUR LICENSEES PRODUCTS MAY REDUCE OUR REVENUE.

Rapid technological change, short product life cycles, cyclical market patterns, declining average selling prices, and increasing foreign and domestic competition characterize the markets in which we and our licensees compete. 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.

We face competition from unlicensed products as well. Our licensees or other third parties may 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. 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.

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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 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 automotive 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.

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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 ARE UNABLE TO CONTINUALLY IMPROVE AND REDUCE THE COST OF OUR TECHNOLOGIES, COMPANIES MAY NOT INCORPORATE OUR TECHNOLOGIES INTO THEIR PRODUCTS, WHICH COULD IMPAIR OUR REVENUE GROWTH.

Our ability to achieve revenue growth 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.

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. Additionally, as haptic technology gains market momentum, 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. 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
- our current products become obsolete or no longer meet new regulatory requirements.

WE HAVE LIMITED ENGINEERING, CUSTOMER SERVICE, 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, 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 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 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. Due to the time generally required to complete and publish additional validation studies (usually more than a year), the negative impact on sales revenue could be significant.

MEDICAL LICENSING AND CERTIFICATION AUTHORITIES MAY NOT RECOMMEND OR REQUIRE USE OF OUR TECHNOLOGIES FOR TRAINING AND/OR TESTING PURPOSES, 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) 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, market penetration for our products could be significantly and adversely affected.

WE HAVE LIMITED DISTRIBUTION CHANNELS AND RESOURCES TO MARKET AND SELL OUR MEDICAL SIMULATORS, TOUCH INTERFACE PRODUCTS, AND THREE-DIMENSIONAL SIMULATION AND DIGITIZING 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 medical simulation, touch interface, or three-dimensional simulation and digitizing 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 medical simulation, touch interface, and three-dimensional simulation 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 represent small, specialized companies and may not have sufficient capital or human resources to support the complexities of selling and supporting 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. The sales volumes for these 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 to 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.

INCREASING COMPETITION IN THE MEDICAL MARKET MAY REDUCE OUR REVENUE.

The medical simulation market is very competitive. As it continues to develop as we anticipate, we believe that we will have more competition. As in many developing markets, acquisitions, or consolidations may occur that could lead to larger competitors with more resources or broader market penetration. This increased competition may result in the decline of our revenue and may cause us to reduce our selling prices.

COMPETITION IN THE MOBILITY OR TOUCHSCREEN MARKETS MAY INCREASE OUR COSTS AND REDUCE OUR REVENUE.

If the mobility or touchscreen markets develop as we anticipate, we believe that we will face a greater number of competitors, possibly including the internal design teams of existing and potential OEM customers. These potential competitors may have significantly greater financial and technical resources than we do, and the costs associated with competing with such potential competitors could be significant. Additionally, increased competition may result in the reduction of our market share and/or cause us to reduce our prices, which may result in a decline in our revenue.

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 OUR FAILURE TO MANAGE THE COMPLEXITIES ASSOCIATED WITH THE CHANGING ECONOMIC ENVIRONMENT AND TECHNOLOGY LANDSCAPE COULD HARM OUR BUSINESS.

Current and any future periods of rapid economic and technological change may place significant strains on our managerial, financial, engineering, or other resources. Current and further economic weakness, in combination with our complex technologies, may demand an unusually high level of managerial effectiveness in anticipating, planning, coordinating, and meeting our operational needs as well as the needs of our licensees. Our failure to effectively manage these resources during periods of rapid economic or technological change may harm our business.

CLENT RICHARDSON, OUR PRESIDENT, CHIEF EXECUTIVE OFFICER, AND DIRECTOR, AND SEVERAL OTHER 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.

Clent Richardson, our President, Chief Executive Officer, and Director was hired in April 2008, and several other members of our executive management team also joined us in 2008. 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 stock option and 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.

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;

litigation or claims regarding our restatement, internal controls, or other matters;

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.

ISSUANCE OF THE SHARES OF COMMON STOCK UPON EXERCISE OF STOCK OPTIONS AND EXERCISE OF WARRANTS AND ISSUANCE AND VESTING OF RESTRICTED STOCK UNITS WILL DILUTE THE OWNERSHIP INTEREST OF EXISTING STOCKHOLDERS AND COULD ADVERSELY AFFECT THE MARKET PRICE OF OUR COMMON STOCK.

The issuance of shares of common stock in the following circumstances will dilute the ownership interest of existing stockholders: (i) upon exercise of some or all of the stock options, (ii) upon exercise of some or all of the warrants, and (iii) upon issuance and vesting of restricted stock units. Any sales in the public market of the common stock issuable upon such exercises could adversely affect prevailing market prices of our common stock. In addition, the existence of these stock options and warrants may encourage short selling by market participants.

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; the timing and magnitude of purchases of our common stock pursuant to our stock repurchase program and any cessation of the program; 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, such as the suit currently pending against us.

OUR STOCK REPURCHASE PROGRAM COULD AFFECT OUR STOCK PRICE AND ADD VOLATILITY.

Any repurchases pursuant to our stock repurchase program could affect our stock price and add volatility. The repurchase program is at our discretion, and thus there can be no assurance that any repurchases will actually be made under the program, nor is there any assurance that a sufficient number of shares of our common stock will be repurchased to satisfy the market s expectations. Furthermore, there can be no assurance that any repurchases conducted under the plan will be made at the best possible price. The existence of a stock repurchase program could also cause our stock price to be higher than it would be in the absence of such a program and could potentially reduce the market liquidity for our stock. Additionally, we are permitted to and could discontinue our stock repurchase program at any time and any such discontinuation could cause the market price of our stock to decline.

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OUR MAJOR STOCKHOLDERS RETAIN SIGNIFICANT CONTROL OVER US, WHICH MAY LEAD TO CONFLICTS WITH OTHER STOCKHOLDERS OVER CORPORATE GOVERNANCE MATTERS AND COULD ALSO AFFECT THE VOLATILITY OF OUR STOCK PRICE.

We currently have, have had in the past, and may have in the future, stockholders who retain greater than 10% of our outstanding stock. Acting together, these stockholders would be able to exercise significant influence over matters that our stockholders vote upon, including the election of directors and mergers or other business combinations, which could have the effect of delaying or preventing a third party from acquiring control over or merging with us. Further, if any individuals in this group elect to sell a significant portion or all of their holdings of our common stock, the trading price of our common stock could experience volatility.

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 management. 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.

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. If we consummate acquisitions through cash and/or an exchange 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 for write-down of assets associated with unsuccessful acquisitions; and
- potential intellectual property infringement claims related to newly acquired product lines.

Any acquisitions, even if successfully completed, might not generate significant additional revenue or provide any benefit to our business. In addition to acquisitions, we may also consider making strategic divestitures. With any divestiture, there are risks that future operating results could be unfavorably impacted.

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.

If we fail to maintain the adequacy of our internal controls, as standards are modified, supplemented, or amended from time to time, we may not be able to ensure that we can conclude on an ongoing basis that we have effective internal controls over financial reporting in accordance with Section 404 of the Sarbanes-Oxley Act. Failure to maintain an effective internal control environment could have a material adverse effect on our business and stock price.

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WE HAVE DETERMINED THAT OUR INTERNAL CONTROLS RELATING TO INCOME TAXES ARE 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 former Chief Executive Officer, conducted an evaluation of the effectiveness of the design and operation of our internal controls as of December 31, 2007. They concluded that our internal controls over financial reporting as they relate to income taxes were ineffective as of that date. We have subsequently initiated actions that are intended to improve our accounting for income taxes and the related internal controls. Any 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.

WE HAVE IDENTIFIED A MATERIAL WEAKNESS IN OUR INTERNAL CONTROLS RELATED TO THE ACCOUNTING FOR INCOME TAXES AS OF DECEMBER 31, 2007 THAT, IF NOT PROPERLY REMEDIATED, COULD RESULT IN MATERIAL MISSTATEMENTS IN OUR FINANCIAL STATEMENTS IN FUTURE PERIODS.

Based on an evaluation of our disclosure controls and procedures as of December 31, 2007, due to the existence of a deficiency in the operation of our internal controls related to the accounting for income taxes, which constituted a material weakness in our internal control over financial reporting, our management has concluded that such disclosure controls and procedures were not effective as of such date and continue to not be effective as of September 30, 2008. A material weakness is a deficiency, or 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. The identified deficiency pertained to controls which were not adequately designed to ensure proper accounting and disclosure of income taxes. These inadequate controls resulted in adjustments to our previously reported quarterly unaudited financial results as of March 31, 2007 and the cumulative loss amounts for quarterly unaudited financial results as of June 30, 2007 and September 30, 2007.

Because of this material weakness, there is risk that a material misstatement of our annual or quarterly financial statements will not be prevented or detected. We are currently in the process of implementing control procedures to remediate the material weakness. We cannot guarantee, however, that such remediation efforts will correct the material weakness such that our internal control over financial reporting will be effective. In the event that we do not adequately remedy this material weakness, or if we fail to maintain effective internal controls in future periods, our operating results, financial position and stock price could be adversely affected.

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 our expected growth could place a significant strain on our management systems, infrastructure and other resources. To manage the expected growth of our operations and increases in the number of our personnel, we will need to invest the necessary capital to upgrade and improve our operational, financial and management reporting systems. Accordingly, we are currently transitioning the preparation of all of our internal reporting to new or upgraded management information systems, which are expected to be implemented near the end of 2008. 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. If our management fails to respond effectively to changes in our business, our business may suffer.

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ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

Below is a summary of stock repurchases for the quarter ending September 30, 2008. See Note 8 of our condensed consolidated financial statements for information regarding our stock repurchase program.

Program/Period (1)	Shares Repurchased (2)	Average Price Per Share	Approximate Dollar Value that May Yet Be Purchased Under the Program
Beginning approximate dollar value available to be repurchased as of June 30, 2008			$ 43,845,097
July 1 - July 31, 2008	440,000	$ 6.78	
August 1 - August 31, 2008	40,000	$ 6.12	
September 1 - September 30, 2008	627,880	$ 6.32	
Total shares repurchased	1,107,880	$ 6.50	7,196,408
Ending approximate dollar value that may be repurchased under the Program as of September 30, 2008			$ 36,648,689

(1) On November 1, 2007, our Board of Directors authorized a share repurchase program of up to $50,000,000. This share repurchase authorization has no expiration date and does not require us to repurchase a specific number of shares. The timing and amount of any share repurchase will depend on the share price, corporate and regulatory requirements, economic and

market conditions, and other factors. The repurchase authorization may be modified, suspended, or discontinued at any time.

(2) All shares were repurchased on the open market as part of the plan publicly announced on November 1, 2007. The repurchases were effected by a single broker in market transactions at prevailing market prices pursuant to a trading plan designed to satisfy the conditions of Rule 10b5-1 under the Securities and Exchange Act of 1934, as amended.

ITEM 6. EXHIBITS

The following exhibits are filed herewith:

Exhibit Number	**Description**
10.44	Executive Incentive Plan dated August 7, 2008 by and between Immersion Corporation and Clent Richardson.
10.45	Settlement Agreement dated August 25, 2008 by and between Microsoft Corporation and Immersion Corporation.
31.1	Certification of Clent Richardson, President, Chief Executive Officer, and Director, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2	Certification of Stephen Ambler, Chief Financial Officer and Vice President, Finance, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Clent Richardson, President, Chief Executive Officer, and Director, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Stephen Ambler, Chief Financial Officer and Vice President, Finance, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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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: November 7, 2008

IMMERSION CORPORATION

By /s/ Stephen Ambler

Stephen Ambler
Chief Financial Officer and Vice President, Finance

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