IMMERSION CORP
Form 10-Q
February 08, 2010

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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 June 30, 2009

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 o No þ

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes o 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. (Check one):

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 January 25, 2010: 27,999,593

IMMERSION CORPORATION
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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)

	June 30, 2009	December 31, 2008
ASSETS		
Current assets:		
Cash and cash equivalents	$ 25,047	$ 64,769
Short-term investments	48,962	20,974
Accounts receivable (net of allowances for doubtful accounts of: June 30, 2009 $241 and December 31, 2008 $436)	4,185	6,114
Inventories net	3,672	3,757
Deferred income taxes	311	311
Prepaid expenses and other current assets	4,012	4,344
Total current assets	86,189	100,269
Property and equipment, net	3,868	3,827
Intangibles and other assets, net	10,329	9,491
Total assets	$ 100,386	$ 113,587
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 903	$ 2,842
Accrued compensation	2,052	2,920
Other current liabilities	3,731	3,493
Deferred revenue and customer advances	7,833	8,042
Total current liabilities	14,519	17,297
Long-term deferred revenue	18,131	15,989
Deferred income tax liabilities	311	311
Other long-term liabilities	217	212
Total liabilities	33,178	33,809
Contingencies (Note 16)		
Stockholders equity:		
Common stock and additional paid-in capital $0.001 par value; 100,000,000 shares authorized; shares issued: June 30, 2009 30,779,628 and December 31, 2008 30,674,045; shares outstanding: June 30, 2009 27,991,759 and December 31, 2008 27,887,482	170,808	167,870

Warrants	11	1,731
Accumulated other comprehensive income	114	109
Accumulated deficit	(85,328)	(71,543)
Treasury stock at cost: June 30, 2009 2,787,869 shares and December 31, 2008 2,786,563 shares	(18,397)	(18,389)
Total stockholders equity	67,208	79,778
Total liabilities and stockholders equity	$ 100,386	$ 113,587

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 June 30,		Six Months Ended June 30,	
	2009	2008 (As Restated)(1)	2009	2008 (As Restated)(1)
Revenues:				
Royalty and license	$ 3,580	$ 3,171	$ 7,361	$ 6,632
Product sales	2,772	3,744	6,051	6,324
Development contracts and other	330	704	776	1,503
Total revenues	6,682	7,619	14,188	14,459
Costs and expenses:				
Cost of product sales (exclusive of amortization and impairment of intangibles shown separately below)	2,312	2,051	3,563	3,735
Sales and marketing	4,016	3,846	8,300	7,191
Research and development	3,412	2,940	7,341	6,430
General and administrative	4,841	5,111	9,226	9,525
Amortization and impairment of intangibles	224	202	439	472
Restructuring costs	705		1,351	
Total costs and expenses	15,510	14,150	30,220	27,353
Operating loss	(8,828)	(6,531)	(16,032)	(12,894)
Change in fair value of warrant liability	(136)		344	
Interest and other income	207	973	510	2,608
Loss from continuing operations before provision for income taxes	(8,757)	(5,558)	(15,178)	(10,286)
Benefit (provision) for income taxes	(300)	1,903	(391)	3,157
Loss from continuing operations	(9,057)	(3,655)	(15,569)	(7,129)
Discontinued operations (Note 10) :				
Gain on sales of discontinued operations net of provision for income taxes of $0	20		187	
Gain from discontinued operations, net of provision (benefit) for income taxes of $(48), $133, $102, and $324	166	210	401	536
Net loss	$ (8,871)	$ (3,445)	$ (14,981)	$ (6,593)

Basic and diluted net loss per share								
Continuing operations		(0.33)		(0.12)		(0.56)		(0.23)
Discontinued operations		0.01		0.01		0.02		0.01
Total	$	(0.32)	$	(0.11)	$	(0.54)	$	(0.22)
Shares used in calculating basic and diluted net loss per share		27,968		30,356		27,946		30,417

See accompanying Notes to Condensed Consolidated Financial Statements.

(1) See Note 2 Restatement of Condensed Consolidated Financial Statements of Notes to Condensed Consolidated Financial Statements.

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IMMERSION CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(unaudited)

	Six Months Ended June 30,	
	2009	2008 As Restated (1)
Cash flows from operating activities:		
Net loss	$ (14,981)	$ (6,593)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	873	541
Amortization and impairment of intangibles	439	472
Stock-based compensation	2,651	2,759
Excess tax benefits from stock-based compensation		(176)
Realized gain on short-term investments		(80)
Change in fair value of warrant liability	(344)	
Write off of equipment	708	
Gain on sales of discontinued operations	(187)	
Changes in operating assets and liabilities:		
Accounts receivable	1,943	728
Inventories	(172)	(822)
Deferred income taxes		(623)
Prepaid expenses and other current assets	332	(1,333)
Other assets	7	19
Accounts payable	(1,789)	290
Accrued compensation and other current liabilities	(783)	1,165
Income taxes payable	4	(319)
Deferred revenue and customer advances	1,933	2,478
Other long-term liabilities	5	30
Net cash used in operating activities	(9,361)	(1,464)
Cash flows provided by (used in) investing activities:		
Purchases of short-term investments	(48,988)	(32,144)
Maturities of short-term investments	21,000	51,979
Additions to intangibles	(1,543)	(1,560)
Purchases of property and equipment	(1,288)	(1,065)
Proceeds from sales of discontinued operations	187	
Net cash provided by (used in) investing activities	(30,632)	17,210
Cash flows provided by (used in) financing activities:		
Issuance of common stock under employee stock purchase plan	134	168
Exercise of stock options and warrants	144	1,121

Excess tax benefits from stock-based compensation				176
Purchases of treasury stock				(6,155)
Tax withholding payment related to vested and released restricted stock units		(7)		
Net cash provided by (used in) financing activities		271		(4,690)
Effect (decrease) of exchange rates on cash and cash equivalents				(14)
Net increase (decrease) in cash and cash equivalents		(39,722)		11,042
Cash and cash equivalents:				
Beginning of the period		64,769		86,493
End of the period	$	25,047	$	97,535
Supplemental disclosure of cash flow information:				
Cash paid (received) for taxes	$	7	$	(731)
Supplemental disclosure of non-cash investing and financing activities:				
Shares issued upon vesting of restricted stock units	$	22	$	
Amounts accrued for property and equipment, and intangibles	$	434	$	701

See accompanying Notes to Condensed Consolidated Financial Statements.

(1) See Note 2 Restatement of Condensed Consolidated Financial Statements of Notes to Condensed Consolidated Financial Statements.

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IMMERSION CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2009
(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 Amendment No. 1 to Annual Report on Form 10-K/A for the fiscal year ended December 31, 2008. 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 June 30, 2009 are not necessarily indicative of the results to be expected for the full year.

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); Emerging Issues Task Force (EITF) No. 00-21, Accounting for Revenue Arrangements with Multiple Deliverables (EITF No. 00-21); and American Institute of Certified Public Accountants (AICPA) Statement of Position (SOP) No. 97-2, Software Revenue Recognition (SOP No. 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 once services commence when vendor-specific objective evidence (VSOE) related to the value of the services does not exist.

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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 proportional performance method over the service period or completed performance method.
License of software or technology, no modification necessary, no services contracted.	Up-front revenue recognition based on SOP No. 97-2 criteria or SAB No. 104, as applicable.

Individual contracts may have characteristics that do not fall within a specific license model or may have characteristics of a combination of license models. Under those circumstances, the Company recognizes revenue in accordance with SAB No. 104, EITF No. 00-21, and SOP No.97-2, as amended, to guide the accounting treatment for each individual contract. See also the discussion regarding Multiple element arrangements below.

Product sales The Company generally 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 proportional performance accounting method based on physical completion of the work to be performed or completed performance method. Losses on contracts are recognized when determined. Revisions in estimates are reflected in the period in which the conditions become known. Customer support and extended warranty contract revenue is recognized ratably over the contractual period.

Multiple element arrangements 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). The Company allocates revenue to each element based on the relative fair value of each of the elements. If vendor specific objective evidence of fair value does not exist, the revenue is generally recorded over the term of the contract or upon delivery of all elements for which vendor specific evidence of fair value does not exist.

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Recent Accounting Pronouncements

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 adoption of this guidance did not have a material impact on the Company s condensed consolidated results of operations, financial position or cash flows.

In April 2009, the FASB issued FSP No. FAS 115-2 and FAS No. 124-2, Recognition and Presentation of Other-Than-Temporary Impairments (FSP No. FAS 115-2 and FAS No. 124-2). This FSP amends the other-than temporary impairment guidance for debt securities to make the guidance more operational and to improve the presentation and disclosure of other-than-temporary impairments in the financial statements. The most significant change the FSP brings is a revision to the amount of other-than-temporary loss of a debt security recorded in earnings. FSP No. FAS 115-2 and FAS No. 124-2 is effective for interim and annual reporting periods ending after June 15, 2009. The adoption of this guidance did not have a material impact on the Company s condensed consolidated results of operations, financial position or cash flows.

In April 2009, the FASB issued FSP No. FAS 157-4, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly (FSP No. FAS 157-4). This FSP provides additional guidance for estimating fair value in accordance with SFAS No. 157, Fair Value Measurements (SFAS No. 157), when the volume and level of activity for the asset or liability have significantly decreased. This FSP also includes guidance on identifying circumstances that indicate a transaction is not orderly. This FSP emphasizes that even if there has been a significant decrease in the volume and level of activity for the asset or liability and regardless of the valuation technique(s) used, the objective of a fair value measurement remains the same. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions. FSP No. FAS 157-4 is effective for interim and annual reporting periods ending after June 15, 2009, and is applied prospectively. The adoption of this guidance did not have a material impact on the Company s condensed consolidated results of operations, financial position or cash flows.

In April 2009, the FASB issued FSP No. FAS 107-1 and Accounting Principles Board (APB) 28-1, Interim Disclosures about Fair Value of Financial Instruments (FSP No. FAS 107-1 and APB No. 28-1). This FSP amends SFAS No. 107, Disclosures about Fair Value of Financial Instruments, to require disclosures about fair value of financial instruments for interim reporting periods of publicly traded companies as well as in annual financial statements. This FSP also amends APB Opinion No. 28, Interim Financial Reporting, to require those disclosures in summarized financial information at interim reporting periods. FSP FAS 107-1 and APB No. 28-1 is effective for interim and annual reporting periods ending after June 15, 2009. The adoption of this guidance did not have a material impact on the Company s condensed consolidated results of operations, financial position or cash flows.

In May 2009, the FASB issued SFAS No. 165, Subsequent Events (SFAS No. 165). SFAS No. 165 provides guidance on management s assessment of subsequent events and incorporates this guidance into accounting literature. It also requires entities to disclose the date through which they have evaluated subsequent events and whether the date corresponds with the release of their financial statements. This guidance is effective for all interim and annual periods ending after June 15, 2009. The adoption of this guidance did not have a material impact on the Company s consolidated results of operations or financial position. The Company has evaluated subsequent events through February 8, 2010, the date of issuance of the Company s condensed consolidated financial statements.

In September 2009, the FASB ratified EITF Issue No. 08-1, Revenue Arrangements with Multiple Deliverables (EITF No. 08-1). EITF No. 08-1 superseded EITF No.00-21 and addresses criteria for separating the consideration in multiple-element arrangements. EITF No. 08-1 will require companies to allocate the overall consideration to each deliverable by using a best estimate of the selling price of individual deliverables in the arrangement in the absence of vendor-specific objective evidence or other third-party evidence of the selling price. EITF No. 08-1 will be effective prospectively for revenue

arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010 and early adoption will be permitted. The Company is currently evaluating the potential impact, if any, of the adoption of EITF No. 08-1 on its consolidated results of operations and financial condition.

In September 2009, the FASB also ratified EITF No. 09-3, Certain Revenue Arrangements That Include Software Elements (EITF No. 09-3). EITF No. 09-3 modifies the scope of Statement of Position No. 97-2, Software Revenue Recognition , to exclude (a) non-software components of tangible products and (b) software components of tangible products that are sold, licensed, or leased with tangible products when the software components and non-software components of the tangible product function together to deliver the tangible product s essential functionally. EITF No. 09-3 has an effective date that is consistent with EITF No. 08-1. The Company is currently evaluating the potential impact, if any, of the adoption of EITF No. 09-3 on its consolidated results of operations and financial condition.

2. RESTATEMENT OF THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Subsequent to the issuance of the Company s unaudited condensed consolidated financial statements for the quarter ended June 30, 2008, the Company s management determined that errors existed in its previously issued financial statements. As a result, the accompanying condensed consolidated financial statements for the quarter and six months ended June 30, 2008 have been restated from amounts previously reported. The following summarizes the nature of the errors and the effects on the condensed consolidated financial statements.

Revenue Transactions

Side Agreement

The Company determined that certain commitments may have been made to a customer of its Medical line of business in the form of an undisclosed apparent side agreement dated in the fourth quarter of fiscal 2008. The customer and the Company had previously executed a distribution agreement in May 2008, and the customer entered into various sales transactions with the Company, both before and after the date of the apparent side agreement. The Company concluded that revenue should not have been recognized on certain transactions resulting in restatement adjustments to revenue in various reporting periods for the following reasons: (i) in certain circumstances, the product remained in a third-party warehouse and was not shipped to the customer until after the quarter in which revenue was recognized; (ii) a previously undisclosed apparent side agreement caused the terms of earlier transactions to be deemed not final until the distribution agreement between the customer and the Company was terminated; (iii) in certain circumstances, the Company had conflicting exclusivity arrangements in effect during the quarters when the Company was recognizing revenue for transactions with such customer; and (iv) concessions related to extended payment terms caused the amount to not be fixed and determinable. As a result, the Company determined that a total of $511,000 of revenue recorded in the quarter and six months ended June 30, 2008 had not been appropriately recognized and has been reversed and will be recorded in subsequent periods.

Additional Transactions Analyzed

The Company also discovered additional transactions in its Medical line of business where revenue was not properly recognized due to one or more of the following reasons:

- Premature recognition of revenue for products sold with FOB Destination or other similar shipping terms, or for incomplete shipment of products or storage of products following shipment;

- Non-standard terms and conditions that prevented recognition of revenue upon shipment, including rights of return, extended payment terms, product replacement commitments, potential free upgrades and other non-standard commitments, that prevented recognition of revenue upon shipment; and

- Lack of probable collectability at the time revenue was recognized.

As a result, for the three months ended June 30, 2008 a net decrease in revenue in the amount of $114,000 was recorded. This included an increase of approximately $80,000 that was originally recorded in the prior quarter which has now been recorded in the second quarter of 2008 and a decrease of approximately $194,000 of revenue originally recorded in the second quarter of 2008 which has been reversed and recognized in subsequent periods. For the six months ended June 30, 2008, a decrease in revenues of $194,000 was recorded which will be recognized in subsequent periods

Other Impact of Revenue Adjustments

As a result of the adjustments to revenues discussed above, cost of product sales decreased by $231,000 and $252,000 for the quarter ended and six months ended June 30, 2008, respectively and commission expense decreased by $21,000 for the quarter ended and six months ended June 30, 2008. There was no other impact on these accounts for the quarter or six months ended June 30, 2008.

Other Errors in Condensed Consolidated Financial Statements

The Company also corrected the condensed consolidated financial statements for the following items:

Stock-Based Compensation Expense. The Company identified a software-based error in its calculated stock-based compensation expense. The previous version of software used to calculate stock-based compensation expense incorrectly continued to apply a weighted average forfeiture rate to the vested portion of stock option awards until the grant s final vest date, rather than reflecting actual forfeitures as awards vested. This error resulted in an understatement of stock-based compensation expense in certain periods prior to the grant s final vest date. The Company recorded additional stock-based compensation expense of $187,000 and $830,000 for the first quarter and six months ended June 30, 2008, respectively.

Interest Income. The Company identified an error in the accounting relating to the timing of the recognition of interest income with respect to its patent license with Sony Computer Entertainment. Accordingly, the Company recorded additional interest income of approximately $64,000 and $192,000 for the second quarter and six months ended June 30, 2008, respectively. This accounting error related to the timing of the recognition of interest income but does not change the overall interest income to be recognized.

Amortization and Impairment of Intangibles. The Company identified instances where it had not commenced amortization of patents in the periods the patents were granted. In addition, the Company identified certain patent applications that were abandoned but had not been previously identified as such and has corrected this error by increasing amortization and impairment of intangibles by $27,000 and $62,000 in the second quarter and six months ended June 30, 2008, respectively.

Impact of Corrections on Previously Issued Condensed Consolidated Financial Statements

The Company s accompanying condensed consolidated financial statements have been restated resulting from the restatement adjustments described above, as follows:

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Detailed Components of Revenue Transaction Adjustments

($ in thousands)

	Revenue		Cost of Product Sales	Commission Expense	Total Impact of Revenue Adjustments
Six months ended June 30, 2008					
Increase (Decrease)	$ (691)	(1)	$ 252	$ 21	$ (418)
Three months ended June 30, 2008					
Increase (Decrease)	$ (602)	(2)	$ 231	$ 21	$ (350)

(1) For the six months ended June 30, 2008 reflects a decrease of $511,000 as discussed in Side Agreement and a decrease of $194,000 in revenue as discussed in Additional Transactions Analyzed and an increase of $14,000 in revenue due to warranty adjustments.

(2) For the three months ended June 30, 2008 reflects a decrease of $511,000 as discussed in Side Agreement

and a net decrease of $114,000 in revenue as discussed in Additional Transactions Analyzed and an increase of $23,000 in revenue due to warranty adjustments.

Summary of Impact of Restatement Adjustments

	Loss from Continuing Operations Before Provision for Income Taxes						Loss from Continuing Operations
	Revenue Transactions Adjustments (1)	Amortization and Impairment of Intangibles	Interest Income	Stock-based Compensation	Total	Income Tax Effect	Total Adjustments Net of Tax
				($ in thousands)			
Six months ended June 30, 2008							
Increase (Decrease)	$ (418)	$ (62)	$ 192	$ (830)	$ (1,118)	$ 199	$ (919)
Three months ended June 30, 2008							
Increase (Decrease)	$ (350)	$ (27)	$ 64	$ (187)	$ (500)	$ 148	$ (352)

(1) See table above

The following tables present the impact of the restatement and reclassification on the Company s previously issued condensed consolidated statements of operations for the quarter and six months ended June 30, 2008 and cash flow for the six months ended June 30, 2008.

Additionally, as disclosed in footnote 10, the previously reported results of operations of the 3D product line for the quarter and six months ended June 30, 2008 have been reclassified and reported separately in the condensed consolidated statement of operations as discontinued operations.

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CONDENSED CONSOLIDATED STATEMENT OF OPERATIONS
(In thousands, except per share amounts)

	Three Months Ended June 30, 2008			
	As Previously Reported	Discontinued Operations Reclassification	Restatement Adjustments	As Restated and Reclassified
Revenues:				
Royalty and license	$ 3,171	$ -	$ -	$ 3,171
Product sales	5,386	(1,040)	(602)	3,744
Development contracts and other	756	(52)	-	704
Total revenues	9,313	(1,092)	(602)	7,619
Costs and expenses:				
Cost of product sales (exclusive of amortization and impairment of intangibles shown separately below)	2,570	(301)	(218)	2,051
Sales and marketing	4,258	(448)	36	3,846
Research and development	2,855	-	85	2,940
General and administrative	5,084	-	27	5,111
Amortization and impairment of intangibles	170	-	32	202
Total costs and expenses	14,937	(749)	(38)	14,150
Operating loss	(5,624)	(343)	(564)	(6,531)
Interest and other income	909	-	64	973
Loss from continuing operations before provision for income taxes	(4,715)	(343)	(500)	(5,558)
Benefit for income taxes	1,624	131	148	1,903
Loss from continuing operations	(3,091)	(212)	(352)	(3,655)
Discontinued operations:				
Gain from discontinued operations, net of provision for income taxes of $133	-	212	(2)	210

Net loss	$ (3,091)	$ -	$ (354)	$ (3,445)
Basic and diluted net loss per share				
Continuing operations	$ (0.10)	$ (0.01)	$ (0.01)	$ (0.12)
Discontinued operations	-	0.01	(0.00)	0.01
Total	$ (0.10)	$ 0.00	$ (0.01)	$ (0.11)
Shares used in calculating basic and diluted net loss per share	30,356	-	-	30,356

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CONDENSED CONSOLIDATED STATEMENT OF OPERATIONS
(In thousands, except per share amounts)

	Six Months Ended June 30, 2008			
	As Previously Reported	Discontinued Operations Reclassification	Restatement Adjustments	As Restated and Reclassified
Revenues:				
Royalty and license	$ 6,632	$ -	$ -	$ 6,632
Product sales	9,237	(2,222)	(691)	6,324
Development contracts and other	1,599	(96)	-	1,503
Total revenues	17,468	(2,318)	(691)	14,459
Costs and expenses:				
Cost of product sales (exclusive of amortization and impairment of intangibles shown separately below)	4,656	(704)	(217)	3,735
Sales and marketing	7,700	(754)	245	7,191
Research and development	6,084	-	346	6,430
General and administrative	9,347	-	178	9,525
Amortization and impairment of intangibles	405	-	67	472
Total costs and expenses	28,192	(1,458)	619	27,353
Operating loss	(10,724)	(860)	(1,310)	(12,894)
Interest and other income	2,416	-	192	2,608
Loss from continuing operations before provision for income taxes	(8,308)	(860)	(1,118)	(10,286)
Benefit for income taxes	2,632	326	199	3,157
Loss from continuing operations	(5,676)	(534)	(919)	(7,129)
Discontinued operations:				
Gain from discontinued operations, net of provision for income taxes of $324	-	534	2	536

Net loss	$	(5,676)	$	-	$	(917)	$	(6,593)
Basic and diluted net loss per share								
Continuing operations	$	(0.19)	$	(0.01)	$	(0.03)	$	(0.23)
Discontinued operations		-		0.01		0.00		0.01
Total	$	(0.19)	$	0.00	$	(0.03)	$	(0.22)
Shares used in calculating basic and diluted net loss per share		30,417		-		-		30,417

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CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS
(In thousands)

	Six Months Ended June 30, 2008		
	As Previously Reported	Restatement Adjustments	As Restated
Cash flows from operating activities:			
Net loss	$ (5,676)	$ (917)	$ (6,593)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:			
Depreciation and amortization	541	-	541
Amortization and impairment of intangibles	405	67	472
Stock-based compensation	1,929	830	2,759
Excess tax benefits from stock-based compensation	(176)	-	(176)
Realized gain on short-term investments	(80)	-	(80)
Changes in operating assets and liabilities:			
Accounts receivable	175	553	728
Inventories	(590)	(232)	(822)
Deferred income taxes	(475)	(148)	(623)
Prepaid expenses and other current assets	(1,164)	(169)	(1,333)
Other assets	19	-	19
Accounts payable	290	-	290
Accrued compensation and other current liabilities	1,186	(21)	1,165
Income taxes payable	(319)	-	(319)
Deferred revenue and customer advances	2,436	42	2,478
Other long-term liabilities	30	-	30
Net cash used in operating activities	(1,469)	5	(1,464)
Cash flows provided by (used in) investing activities:			
Purchases of short-term investments	(32,144)	-	(32,144)
Maturities of short-term investments	51,979	-	51,979
Additions to intangibles	(1,555)	(5)	(1,560)
Purchases of property and equipment	(1,065)	-	(1,065)
Net cash provided by investing activities	17,215	(5)	17,210
Cash flows provided by (used in) financing activities:			
Issuance of common stock under employee stock purchase plan	168	-	168
Exercise of stock options and warrants	1,121	-	1,121
Excess tax benefits from stock-based compensation	176	-	176
Purchases of treasury stock	(6,155)	-	(6,155)
Net cash used in financing activities	(4,690)	-	(4,690)
Effect (decrease) of exchange rates on cash and cash equivalents	(14)	-	(14)

Net increase in cash and cash equivalents	11,042	-	11,042
Cash and cash equivalents:			
Beginning of the period	86,493	-	86,493
End of the period	$ 97,535	$ -	$ 97,535
Supplemental disclosure of cash flow information:			
Cash received for taxes	$ (731)	$ -	$ (731)
Non-cash investing and financing activities:			
Amounts accrued for property and equipment, and intangibles	$ 701	$ -	$ 701

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3. FAIR VALUE MEASUREMENTS

Cash Equivalents, Short-term Investments, and Warrant Derivative Liabilities

The financial instruments of the Company measured at fair value on a recurring basis are cash equivalents, short-term investments, and warrant derivative liabilities. 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 Company s warrant derivative liabilities are generally classified within Level 3 of the fair value hierarchy because they are valued using unobservable inputs which reflect the reporting entity s own assumptions that market participants would use in pricing the liability. Unobservable inputs are developed based on the best information available in the circumstances and also include the Company s own data.

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 and include most investment-grade corporate commercial papers. Such instruments are generally classified within Level 2 of the fair value hierarchy.

The types of instruments valued based on unobservable inputs which reflect the reporting entity s own assumptions that market participants would use in pricing the liability include the warrant derivative liability. Such instruments are generally classified within Level 3 of the fair value hierarchy.

Financial instruments measured at fair value on a recurring basis as of June 30, 2009 and December 31, 2008 are classified based on the valuation technique in the table below:

	June 30, 2009 Fair value measurements using			
	Level 1	**Level 2**	**Level 3**	**Total**
		(In thousands)		
Assets:				
Corporate commercial paper	$	$ 9,993	$	$ 9,993
U.S. government agency securities	39,066			39,066
Money market accounts	22,245			22,245
Total assets at fair value	$ 61,311	$ 9,993	$	$ 71,304
Liabilities:				
Warrant derivative liabilities	$	$	$ 173	$ 173
Total liabilities at fair value	$	$	$ 173	$ 173

The above table excludes $2.7 million of cash held in banks.

	December 31, 2008 Fair value measurement using			
	Level 1	**Level 2**	**Level 3**	**Total**
		(In thousands)		
Corporate commercial paper	$	$ 24,971	$	$ 24,971
U.S. government agency securities	23,978			23,978
Money market accounts	34,429			34,429

Total	$ 58,407	$ 24,971	$	$ 83,378

The above table excludes $2.4 million of cash held in banks.

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The following table provides a summary of changes in fair value in the Level 3 financial instrument for the three months and six months ending June 30, 2009:

Warrant Derivative Liability	Three Months Ended June 30, 2009 Fair Value Measurement Using Significant Unobservable Inputs (Level 3) (In thousands)	Six Months Ended June 30, 2009 Fair Value Measurement Using Significant Unobservable Inputs (Level 3) (In thousands)
Balances, beginning of the period	$ 37	$ 517
Change in fair value		
Included in net loss	136	(344)
Balances, end of period	$ 173	$ 173

Short term investments measured at fair value on a recurring basis as of June 30, 2009 and December 31, 2008 are as below:

	June 30, 2009			
	Amortized Cost	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Fair Value
	(In thousands)			
Assets:				
Corporate commercial paper	$ 9,991	$ 2	$	$ 9,993
U.S. government agency securities	38,951	18		38,969
Total	$ 48,942	$ 20	$	$ 48,962

	December 31, 2008			
	Amortized Cost	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Fair Value
	(In thousands)			
Assets:				
Corporate commercial paper	$ 9,980	$ 1	$	$ 9,981
U.S. government agency securities	10,975	18		10,993
Total	$ 20,955	$ 19	$	$ 20,974

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The contractual maturities of the Company s available-for-sale securities on June 30, 2009 and December 31, 2008 were all due in one year or less.

4. INVENTORIES

	June 30, 2009	December 31, 2008
	(In thousands)	
Raw materials and subassemblies	$ 2,680	$ 3,119
Work in process	284	209
Finished goods	708	429
Inventories net	$ 3,672	$ 3,757

Included in the cost of product sales for the three and six months ended June 30, 2009 is a write off of $554,000 resulting from a book to physical adjustment of inventory in the Medical line of business.

5. PROPERTY AND EQUIPMENT

	June 30, 2009	December 31, 2008
	(In thousands)	
Computer equipment and purchased software	$ 4,474	$ 4,735
Machinery and equipment	1,710	3,269
Furniture and fixtures	1,405	1,336
Leasehold improvements	1,457	1,261
Total	9,046	10,601
Less accumulated depreciation	(5,178)	(6,774)
Property and equipment, net	$ 3,868	$ 3,827

The sales and marketing expense for the three and six months ended June 30, 2009 included a charge of $666,000 resulting from a book to physical adjustment of demo equipment in the Medical line of business.

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6. INTANGIBLES AND OTHER ASSETS

	June 30, 2009	December 31, 2008
	(In thousands)	
Patents and technology	$ 18,056	$ 17,008
Other assets	148	156
Gross intangibles and other assets	18,204	17,164
Accumulated amortization of patents and technology	(7,875)	(7,673)
Intangibles and other assets, net	$ 10,329	$ 9,491

The Company amortizes its intangible assets related to patents and trademarks, over their estimated useful lives, generally 10 years. The estimated annual amortization expense for intangible assets as of June 30, 2009 is $797,000 in 2009, $1.2 million in 2010, $1.2 million in 2011, $1.2 million in 2012, $1.1 million in 2013, and $5.1 million in total for all years thereafter.

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

	June 30, 2009	December 31, 2008
	(In thousands)	
Accrued legal	$ 392	$ 491
Income taxes payable	40	36
Other current liabilities	3,299	2,966
Total other current liabilities	$ 3,731	$ 3,493
Deferred revenue, current	$ 7,765	$ 7,954
Customer advances	68	88
Total deferred revenue, current and customer advances	$ 7,833	$ 8,042

8. LONG-TERM DEFERRED REVENUE

On June 30, 2009, long-term deferred revenue was $18.1 million and included approximately $16.5 million of deferred revenue from Sony Computer Entertainment. On December 31, 2008, long-term deferred revenue was $16.0 million and included approximately $14.5 million from Sony Computer Entertainment.

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9. STOCK-BASED COMPENSATION

Stock Options and Awards

The Company s equity incentive program is a long-term retention program that is intended to attract, retain, and provide incentives for talented employees, consultants, officers, and directors and to align stockholder and employee interests. The Company may grant options, stock appreciation rights, restricted stock, restricted stock units (RSUs), performance shares, performance units, and other stock-based or cash-based awards to employees, directors, and consultants. Under these programs, stock options may be granted at prices not less than the fair market value on the date of grant for stock options. These options generally vest over 4 years and expire 10 years from the date of grant. RSUs generally vest over 3 years. Restricted stock generally vests over one year. On June 30, 2009, 3,466,081 shares of common stock were available for grant, and there were 6,548,887 options to purchase shares of common stock outstanding, as well as 311,917 RSUs and shares of restricted stock outstanding.

General Stock Option Information

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

	Number of Shares
Outstanding at December 31, 2008 (4,055,180 exercisable at a weighted average price of $9.35 per share)	7,009,667
Granted (weighted average fair value of $2.10 per share)	1,330,183
Exercised	(71,207)
Forfeited and cancelled	(1,719,756)
Outstanding at June 30, 2009	6,548,887
Exercisable at June 30, 2009	3,744,748

Restricted Stock Units

Restricted stock unit activity for the six months ended June 30, 2009 is as follows:

	Number of Shares
Beginning balance at December 31, 2008	34,500
Awarded	292,287
Released	(4,000)
Forfeited	(37,870)
Ending Balance at June 30, 2009	284,917
Expected to Vest (1)	194,713

(1) RSUs expected to vest reflect estimated forfeiture rates.

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Restricted Stock

Restricted stock activity for the six months ended June 30, 2009 is as follows:

	Number of Shares
Beginning balance at December 31, 2008	
Awarded	27,000
Released	
Forfeited	
Ending balance at June 30, 2009	27,000

The assumptions used to value option grants and shares under the Company s Employee Stock Purchase Plan are as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
Options	**2009**	**2008**	**2009**	**2008**
Expected term (in years)	5.5	5.5	5.5	5.5
Volatility	69%	63%	69%	62%
Interest rate	2.3%	3.4%	1.8%	2.9%
Dividend yield				

	Three Months Ended June 30,		Six Months Ended June 30,	
Employee Stock Purchase Plan	**2009**	**2008**	**2009**	**2008**
Expected term (in years)	0.5	0.5	0.5	0.5
Volatility	109%	73%	109%	73%
Interest rate	0.4%	2.2%	0.4%	2.2%
Dividend yield				

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
Income Statement Classifications	(In thousands)		(In thousands)	
Cost of product sales	$ 33	$ 65	$ 102	$ 108
Sales and marketing	213	354	443	777
Research and development	240	268	713	814
General and administrative	761	437	1,393	993
Total continuing operations	1,247	1,124	2,651	2,692
Discontinued operations		28		67
Total	$ 1,247	$ 1,152	$ 2,651	$ 2,759

As of June 30, 2009, there was $9.8 million of unrecognized compensation cost, adjusted for estimated forfeitures, related to non-vested stock options, restricted stock and RSUs granted to the Company s employees and directors. This cost will be recognized over an estimated weighted-average period of approximately 3.16 years for options, 0.68 years for restricted stock and 2.68 years for RSUs. Total unrecognized compensation cost will be adjusted for future changes in estimated forfeitures.

Stock Repurchase Program

On November 1, 2007, the Company announced that its board of directors authorized the repurchase of up to $50 million of the Company s common stock. The Company may repurchase its stock for cash in the open market in accordance with applicable securities laws. The timing of and amount of any stock repurchase will depend on share price, corporate and regulatory requirements, economic and market conditions, and other factors. The stock repurchase authorization has no expiration date, does not require the Company to repurchase a specific number of shares, and may be modified, suspended, or discontinued at any time. During the three months and six months ended June 30, 2009, there were no stock repurchases under this program.

During the three months and six months ended June 30, 2008 there were 718,683 shares of stock repurchased under this program.

Warrants

The Company adopted EITF Issue No. 07-5, Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity s Own Stock (EITF 07-5), Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity s Own Stock effective January 1, 2009. EITF 07-5 provides that an entity should use a two step approach to evaluate whether an equity-linked financial instrument is indexed to its own stock, including evaluating the instrument s contingent exercise and settlement provisions. Therefore, warrants to purchase 426,951 shares of the Company s common stock issued in 2004 that were previously classified as Warrants have been retroactively restated upon adoption of EITF 07-5 and classified to Other Current Liabilities and Retained Earnings effective January 1, 2009 due to the presence of a warrant adjustment feature that allows for a change in the number of shares subject to issuance and a change in the exercise price of the warrant under certain circumstances, including the issuance of stock for cash in a secondary offering. The warrants expire on December 23, 2009 and the fair value balance of the remaining liability is now marked to market and recognized quarterly in non-operating income. The Company calculated the fair value of warrants using the Black-Scholes option pricing model, assuming a risk-free rate of 1.6%, a volatility factor of 66.9% as of January 1, 2009 and a contractual life of one year, and a derivative liability was established in the amount of $517,000 with an offset to warrants of $1.7 million and the cumulative effect of the change in accounting principle in the amount of $1.2 million recognized as an adjustment to the opening balance of

retained earnings. At June 30, 2009, the Company recalculated the fair value of the warrants using the Black-Scholes option pricing model assuming a risk-free rate of 2.3%, a volatility factor of 69% and a contractual life of six months. This resulted in a credit (charge) to non-operating income of $(136,000) and $344,000 for the quarter and six months ended June 30, 2009. The fair value of the warrants derivative liability will be recalculated at each balance sheet date until they expire in December 2009.

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10. RESTRUCTURING COSTS AND DISCONTINUED OPERATIONS

The Company accounts for restructuring costs and discontinued operations in accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets and SFAS No. 146, Accounting for Costs Associated with Exit of Disposal Activities , respectively. The following table sets forth the charges and expenses that are included in the restructuring line on the Company s condensed consolidated Statement of Operations for the six months ended June 30, 2009:

	December 31, 2008 Restructuring Reserve	Six Months Ended June 30, 2009 Add Charges	Deduct Cash Payments	Non-Cash Expenses	June 30, 2009 Restructuring Reserve
			($ in thousands)		
Medical workforce reductions	$	$ 464	$ (310)	$ (14)	$ 140
Touch workforce reductions	142	542	(632)	(2)	50
Medical division location transition		361	(285)		76
Total	$ 142	$ 1,367	$ (1,227)	$ (16)	$ 266

Restructuring Costs

On March 2, 2009, the Company announced that it was relocating its Medical business operations from Gaithersburg, Maryland to San Jose, California. The Company had workforce reductions that were recorded as Medical segment restructuring charges for the three months and six months ended June 30, 2009. Workforce reduction costs consisting of severance benefits of $133,000 are included in accrued compensation on the Company s condensed consolidated balance sheet. Other restructuring items are included in other current liabilities on the Company s condensed consolidated balance sheet. All of the remaining severance benefits have been paid in the third quarter of 2009 with the exception of certain COBRA costs that will be paid by the end of 2010.

In addition, for the first three months and six months of 2009, there were reorganizations in the Company s Touch segment due to business changes causing workforce reductions that have been recorded as accrued compensation in the Company s condensed consolidated balance sheet and restructuring charges in the statement of operations for the three months and six months ended June 30, 2009.

Results of Discontinued Operations

On November 17, 2008, the Company announced that it would divest its 3D product line which was part of its Touch segment. The Company s 3D product line consisted of a variety of products in the area of 3D digitizing, 3D measurement and inspection, and 3D interaction and included products such as MicroScribe digitizers, the CyberGlove family of products, and a SoftMouse 3D positioning device. In the three months ended March 31, 2009, the Company sold its CyberGlove and SoftMouse 3D positioning device product families including inventory, fixed assets, and intangibles and has recorded a gain on sale of discontinued operations of $167,000. Negotiated consideration for the sales was $900,000 in the form of cash and notes receivable and the proceeds will be recognized when they are received. In the three months ended June 30, 2009, the Company sold its MicroScribe device product family including inventory, fixed assets and intangibles and has recorded a gain on sale of discontinued operations of $20,000. Negotiated consideration for the sale was $1.8 million in the form of cash and notes receivable and the proceeds will be recognized when they are received. Accordingly, the operations of the 3D product line have been classified as discontinued operations, net of income tax, in the condensed consolidated statement of operations. Included in restructuring costs within discontinued operations for the year ended December 31, 2008 were asset impairment charges which included reserves taken against capitalized patent costs of $255,000 and fixed asset write offs of $20,000 due to the divesting of the product line. The Company had also accrued $105,000 of severance charges at December 31, 2008 which had been paid in cash as of September 30, 2009. Revenues included in

discontinued operations of the 3D product line were $118,000 and $649,000 for the three months and six months ended June 30, 2009, respectively. Revenues included in

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discontinued operations of the 3D product line were $1.1 million and $2.3 million for the three months and six months ended June 30, 2008, respectively. The assets sold consisted primarily of intangibles that had no carrying value on the Company s books at the time of sale.

11. INTEREST AND OTHER INCOME

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

12. INCOME TAXES

For the three months and six months ended June 30, 2009, the Company recorded income tax provisions of $300,000 and $391,000 on pre-tax losses from continuing operations of $8.8 million and $15.2 million, yielding effective tax rates of 3.4% and 2.6% respectively. For the three months and six months ended June 30, 2008, the Company recorded income tax benefits of $1.9 million and $3.2 million on pre-tax losses from continuing operations of $5.6 million and $10.3 million, yielding effective tax rates of (34.2)% and (30.7)%, respectively. The effective tax rate differs from the statutory rate primarily due to the valuation allowance, foreign withholding taxes and interest on unrecognized tax benefits. The income tax provision or benefit for the six months ended June 30, 2009 and 2008, 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 tax effect of the discontinued operations is removed to arrive at the income tax provision or benefit from continuing operations.

The Company adopted FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109, (FIN 48), regarding accounting for uncertain tax benefits, on January 1, 2007. As of June 30, 2009, the Company has unrecognized tax benefits of approximately $647,000, including interest of $20,000. The total amount of unrecognized tax benefits that would affect the Company s effective tax rate, if recognized, is $219,000. There were no material changes in the amount of unrecognized tax benefits during the quarter ended June 30, 2009. The Company does not expect any material changes to its liability for unrecognized tax benefits during the next twelve months. The Company s policy is to account for interest and penalties related to uncertain tax positions as a component of income tax provision.

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

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

The net tax benefits from employee stock option transactions were approximately $0 and $0 during the three months and six months ended June 30, 2009, respectively. The net tax benefits from employee stock option transactions were approximately $75,000 and $182,000 during the three months and six months ended June 30, 2008, respectively. The Company includes only the direct tax effects of employee stock incentive plans in calculating this increase to additional paid-in capital.

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13. NET LOSS PER SHARE

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

	Three Months Ended June 30		Six Months Ended June 30	
	2009	**2008**	**2009**	**2008**
Numerator:				
Loss from continuing operations	$ (9,057)	$ (3,655)	$ (15,569)	$ (7,129)
Gain from discontinued operations	186	210	588	536
Net loss	$ (8,871)	$ (3,445)	$ (14,981)	$ (6,593)
Denominator:				
Shares used in computation, basic and diluted (weighted average common shares outstanding)	27,968	30,356	27,946	30,417
Basic and diluted net loss per share:				
Continuing operations	$ (0.33)	$ (0.12)	$ (0.56)	$ (0.23)
Discontinued operations	0.01	0.01	0.02	0.01
Total	$ (0.32)	$ (0.11)	$ (0.54)	$ (0.22)

As of June 30, 2009 and 2008, the Company had securities outstanding that could potentially dilute basic earnings per share in the future, but these were excluded from the computation of diluted net loss per share in the periods presented since their effect would have been anti-dilutive. These outstanding securities consisted of the following:

	June 30, 2009	**June 30, 2008**
Outstanding stock options	6,548,887	7,505,995
Restricted stock and RSUs	311,917	
Warrants	428,567	436,772

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14. COMPREHENSIVE LOSS

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	**2008**	**2009**	**2008**
	(In thousands)		**(In thousands)**	
Net loss	$ (8,871)	$ (3,445)	$ (14,981)	$ (6,593)
Change in unrealized losses on short-term investments	2	(22)		(29)
Foreign currency translation adjustment	72	(8)	5	(20)
Total comprehensive loss	$ (8,797)	$ (3,475)	$ (14,976)	$ (6,642)

15. SEGMENT REPORTING

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

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

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

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
	(In thousands)		(In thousands)	
Revenues:				
Touch	$ 4,187	$ 3,920	$ 8,661	$ 7,882
Medical	2,495	3,699	5,561	6,618
Intersegment eliminations			(34)	(41)
Total	$ 6,682	$ 7,619	$ 14,188	$ 14,459
Operating loss:				
Touch	$ (3,875)	$ (5,688)	$ (8,891)	$ (10,577)
Medical	(4,953)	(855)	(7,140)	(2,312)
Intersegment eliminations		12	(1)	(5)
Total	$ (8,828)	$ (6,531)	$ (16,032)	$ (12,894)

	June 30, 2009	December 31, 2008
	(In thousands)	
Total Assets:		
Touch	$ 126,275	$ 129,305
Medical	9,835	11,471
Intersegment eliminations	(35,724)	(27,189)
Total	$ 100,386	$ 113,587

16. CONTINGENCIES

In re Immersion Corporation Initial Public Offering Securities Litigation

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.

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

Other Contingencies

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

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

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

17. SUBSEQUENT EVENTS

In re Immersion Corporation Securities Litigation

In September and October 2009, various putative shareholder class action and derivative complaints were filed in federal and state court against the Company and certain current and former Immersion directors and officers.

On September 2, 2009, a securities class action complaint was filed in the United States District Court for the Northern District of California against the Company and certain of its current and former directors and officers. Over the following five weeks, four additional class action complaints were filed. (One of these four actions was later voluntarily dismissed.) The securities class action complaints name the Company and certain

current and former Immersion directors and officers as defendants and allege violations of federal securities laws based on the Company s issuance of allegedly misleading financial statements. The various complaints assert claims covering the period from May 2007 through July 2009 and seek compensatory damages allegedly sustained by the purported class members.

On December 21, 2009, these class actions were consolidated by the court as *In Re Immersion Corporation Securities Litigation.* On the same day, the court appointed a lead plaintiff and lead plaintiff s counsel. The lead plaintiff will file a consolidated complaint following the Company s restatement of financial statements which defendants will then have the opportunity to file responsive pleadings.

In re Immersion Corporation Derivative Litigation

On September 15, 2009, a putative shareholder derivative complaint was filed in the United States District Court for the Northern District of California, purportedly on behalf of the Company and naming certain of its current and former directors and officers as individual defendants. Thereafter, two additional putative derivative complaints were filed in the same court.

The derivative complaints arise from the same or similar alleged facts as the federal securities actions and seek to bring state law causes of action on behalf of the Company against the individual defendants for breaches of fiduciary duty, gross negligence, abuse of control, gross mismanagement, breach of contract, waste of corporate assets, unjust enrichment, as well as for violations of federal securities laws. The federal derivative complaints seek compensatory damages, corporate governance changes, unspecified equitable and injunctive relief, the imposition of a constructive trust, and restitution. On November 17, 2009, the court consolidated these actions as *In re Immersion Corporation Derivative Shaw V. Richardson et. al. Litigation* and appointed lead counsel. Plaintiffs will file a consolidated derivative complaint following the Company s restatement of financial statements to which defendants will then have the opportunity to file responsive pleadings.

On October 7, 2009, a putative shareholder derivative complaint was filed in the Superior Court of the State of California for the County of Santa Clara, purportedly on behalf of the Company, seeking compensatory damages, equitable and injunctive relief, and restitution. The complaint names certain current and former directors and officers of the Company as individual defendants. This complaint arises from the same or similar alleged facts as the federal securities actions and seeks to bring causes of action on behalf of the Company against the individual defendants for breaches of fiduciary duty, waste of corporate assets and unjust enrichment. Plaintiff will file on amended complaint in this action following the Company s restatement of financial statements to which defendants will then have the opportunity to file responsive pleadings.

The Company cannot predict the ultimate outcome of the above-mentioned federal and state actions, and it is unable to estimate any potential liability it may incur.

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; and mobile communications. We manage these application areas under two operating and reportable segments: 1) Touch and 2) Medical.

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

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

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

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

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

Revenue Recognition

We recognize revenues in accordance with applicable accounting standards, including SAB No. 104, EITF No. 00-21, and SOP No. 97-2. Revenue is recognized when persuasive evidence of an arrangement exists, delivery has occurred or service has been rendered, the fee is fixed and determinable, and collectability is probable. We derive our revenues from three principal sources: royalty and license fees, product sales, and development contracts.

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

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

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

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

Product sales We generally 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 the majority of our products with warranties ranging from three to sixty months. We record the estimated warranty costs during the quarter the revenue is recognized. Historically, warranty-related costs and related accruals have not been significant. We offer a general right of return on the MicroScribe product line for 14 days after purchase. We recognize revenue at the time of shipment of a MicroScribe digitizer and provide an accrual for potential returns based on historical experience. We offer no other general right of return on our products.

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

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

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

Stock-based Compensation

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

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

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

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

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

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

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

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

Accounting for Income Taxes

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

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

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

Short-term Investments

Our short-term investments consist primarily of highly liquid commercial paper and government agency securities purchased with an original or remaining maturity of greater than 90 days on the date of purchase. We classify all debt securities with readily determinable market values as available-for-sale in accordance with SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities. Even though the stated maturity dates of these debt securities may be one year or more beyond the balance sheet date, we have classified all debt securities as short-term investments in accordance with Accounting Research Bulletin No. 43, Chapter 3A, Working Capital Current Assets and Current Liabilities, as they are reasonably expected to be realized in cash or sold within one year. These investments are carried at fair market value with unrealized gains and losses considered to be temporary in nature reported as a separate component of other comprehensive income (loss) within stockholders equity.

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

Effective January 1, 2008, we adopted the provisions of SFAS No. 157, which defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements required under other accounting pronouncements. SFAS No. 157 clarifies that fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly

transaction between market participants. SFAS No. 157 also requires that a fair value measurement reflect the assumptions market participants would use in pricing an asset or liability based on the best information available. Assumptions include the risks inherent in a particular valuation technique (such as a pricing model) and/or the risks inherent in the inputs to the model.

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

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

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

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

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

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

Further information about the application of SFAS No. 157 may be found in Note 3 to the condensed consolidated financial statements.

Recovery of Accounts Receivable

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

Inventory Reserves

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

Product Return and Warranty Reserves

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

Intangible Assets

We have acquired patents and other intangible assets. In addition, we capitalize the external legal and filing fees associated with patents and trademarks. We assess the recoverability of our intangible assets, and we must make assumptions regarding estimated future cash flows and other factors to determine the fair value of the respective assets that affect our consolidated financial statements. If these estimates or related assumptions change in the future, we may be required to record impairment charges for these assets. We amortize our intangible assets related to patents and trademarks, 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 six months ended June 30, 2009, we capitalized costs associated with patents and trademarks $1.3 million. Our total amortization expense for the three and six months ended June 30, 2009 for all intangible assets was $224,000 and $438,000, respectively.

Restructuring Costs

We calculate our Restructuring costs based upon our estimate of workforce reduction costs, asset impairment charges, and other appropriate charges resulting from a restructuring. The Company accounts for restructuring costs in accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets and SFAS No. 146, Accounting for Costs Associated with Exit of Disposal Activities based on our assumptions, judgments, and estimates, we determine whether we need to record an impairment charge to reduce the value of the asset carried on our balance sheet to its estimated fair value. Assumptions, judgments and estimates about future values are complex and often subjective. They can be affected by a variety of factors, including external factors such as industry and economic trends, and internal factors such as changes in our business strategy.

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 SIX MONTHS ENDED JUNE 30, 2009 AND 2008

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

Overview

We had a 12% decrease in revenues from continuing operations during the second quarter of 2009 as compared to the second quarter of 2008. The second quarter revenue decline was primarily due to a 26% decrease in product sales, mainly medical product sales, and a 53% decrease in development contract revenues. We believe that the current economic downturn has had a negative effect on capital purchases of our products. The revenue decrease was partially offset by a 13% increase in royalty and license revenues from increased Touch royalty and license fees mainly from customers that sell mobile devices. We had a 2% decrease in revenues from continuing operations during the six months ended June 30, 2009 as compared to the six months ended June 30, 2008. The first six months revenue decline was primarily due to a 48% decrease in development contract revenues and a 4% decrease in product sales, mainly medical product sales. The revenue decrease was partially offset by an 11% increase in royalty and license revenues from increased Touch royalty and license fees mainly from customers that sell mobile devices. In conjunction with moving our medical operating segment to San Jose and other workforce reductions in our Touch segment, we had restructuring costs of $705,000 and $1.4 million for the three and six months ended June 30, 2009, respectively. We had physical inventory write offs of $543,000 and $554,000 for the three and six months ended June 30, 2009 primarily consisting of physical count to book adjustments of medical demo equipment. We also recognized write offs of demo equipment of $668,000 and $666,000 for the three and six months ended June 30, 2009, respectively, resulting from a reconciliation of the fixed asset records to the physical inventory at the time of the move. We divested our 3D product line and recorded gains of $166,000 and $401,000 from discontinued operations for the three and six months ended June 30, 2009, respectively. This was compared to gains of $210,000 and $536,000 for the three and six months ended June 30, 2008, respectively. We also had gains on sales of discontinued operations of $20,000 and $187,000 for the three and six months ended June 30, 2009, respectively. Our net loss was $8.9 million for the second quarter of 2009 compared to a net loss of $3.4 million for the second quarter of 2008. Our net loss was $15.0 million for the six months ended June 30, 2009 compared to a net loss of $6.6 million for the six months ended June 30, 2008.

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

REVENUES	June 30, 2009	June 30, 2008	Change
	(In thousands)		
Three months ended:			
Royalty and license	$ 3,580	$ 3,171	13%
Product sales	2,772	3,744	(26)%
Development contracts and other	330	704	(53)%
Total Revenue	$ 6,682	$ 7,619	(12)%
Six months ended:			
Royalty and license	$ 7,361	$ 6,632	11%
Product sales	6,051	6,324	(4)%
Development contracts and other	776	1,503	(48)%
Total Revenue	$ 14,188	$ 14,459	(2)%

Three Months Ended June 30, 2009 Compared to Three Months Ended June 30, 2008

Total Revenue Our total revenue from continuing operations for the second quarter of 2009 decreased by $937,000 or 12% from the second quarter of 2008.

Royalty and license revenue Royalty and license revenue is comprised of royalties earned on sales by our TouchSense licensees and license fees charged for our intellectual property portfolio. Royalty and license revenue for the second quarter of 2009 was $3.6 million, an increase of $409,000 or 13% from the second quarter of 2008. The increase in royalty and license revenue was primarily due to an increase in royalty and license revenue from our Touch segment from increased shipments by licensees of mobile devices partially offset by decreased revenue from gaming and automotive licensees. We expect royalty revenue to be a significant component of our revenue as our technology continues to be included in mobile phone handsets.

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

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

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

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

Product sales Product sales for the second quarter of 2009 were $2.8 million, a decrease of $972,000 or 26% as compared to the second quarter of 2008. The decrease in product sales was primarily due to a decrease in medical product sales. Reduced medical product sales were mainly due to decreased sales of our endoscopy, endovascular, Virtual IV, and laparoscopy simulators partially offset by an increase in sales of our arthroscopy simulators. We believe that the current economic downturn has had and may continue to have a negative effect on capital purchases of our products in the near term.

Development contract and other revenue Development contract and other revenue is comprised of revenue on commercial contracts and extended support contracts. Development contract and other revenue was $330,000 during the second quarter of 2009, a decrease of $374,000 or 53% as compared to the second quarter of 2008. The decrease was mainly attributable to a decrease in medical contract revenue due to the completion of work performed under medical contracts that occurred through the first six months of 2008. We do not currently have any government projects in development. We continue to transition our engineering resources from certain commercial development contract efforts to product development efforts that focus on leveraging our existing sales and channel distribution capabilities.

We categorize our geographic information into four major regions: North America, Europe, Far East, and Rest of the World. In the second quarter of 2009, revenue generated in North America, Europe, Far East, and Rest of the World represented 54%, 14%, 32%, and 0%, respectively, compared to 66%, 16%, 13%, and 5%, respectively, for the second quarter of 2008. The shift in revenues among regions was mainly due to an increase in touch royalty revenue in the Far East, a decrease in medical product and contract revenue in North America, a decrease in touch royalty revenue from Europe, and a decrease in medical product revenue from the Rest of the World. We mainly attribute the increase in touch royalty revenue in the Far East to increased revenue from licensees of mobile devices, partially due to the addition of increased international sales and support personnel in 2008. The decrease in medical product revenue in North America and Rest of the World is partially attributable to the current economic downturn has had a negative effect on capital purchases of our products.

Six Months Ended June 30, 2009 Compared to Six Months Ended June 30, 2008

Total Revenue Our total revenue from continuing operations for the six months ended June 30, 2009 decreased by $271,000 or 2% from the first six months ended June 30, 2008.

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Royalty and license revenue Royalty and license revenue is comprised of royalties earned on sales by our TouchSense licensees and license fees charged for our intellectual property portfolio. Royalty and license revenue for the six months ended June 30, 2009 was $7.4 million, an increase of $729,000 or 11% from the six months ended June 30, 2008. The increase in royalty and license revenue was primarily due to an increase in royalty and license revenue from our Touch segment from increased shipments by licensees of mobile devices partially offset by decreased shipments by gaming and automotive licensees.

Product sales Product sales for the six months ended June 30, 2009 were $6.1 million, a decrease of $273,000 or 4% as compared to the six months ended June 30, 2008. The decrease in product sales was primarily due to a decrease in medical product sales. Reduced medical product sales were mainly due to decreased sales of our Virtual IV, endovascular, and endoscopy simulators partially offset by an increase in sales of our laparoscopy and arthroscopy simulators.

Development contract and other revenue Development contract and other revenue is comprised of revenue on commercial contracts and extended support contracts. Development contract and other revenue was $776,000 during the six months ended June 30, 2009, a decrease of $727,000 or 48% as compared to the six months ended June 30, 2008. The decrease was mainly attributable to a decrease in medical contract revenue due to the completion of work performed under medical contracts that occurred through the first six months of 2008. Partially offsetting that decrease was increased revenue recognized on Touch development contracts and support.

In the first six months of 2009, revenue generated in North America, Europe, Far East, and Rest of the World represented 51%, 19%, 29%, and 1%, respectively, compared to 64%, 19%, 12%, and 5%, respectively, for the first six months of 2008. The shift in revenues among regions was mainly due to an increase in Touch royalty revenue from Europe and the Far East and a decrease in touch royalty and medical product and contract revenue in North America and Medical product revenue from the Rest of the World.

	June 30,		Change
COST OF PRODUCT SALES	**2009**	**2008**	
	(In thousands)		
Three months ended:			
Cost of product sales	$2,312	$2,051	13%
% of total product revenue	83%	55%	
Six months ended:			
Cost of product sales	$3,563	$3,735	(5)%
% of total product revenue	59%	59%	

Cost of Product Sales Our cost of product sales (exclusive of amortization of intangibles) consists primarily of materials, labor, and overhead. There is no cost of product sales associated with royalty and license revenue or development contract revenue. Cost of product sales from continuing operations was $2.3 million, an increase of $261,000 or 13% for the second quarter of 2009 as compared to the second quarter of 2008. The increase in cost of product sales was primarily due to increased physical inventory write off costs of $535,000 and increased obsolescence expense of $306,000 partially offset by reduced overhead costs of $490,000 and reduced direct material costs of $107,000. The physical inventory write off costs consisted primarily of physical count to book adjustments of medical demo equipment inventory in the second quarter of 2009. The increase in obsolescence expense was mainly due to additional excess and obsolescence write-off from medical product parts. Overhead costs decreased mainly as a result of reduced salary expense from decreased headcount. The decrease in direct material costs was mainly the result of reduced product sales. The cost of product sales increased as a percentage of product revenue in the second quarter of 2009 from the second quarter of 2008 and increased in the second quarter of 2009 from the first quarter of 2009. These increases are mainly due to the increased physical inventory costs and obsolescence expense in the second quarter of 2009 mentioned above partially offset by reduced overhead costs including reduced headcount.

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Cost of product sales from continuing operations was $3.6 million, a decrease of $172,000 or 5% for the six months ended June 30, 2009 as compared to the six months ended June 30, 2008. The decrease in cost of product sales was primarily due to reduced overhead costs of $579,000 and reduced material and production costs of $300,000 partially offset by increased physical inventory write off costs of $564,000, increased obsolescence expense of $97,000 and increased freight costs of $29,000. Overhead costs decreased mainly as a result of reduced salary expense from decreased headcount. The decrease in material and production costs was mainly the result of reduced product sales and the result of a product mix change. The physical inventory write off costs were primarily consisting of physical count to book adjustments of medical equipment parts in the second quarter of 2009. The increase in obsolescence expense was mainly due to additional excess and obsolescence write-off from medical product parts.

	June 30,		Change
OPERATING EXPENSES AND OTHER	**2009**	**2008**	
	($ In thousands)		
Three months ended:			
Sales and marketing	$4,016	$3,846	4%
% of total revenue	60%	50%	
Research and development	$3,412	$2,940	16%
% of total revenue	51%	39%	
General and administrative	$4,841	$5,111	(5)%
% of total revenue	72%	67%	
Amortization and impairment of intangibles	$ 224	$ 202	11%
% of total revenue	3%	3%	
Restructuring Costs	$ 705	$	*%
% of total revenue	11%	*%	
Six months ended:			
Sales and marketing	$8,300	$7,191	15%
% of total revenue	59%	50%	
Research and development	$7,341	$6,430	14%
% of total revenue	52%	44%	
General and administrative	$9,226	$9,525	(3)%
% of total revenue	65%	66%	
Amortization and impairment of intangibles	$ 439	$ 472	(7)%
% of total revenue	3%	3%	
Restructuring Costs	$1,351	$	*%
% of total revenue	10%	*%	

* Not meaningful

Sales and Marketing Our sales and marketing expenses are comprised primarily of employee compensation and benefits costs, advertising, public relations, trade shows, brochures, market development

funds, travel, and an allocation of facilities costs. Sales and marketing expenses from continuing operations were $4.0 million, an increase of $170,000 or 4% in the second quarter of 2009 compared to the comparable period in 2008. The increase was primarily due to a write off of demo equipment of $668,000, primarily resulting from a reconciliation of the fixed asset records to the physical inventory at the time of the move and increased consulting costs of $34,000 partially offset by reduced compensation, benefits, and overhead of $334,000 primarily due to decreased sales and marketing headcount, decreased employee recruitment expense of $82,000, decreased marketing, advertising, and public relations costs of $58,000, and decreased bad debt expense of $56,000. We are taking steps to reduce our sales and marketing expenses, although we expect to continue to focus our sales and marketing efforts on mobile device, touchscreen, and medical market opportunities to build greater market acceptance for our touch technologies.

Sales and marketing expenses from continuing operations were $8.3 million, an increase of $1.1 million or 15% in the first six months of 2009 compared to the comparable period in 2008. The increase was primarily due to a write off of demo equipment of $666,000, primarily resulting from a reconciliation of the fixed asset records to the physical inventory at the time of the move, increased consulting costs of $254,000 to supplement our sales and marketing staff, increased marketing, advertising, and public relations costs of $232,000, increased sales and marketing travel expense of $194,000, partially offset by reduced sales and marketing employee recruitment charges of $182,000 and a reduction in bad debt expense of $161,000. The increased sales and marketing expenses were primarily due to the expansion of our sales and marketing efforts internationally.

Research and Development Our research and development expenses are comprised primarily of employee compensation and benefits costs, consulting fees, tooling and supplies, and an allocation of facilities costs. Research and development expenses from continuing operations were $3.4 million, an increase of $472,000 or 16% in the second quarter of 2009 compared to the same period in 2008. The increase was primarily due to increased compensation, benefits, and overhead of $231,000, increased consulting costs of $164,000 to supplement our engineering staff, and engineering travel costs of $64,000. The increased compensation, benefits, and overhead expense was primarily due to increased research and development headcount. We believe that continued significant investment in research and development is critical to our future success, and we expect to make significant investments in areas of research and technology development to support future growth.

Research and development expenses from continuing operations were $7.3 million, an increase of $911,000 or 14% in the first six months of 2009 compared to the same period in 2008. The increase was primarily due to increased compensation, benefits, and overhead of $622,000 and increased consulting costs of $267,000 to supplement our engineering staff. The increased compensation, benefits, and overhead expense was primarily due to increased research and development headcount.

General and Administrative Our general and administrative expenses are comprised primarily of employee compensation and benefits, legal and professional fees, office supplies, travel, and an allocation of facilities costs. General and administrative expenses from continuing operations were $4.8 million, a decrease of $270,000 or 5% in the second quarter of 2009 compared to the same period in 2008. The decrease was primarily due to reduced legal, professional, and license fee expenses of $649,000, partially offset by increased compensation, benefits, and overhead of $241,000, and increased supplies and office expenses of $60,000. The decreased legal, professional, and license fee expenses were primarily due to decreased litigation costs of $1.1 million, mainly Microsoft litigation which was settled in 2008; partially offset by increased costs resulting from our internal investigation. Increased compensation, benefits, and overhead are primarily increased stock compensation costs. We expect that the dollar amount of general and administrative expenses to continue to be a significant component of our operating expenses, but we are currently taking steps to reduce our general and administrative expenses. We will continue to incur costs related to litigation as we continue to assert our intellectual property and contractual rights and defend lawsuits brought against us.

General and administrative expenses from continuing operations were $9.2 million, a decrease of $299,000 or 3% in the first six months of 2009 compared to the same period in 2008. The decrease was primarily due to reduced legal, professional, and license fee expenses of $1.2 million, partially offset by increased compensation, benefits, and overhead of $574,000, increased travel of $134,000, and increased

supplies and office expenses of $91,000, and increased public company expense of $65,000. The decreased legal, professional, and license fee expenses were primarily due to decreased litigation costs of $2.0 million, mainly Microsoft litigation which was settled in 2008; partially offset by costs resulting from our current internal investigation. The increased compensation, benefits, and overhead expense was primarily due to increased general and administrative headcount and increased non-cash stock-based compensation charges.

Amortization and impairment of Intangibles Our amortization and impairment of intangibles is comprised primarily of patent amortization and other intangible amortization along with impairment s or write off of intangibles. Amortization and impairment of intangibles increased by $22,000 or 11% in the second quarter of 2009 compared to the same period in 2008. Amortization and impairment of intangibles decreased by $33,000 or 7% in the first six months of 2009 compared to the same period in 2008. The decrease was primarily attributable to some intangible assets reaching full amortization.

Restructuring Restructuring costs in the second quarter of 2009 consist primarily of severance benefits and move and close down of facility costs paid in connection with the reduction of workforce and relocation of the Maryland medical business operations to San Jose of $646,000. Restructuring costs also include severance benefits paid as the result of the reduction of workforce due to business changes in our Touch segment of $59,000. There were no restructuring charges incurred in the second quarter of 2008. We do not expect to record significant additional costs relating to the reduction of workforce and relocation of the Maryland medical business operations to San Jose except for some employee move and temporary housing costs.

Restructuring costs in the first six months of 2009 consist primarily of severance benefits and move and close down of facility costs paid in connection with the reduction of workforce and relocation of the Maryland medical business operations to San Jose of $811,000. Restructuring costs also include severance benefits paid as the result of the reduction of workforce due to business changes in our Touch segment of $540,000. There were no restructuring charges incurred in the six months ended June 30, 2008.

Change in fair value of warrant liability In January 2009, we adopted EITF Issue No. 07-5, Determining Whether an Instrument (or Embedded Feature) is Indexed to an Entity s Own Stock . Quarterly we recalculate the fair value of our warrants using the Black-Scholes option pricing model. For the three months and six months ended June 30, 2009, the gain or loss from the change in fair value of the warrant liability was ($136,000) and $344,000, respectively.

Interest and Other Income Interest and other income consist primarily of interest income and dividend income from cash and cash equivalents and short-term investments and gain on sale of short-term investments. Interest and other income decreased by $766,000 in the second quarter of 2009 compared to the same period in 2008. This was primarily the result of decreased interest income due to a reduction in cash equivalents and short-term investments and reduced interest rates on cash, cash equivalents, and short-term investments. We expect that the accretion of interest income from Sony Computer Entertainment that was approximately $112,000 in the second quarter of 2009 and will total approximately $377,000 in 2009 will be completed at the end of 2009.

Interest and other income decreased by $2.1 million in the first six months of 2009 compared to the same period in 2008. This was primarily the result of decreased interest income due to a reduction in cash equivalents and short-term investments and reduced interest rates on cash, cash equivalents, and short-term investments.

Provision for Income Taxes We recorded a provision for income taxes for second quarter of 2009 of $300,000 on pre-tax loss from continuing operations of $8.8 million, yielding an effective tax rate 3.4%. For the second quarter of 2008, we recorded a benefit for income taxes of $1.9 million on pre-tax loss from continuing operations of $5.6 million, yielding an effective tax rate of (34.2)%. The income tax provision or benefit for the second quarter of 2009 and 2008 are arrived at 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 tax effect of the discontinued operations is removed to arrive at the income tax provision or benefit from continuing operations.

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We recorded a provision for income taxes for the six months ended June 30, 2009 of $391,000 on pre-tax loss from continuing operations of $15.2 million, yielding an effective tax rate of 2.6% which reflects the continuing impact of the valuation allowance on the deferred tax asset taken in Q3 2008. During 2008, we recorded a valuation allowance due to uncertainty in realization of asset balances due to losses. For the six months ended June 30, 2008, we recorded a benefit for income taxes of $3.2 million on pre-tax loss from continuing operations of $10.3 million, yielding an effective tax rate of (30.7)%. The income tax provision or benefit for the six months ended June 30, 2009 and June 30, 2008 are arrived at as a result of applying the estimated annual effective tax rate to cumulative loss before taxes, plus foreign withholding tax expense, adjusted for certain discrete items which are fully recognized in the period they occur.

Discontinued Operations In the three months ended June 30, 2009, we sold our MicroScribe family of products and have recorded a gain on sale of discontinued operations of $20,000. The remaining operations of the 3D product line have been classified as discontinued operations in the condensed consolidated statement of operations. Gain from discontinued operations, net of tax, decreased by $44,000 in the second quarter of 2009 compared to the same period in 2008, primarily due to the decrease in activity due to the ceasing of 3D operations in the quarter ended March 31, 2009 resulting in reduced sales volumes and costs and expenses associated with 3D operations during subsequent periods.

In the six months ended June 30, 2009, we ceased operations of the 3D product line and sold our CyberGlove family of products, SoftMouse 3D positioning device family of products, and our Microscribe family of products, and recorded a gain on sale of discontinued operations of $187,000. Accordingly, the operations of the 3D product line have been classified as discontinued operations in the condensed consolidated statement of operations. Gain from discontinued operations, net of tax, decreased by $135,000 in the six months ended June 30, 2009 compared to the same period in 2008, primarily due to the decrease in activity due to the ceasing of 3D operations in the quarter ended March 31, 2009 resulting in reduced sales volumes and costs and expenses associated with 3D operations during that period.

SEGMENT RESULTS FOR THE THREE AND SIX MONTHS ENDED JUNE 30, 2009 AND 2008

We have two operating and reportable segments. One segment, Touch, develops and markets touch feedback technologies that enable software and hardware developers to enhance realism and usability in their computing, entertainment, and industrial applications. The second segment, Medical, develops, manufactures, and markets medical training simulators that recreate realistic healthcare environments.

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	Three Months Ended June 30, 2009	Three Months Ended June 30, 2008	Six Months Ended June 30, 2009	Six Months Ended June 30, 2008
	(In thousands)		(In thousands)	
Revenues:				
Touch	$ 4,187	$ 3,920	$ 8,661	$ 7,882
Medical	2,495	3,699	5,561	6,618
Intersegment eliminations			(34)	(41)
Total	$ 6,682	$ 7,619	$ 14,188	$ 14,459
Operating loss:				
Touch	$ (3,875)	$ (5,688)	$ (8,891)	$ (10,577)
Medical	(4,953)	(855)	(7,140)	(2,312)
Intersegment eliminations		12	(1)	(5)
Total	$ (8,828)	$ (6,531)	$ (16,032)	$ (12,894)

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

Touch segment Revenues from the Touch segment were $4.2 million, an increase of $267,000 or 7% in the second quarter of 2009 compared to the same period in 2008. Royalty and license revenues increased by $400,000 mainly due to increased revenue from licensees of mobile devices partially offset by decreased revenue from gaming and automotive licensees. Development contract revenue decreased by $117,000 primarily due to decreased development contracts and support. Operating loss for the second quarter of 2009 was $3.9 million, a decrease of $1.8 million compared to the same period in 2008. The decrease was primarily due to a decrease in general and administrative expenses of $990,000 mainly due to decreased litigation costs, increased gross margin of $768,000 mainly due to increased royalty and license revenue, and a decrease in sales and marketing expenses of $548,000. The decreases to the operating loss were partially offset by an increase in research and development costs of $371,000 and an increase in restructuring costs of $101,000.

Revenues from the Touch segment were $8.7 million, an increase of $779,000 or 10% in the first six months of 2009 compared to the same period in 2008. Royalty and license revenues increased by $721,000 mainly due to increased revenue from licensees of mobile devices partially offset by decreased revenue from gaming and automotive

licensees. Development contract revenue increased by $65,000 primarily due to increased development contracts and support. Operating loss for the six months ended June 30, 2009 was $8.9 million, a decrease of $1.7 million compared to the same period in 2008. The decrease was primarily due to increased gross margin of $1.6 million mainly due to increased royalty and license revenue, a decrease in general and administrative expenses of $1.3 million mainly due to decreased litigation costs, and decreased sales and marketing expenses of $178,000. The decreases to operating loss were partially offset by an increase of research and development expenses of $838,000, and an increase in restructuring costs of $581,000.

Medical segment Revenues from the Medical segment were $2.5 million, a decrease of $1.2 million or 33%, for the second quarter of 2009 compared to the same period in 2008. The decrease was primarily due to a reduction of product sales mainly due to decreased sales of our endoscopy, endovascular, Virtual IV, and laparoscopy simulators partially offset by an increase in sales of our arthroscopy simulators and a reduction of medical development contract revenue due to the completion of work performed under medical contracts that occurred through the first six months of 2008. Operating loss for the second quarter of 2009 was $5.0 million, an increase of $4.1 million compared to the same period in 2008. The increase was mainly due to a decrease in gross margin of $2.0 million primarily due to reduced revenue and physical

inventory write offs primarily consisting of physical count to book adjustments of medical equipment parts, increased general and administrative expenses of $719,000 primarily due to increased legal costs, increased sales and marketing expenses of $719,000 including fixed asset write offs resulting from a reconciliation of the fixed asset records to the physical inventory, an increase in restructuring costs of $604,000 mainly due to the facility move to San Jose, and increased research and development expenses of $101,000.

Revenues from the Medical segment were $5.6 million, a decrease of $1.1 million or 16%, for the first six months of 2009 compared to the same period in 2008. The decrease was primarily due to a reduction of product sales mainly due to decreased sales of our Virtual IV, endovascular, and endoscopy simulators partially offset by an increase in sales of our laparoscopy and arthroscopy simulators. and a reduction of medical development contract revenue due to the completion of work performed under medical contracts that occurred through the first six months of 2008. Operating loss for the six months ended June 30, 2009 was $7.1 million, an increase of $4.8 million compared to the same period in 2008. The increase was mainly due to a decrease in gross margin of $1.7 million primarily due to reduced revenue and physical inventory write offs primarily consisting of physical count to book adjustments of medical equipment parts, increased sales and marketing expenses of $1.3 million primarily due to an expansion of international sales and marketing efforts and fixed asset write offs resulting from a reconciliation of the fixed asset records to the physical inventory, increased general and administrative expenses of $969,000 mainly due to increased legal costs, and an increase in restructuring costs of $770,000 mainly due to the facility move to San Jose.

LIQUIDITY AND CAPITAL RESOURCES

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

On June 30, 2009, our cash, cash equivalents, and short-term investments totaled $74.0 million, a decrease of $11.7 million from $85.7 million on December 31, 2008.

In March 2007, we concluded our patent infringement litigation against Sony Computer Entertainment and we received $97.3 million. Furthermore, we entered into a new business agreement under which, we are to receive twelve quarterly installments of $1.875 million for a total of $22.5 million beginning on March 31, 2007 and ending on December 31, 2009. As of June 30, 2009, we had received ten of these installments.

Net cash used in operating activities during the six months ended June 30, 2009 was $9.4 million, a change of $7.9 million from the $1.5 million used during the six months ended June 30, 2008. Cash used in operations during the six months ended June 30, 2009 was primarily the result of a net loss of $15.0 million, a decrease of $1.8 million due to a change in accounts payable, a decrease of $783,000 due to a change in accrued compensation and other current liabilities, and a decrease of $172,000 due to a change in inventories. These decreases were offset by a $1.9 million increase due to a change in accounts receivable, a $1.9 million increase due to a change in deferred revenue and customer advances, and an increase of $332,000 due to a change in prepaid expenses and other current assets. Cash used in operations during the six months ended June 30, 2009 was also impacted by noncash charges and credits of $4.1 million, including $2.7 million of noncash stock-based compensation, $873,000 in depreciation and amortization, $439,000 in amortization and impairment of intangibles, $708,000 of write off of equipment, partially offset by a decrease in the fair market value of warrant liability of $344,000 and gain on sales of discontinued operations of $187,000.

Net cash used in investing activities during the six months ended June 30, 2009 was $30.6 million, compared to the $17.2 million provided by investing activities during the six months ended June 30, 2008, an increase of $47.8 million. Net cash used in investing activities during the period consisted of purchases of short-term investments of $49.0 million; a $1.5 million increase in intangibles and other assets, primarily due to capitalization of external patent filing and application costs; and $1.3 million used to purchase property and equipment; partially offset by maturities or sales of short-term investments of $21.0 million and proceeds from sales of discontinued operations of $187,000.

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Net cash provided by financing activities during the six months ended June 30, 2009 was $271,000 compared to $4.7 million used during the six months ended June 30, 2008, or a $5.0 million increase from the prior year. Net cash provided by financing activities for the period consisted primarily of issuances of common stock and exercises of stock options and warrants in the amount of $278,000.

We believe that our cash and cash equivalents will be sufficient to meet our working capital needs for at least the next twelve months. We will continue to protect and defend our extensive intellectual property portfolio across all business segments. We anticipate that capital expenditures for the year ended December 31, 2009 will total approximately $3.0 million in connection with anticipated maintenance and upgrades to operations and infrastructure. Cash flows from our discontinued operations have been included in our consolidated statement of cash flows with continuing operations within each cash flow category. The absence of cash flows from discontinued operations is not expected to affect our future liquidity or capital resources. Additionally, if we acquire one or more businesses, patents, or products, our cash or capital requirements could increase substantially. In the event of such an acquisition, or should any unanticipated circumstances arise that significantly increase our capital requirements, we may elect to raise additional capital through debt or equity financing. Any of these events could result in substantial dilution to our stockholders. There is no assurance that such additional capital will be available on terms acceptable to us, if at all.

SUMMARY DISCLOSURES ABOUT CONTRACTUAL OBLIGATIONS AND COMMERCIAL COMMITMENTS

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

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

As discussed in Note 12 to the condensed consolidated financial statements, effective January 1, 2007, we adopted the provisions of FIN 48. On June 30, 2009, we had a liability for unrecognized tax benefits totaling approximately $647,000, including interest of $20,000. Due to the uncertainties related to these tax matters, we are unable to make a reasonably reliable estimate when cash settlement with a taxing authority will occur. Settlement of such amounts could require the utilization of working capital.

RECENT ACCOUNTING PRONOUNCEMENTS

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

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

Cash Equivalents and Short-term Investments We have cash equivalents and short-term investments of $71.3 million as of June 30, 2009. These securities are subject to interest rate fluctuations. An increase in interest rates could adversely affect the market value of our cash equivalents and short-term investments. A hypothetical 100 basis point increase in interest rates would result in an approximate $180,000 decrease in the fair value of our cash equivalents and short-term investments as of June 30, 2009.

We limit our exposure to interest rate and credit risk by establishing and monitoring clear policies and guidelines for our cash equivalents and short-term investment portfolios. The primary objective of our policies is to preserve principal while at the same time maximizing yields, without significantly increasing risk. Our investment policy limits the maximum weighted average duration of all invested funds to 12 months. Our policy s guidelines also limit exposure to loss by limiting the sums we can invest in any individual security and restricting investment to securities

that meet certain defined credit ratings. We do not use derivative financial instruments in our investment portfolio to manage interest rate risk.

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

ITEM 4. CONTROLS AND PROCEDURES

EVALUATION OF DISCLOSURE CONTROLS AND PROCEDURES

Our management, with the participation of our Interim Chief Executive Officer and Interim Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures as defined in Rules 13a-15(e) and 15d-15(e) of the Exchange Act as of June 30, 2009. The purpose of these controls and procedures is to ensure that information required to be disclosed in the reports we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in the SEC s rules, and that such information is accumulated and communicated to our management, including our Interim Chief Executive Officer and our Interim Chief Financial Officer, to allow timely decisions regarding required disclosures.

Our management, with the participation of our Interim Chief Executive Officer and Interim Chief Financial Officer evaluated our disclosure controls and procedures and determined that there were material weaknesses in our internal control over financial reporting as of June 30, 2009, as more fully described in Management s Report on Internal Control over Financial Reporting (As Revised), in Amendment No. 1 to our Annual Report on 10-K on Form 10-K/A filed on February 8, 2010 and in Evaluation of Disclosure Controls and Procedures (As Revised) in Amendment No. 1 to our Quarterly Report on 10-Q for the period ended March 31, 2009 on Form 10-Q/A filed on February 8, 2010. Additionally, as of June 30, 2009, we did not maintain effective control over inventory and fixed assets. Specifically, we determined that inventory, including capitalized demonstration and customer loaner equipment was not appropriately tracked. As a result, we have concluded that there is a material weakness in inventory control and fixed asset management. A material weakness is a deficiency, or combination of deficiencies, such that there is a reasonable possibility that a material misstatement of the annual or interim financial statements will not be prevented or detected on a timely basis. Based on this evaluation and because of the material weaknesses described in our Form 10-K/A and Form 10-Q/A which have not been remediated as of June 30, 2009, our Interim Chief Executive Officer and Interim Chief Financial Officer have concluded that certain disclosure controls and procedures were not effective as of June 30, 2009.

CHANGES IN INTERNAL CONTROL OVER FINANCIAL REPORTING

Other than the remedial efforts to address our material weaknesses as described further below, that took place or that were ongoing during the three months ended June 30, 2009, there were no changes in our internal control over financial reporting during the three months ended June 30, 2009 that have materially affected or are reasonably likely to materially affect, our internal control over financial reporting.

Plans for Remediation

We will not be able to assess whether the steps we are taking will fully remedy the material weaknesses in our internal control over financial reporting until we have fully implemented them and a sufficient time passes in order to evaluate their effectiveness.

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Subsequent to December 31, 2007 through the filing date of this Amendment, we have undertaken the following remedial efforts to address the material weakness in our internal control over financial reporting with respect to income taxes as initially reported in our Annual Report on Form 10-K for the year ended December 31, 2007:

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

In November 2008, we hired a senior tax manager who had responsibility to consider and apply proper accounting for income taxes, design and implement controls to ensure that the rationale for positions taken on certain tax matters would 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. In June 2009, the senior tax manager departed the Company and we outsourced the preparation of the Company s quarterly and annual tax calculations and the related financial disclosures including the rationale for recognizing the benefits of certain tax positions in the financial statements to an external provider with oversight responsibility remaining with the corporate controller. We continue to evaluate additional steps to remediate this material weakness.

Subsequent to June 30, 2009 through the filing date of this 10-Q, we have undertaken the following remedial efforts to address the material weaknesses in our internal control over financial reporting with respect to revenue recognition described in Amendment No. 1 to our Annual Report on 10-K/A filed on February 8, 2010 :

We are in the process of improving our documentation of our existing revenue recognition policies, including policies involving non-standard terms and conditions, multiple element arrangements, modifications to shipping terms and requests for pre-release products;

We have restructured our finance department such that the individuals responsible for the recognition of revenue are all located at our headquarters and report directly to the Interim CFO with clearly delineated responsibilities;

We have held training sessions on revenue recognition policies with the sales personnel and will continue to implement training and oversight of executive, finance, sales and operational personnel and new hires to ensure compliance with revenue recognition policies;

We have redesigned the quarterly sub-certification process to cover a wider variety of topics that could affect the financial statements and added more employees to this certification process;

We have implemented a process of obtaining quarterly certifications from all sales personnel certifying that they are not aware of any side agreements modifying our standard terms of contracts;

We have implemented a process of obtaining, on an annual basis, signed acknowledgments from each employee that he or she has read and is in compliance with our code of ethics and employee handbook;

We have improved our legal and financial review process of all sales order packages for all terms and conditions prior to shipment; and

We are in the process of automating the approval process for the release of all products in development to production, which approval process requires the approval of finance personnel.

In addition, we continue to take the steps set forth in the remedial plan approved by the Audit Committee as further discussed in the Explanatory Note and Item 9 in the Form 10-K/A for the year ended December 31, 2008.

Subsequent to June 30, 2009 through the filing date of this Amendment, we have undertaken the following remedial efforts to address the material weaknesses in our internal control over financial reporting with respect to the calculation of stock-based compensation, warrants and inventory control and fixed assets management as discussed above or in the amendments to our Annual Report on Form 10-K and Quarterly Report on Form 10-Q describes above: