

IMMERSION CORP
Form 10-Q
August 07, 2012
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(MARK ONE)

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

For the quarterly period ended June 30, 2012

OR

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

For the transition period from to

Commission file number 000-27969

IMMERSION CORPORATION

(Exact name of registrant as specified in its charter)

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Delaware
(State or other jurisdiction of
incorporation or organization)

94-3180138
(I.R.S. Employer
Identification No.)

30 Rio Robles, San Jose, California 95134

(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 No

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

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

Large accelerated filer Accelerated filer

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

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

Number of shares of common stock outstanding at July 26, 2012: 27,751,120.

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Table of Contents**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, 2012	December 31, 2011
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 8,397	\$ 7,298
Short-term investments	43,964	48,987
Accounts and other receivables (net of allowances for doubtful accounts as of: June 30, 2012 \$33 and December 31, 2011 \$21)	2,748	1,487
Inventories	403	423
Deferred income taxes	215	215
Prepaid expenses and other current assets	743	479
Total current assets	56,470	58,889
Property and equipment, net	1,520	1,737
Intangibles and other assets, net	14,933	14,053
Total assets	\$ 72,923	\$ 74,679
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	\$ 1,678	\$ 365
Accrued compensation	2,089	2,830
Other current liabilities	1,778	2,054
Deferred revenue and customer advances	5,109	4,120
Total current liabilities	10,654	9,369
Long-term deferred revenue	11,738	13,229
Deferred income tax liabilities	215	215
Other long-term liabilities	604	245
Total liabilities	23,211	23,058
Contingencies (Note 13)		
Stockholders equity:		
Common stock and additional paid-in capital \$0.001 par value; 100,000,000 shares authorized; shares issued: June 30, 2012 32,222,273 and December 31, 2011 31,786,030; shares outstanding: June 30, 2012 27,906,779 and December 31, 2011 27,857,824	185,038	182,508
Accumulated other comprehensive income	101	118
Accumulated deficit	(108,531)	(106,157)
Treasury stock at cost: June 30, 2012 4,315,494 shares and December 31, 2011 3,928,206 shares	(26,896)	(24,848)

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Total stockholders' equity	49,712	51,621
Total liabilities and stockholders' equity	\$ 72,923	\$ 74,679

See accompanying Notes to Condensed Consolidated Financial Statements.

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IMMERSION CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

AND COMPREHENSIVE INCOME (LOSS)

(In thousands, except per share amounts)

(Unaudited)

	Three Months Ended June 30		Six Months Ended June 30	
	2012	2011	2012	2011
Revenues:				
Royalty and license	\$ 5,930	\$ 5,882	\$ 15,015	\$ 14,235
Product sales	344	546	616	1,547
Development contracts and other	202	254	536	668
Total revenues	6,476	6,682	16,167	16,450
Costs and expenses:				
Cost of revenues (exclusive of amortization, impairment, and abandonment of intangibles shown separately below)	214	247	529	721
Sales and marketing	1,694	1,909	3,440	3,759
Research and development	2,124	2,243	4,318	4,342
General and administrative	4,361	3,061	9,132	6,172
Amortization, impairment, and abandonment of intangibles	393	335	734	692
Total costs and expenses	8,786	7,795	18,153	15,686
Operating income (loss)	(2,310)	(1,113)	(1,986)	764
Interest and other income	68	52	78	114
Income (loss) from continuing operations before provision for income taxes	(2,242)	(1,061)	(1,908)	878
Provision for income taxes	(66)	(267)	(619)	(861)
Income (loss) from continuing operations	(2,308)	(1,328)	(2,527)	17
Discontinued operations (Note 10):				
Gain on sales of discontinued operations net of provision for income taxes of \$97, \$12, \$97, and \$39	153	18	153	61
Net income (loss)	\$ (2,155)	\$ (1,310)	\$ (2,374)	\$ 78
Basic net income (loss) per share				
Continuing operations	(0.08)	(0.05)	(0.09)	0.00
Discontinued operations	0.00	0.00	0.00	0.00
Total	\$ (0.08)	\$ (0.05)	\$ (0.09)	\$ 0.00

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Shares used in calculating basic net income (loss) per share	28,058	28,610	28,000	28,431
Diluted net income (loss) per share				
Continuing operations	(0.08)	(0.05)	(0.09)	0.00
Discontinued operations	0.00	0.00	0.00	0.00
Total	\$ (0.08)	\$ (0.05)	\$ (0.09)	\$ 0.00
Shares used in calculating diluted net income (loss) per share	28,058	28,610	28,000	29,241
Other Comprehensive Income (loss)				
Change in unrealized gains (losses) on short-term investments	2	18	(17)	22
Total Other Comprehensive Income (loss)	2	18	(17)	22
Total Comprehensive Income (loss)	\$ (2,153)	\$ (1,292)	\$ (2,391)	\$ 100

See accompanying Notes to Condensed Consolidated Financial Statements.

Table of Contents**IMMERSION CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(In thousands) (unaudited)**

	Six Months Ended June 30,	
	2012	2011
Cash flows from operating activities:		
Net income (loss)	\$ (2,374)	\$ 78
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization of property and equipment	327	485
Amortization, impairment, and abandonment of intangibles	734	692
Stock-based compensation	1,538	1,765
Allowance (recovery) for doubtful accounts	12	(20)
Loss on disposal of equipment	18	3
Gain on sales of discontinued operations	(153)	(61)
Changes in operating assets and liabilities:		
Accounts and other receivables	(1,273)	(464)
Inventories	20	(42)
Prepaid expenses and other current assets	(264)	3,204
Other assets	(25)	(54)
Accounts payable	1,149	250
Accrued compensation and other current liabilities	(532)	(1,602)
Deferred revenue and customer advances	(502)	(1,071)
Other long-term liabilities	359	(33)
Net cash provided by (used in) operating activities	(966)	3,130
Cash flows provided by (used in) investing activities:		
Purchases of available-for-sale investments	(29,956)	(29,927)
Proceeds from maturities of available-for-sale investments	35,000	30,000
Additions to intangibles	(1,466)	(1,522)
Purchases of property and equipment	(868)	(39)
Proceeds from sales of discontinued operations	250	100
Net cash provided by (used in) investing activities	2,960	(1,388)
Cash flows provided by (used in) financing activities:		
Issuance of common stock under employee stock purchase plan	51	65
Exercise of stock options	941	1,849
Purchase of treasury stock	(1,887)	0
Net cash provided by (used in) financing activities	(895)	1,914
Net increase in cash and cash equivalents	1,099	3,656
Cash and cash equivalents:		
Beginning of the period	7,298	12,243
End of the period	\$ 8,397	\$ 15,899

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Supplemental disclosure of cash flow information:

Cash paid (received) for taxes	\$ 18	\$ (3,320)
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Supplemental disclosure of non-cash operating, investing, and financing activities:

Amounts accrued for property and equipment, and intangibles	\$ 644	\$ 630
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Amounts accrued for purchase of treasury stock	\$ 161	\$ 0
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Issuance of shares from Employee Stock Purchase Plan and Release of Restricted Stock Units and Awards under company stock plan	\$ 1,259	\$ 1,257
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See accompanying Notes to Condensed Consolidated Financial Statements.

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IMMERSION CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2012

(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 wholly-owned subsidiaries: Immersion Canada Inc.; Immersion International, LLC; Immersion Medical, Inc.; Immersion Japan K.K.; Immersion Ltd.; Immersion Software Ireland Ltd.; and Haptify, Inc. 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 GAAP. These condensed consolidated financial statements should be read in conjunction with the Company's audited consolidated financial statements included in the Company's Annual Report on Form 10-K, for the fiscal year ended December 31, 2011. 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 periods presented have been included.

The results of operations for the interim periods ended June 30, 2012 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 Accounting Standards Codification (ASC) 605-10-S99, Revenue Recognition (ASC 605-10-S99); ASC 605-25, Multiple Element Arrangements (ASC 605-25); and ASC 985-605, Software-Revenue Recognition (ASC 985-605). The Company derives its revenues from three principal sources: royalty and license fees, product sales, and development contracts. As described below, management judgments and estimates must be made and used in connection with the revenue recognized in any accounting period. Material differences may result in the amount and timing of revenue for any period based on the judgments and estimates made by management. Specifically, in connection with each transaction, the Company must evaluate whether: (i) persuasive evidence of an arrangement exists, (ii) delivery has occurred, (iii) the fee is fixed or determinable, and (iv) collectibility is probable. The Company applies these criteria as discussed below.

Persuasive evidence of an arrangement exists: For a license arrangement, the Company requires a written contract, signed by both the customer and the Company. For a stand-alone product sale, the Company requires a purchase order or other form of written agreement with the customer.

Delivery has occurred. The Company delivers software and product to customers physically and also delivers software electronically. For physical deliveries not related to software, the transfer terms typically include transfer of title and risk of loss at the Company's shipping location. For electronic deliveries, delivery occurs when the Company provides the customer access codes or keys that allow the customer to take immediate possession of the software.

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The fee is fixed or determinable. The Company's arrangement fee is based on the use of standard payment terms which are those that are generally extended to the majority of customers. For transactions involving extended payment terms, the Company deems these fees not to be fixed or determinable for revenue recognition purposes and revenue is deferred until the fees become due and payable.

Collectibility is probable. To recognize revenue, the Company must judge collectibility of the arrangement fees, which is done on a customer-by-customer basis pursuant to the credit review policy. The Company typically sells to customers with whom there is a history of successful collection. For new customers, the Company evaluates the customer's financial condition and ability to pay. If it is determined that collectibility is not probable based upon the credit review process or the customer's payment history, revenue is recognized when payment is received.

Royalty and license revenue The Company licenses its portfolio of patents to customers in a variety of industries such as mobility, gaming, automotive, and medical devices. A majority of these are variable fee arrangements where the royalties earned by the Company are based on unit or sales volumes of the respective licensees. The Company also enters into fixed license fee arrangements. However, the terms of the royalty agreements generally require licensees to give notification of royalties due to the Company within 30-45 days of the end of the quarter during which their related sales occur. As the Company is unable to estimate the licensees' sales in any given quarter to determine the royalties due to it, the Company recognizes royalty revenues based on royalties reported by licensees during the quarter and when all revenue recognition criteria are met. The Company recognizes fixed license fee revenue for licenses to intellectual property when earned under the terms of the agreements, which is generally recognized when all deliverables including services are completed or recognized on a straight-line basis over the expected term of the license. Certain royalties are based upon customer shipments or revenues and could be subject to change and may result in out of period adjustments.

Development contracts and other revenue Development contracts and other revenue are comprised of professional services (consulting services and/or development contracts). Professional services revenues are recognized under the proportional performance accounting method based on physical completion of the work to be performed or completed performance method. A provision for losses on contracts is made, if necessary, in the period in which the loss becomes probable and can be reasonably estimated. Revisions in estimates are reflected in the period in which the conditions become known. To date, such losses have not been significant.

Multiple element arrangements The Company enters into multiple element arrangements in which customers purchase time-based licenses, which include a combination of software and/or intellectual property licenses, professional services and in limited cases, post contract customer support. For arrangements that are software based and include software and professional services, the services are generally not essential to the functionality of the software, and customers may purchase consulting services to facilitate the adoption of the Company's technology, but they may also decide to use their own resources or appoint other professional service organizations to perform these services. For these arrangements, including those with post contract customer support, revenue is recognized either over the period of the ongoing obligation which is generally consistent with the contractual term, or when all deliverables including services have been completed.

Also affecting revenue recognition for contracts that have multiple element arrangements are two Accounting Standards Updates (ASU). In September 2009, the Financial Accounting Standards Board (FASB) ratified ASU 2009-13 (update to ASC 605), Revenue Arrangements with Multiple Deliverables (ASU 2009-13 (update to ASC 605)). This guidance addresses criteria for separating the consideration in multiple-element arrangements. ASU 2009-13 (update to ASC 605) requires 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. ASU 2009-13 (update to ASC 605) was effective prospectively for

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revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. The Company adopted ASU 2009-13 (update to ASC 605) as of January 1, 2011, and its application has had no impact on the Company's condensed consolidated financial statements to date. In September 2009, the FASB ratified ASU 2009-14 (update to ASC 605), Certain Revenue Arrangements That Include Software Elements (ASU 2009-14 (update to ASC 605)). ASU 2009-14 (update to ASC 605) provides guidance 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 functionality. ASU 2009-14 (update to ASC 605) had an effective date that is consistent with ASU 2009-13 (update to ASC 605) above. The Company adopted ASU 2009-14 (update to ASC 605) as of January 1, 2011, and its application has had no impact on the Company's condensed consolidated financial statements to date.

Product sales The Company recognizes revenue from the sale of products and the license of associated software, if any, and expenses all related costs of products sold, once delivery has occurred and customer acceptance, if required, has been achieved. The Company has determined that the license of software for its medical simulation products is incidental to the product as a whole. The Company typically grants to customers a warranty which guarantees that products will substantially conform to the Company's current specifications for generally three to twelve months from the delivery date pursuant to the terms of the arrangement. Historically, warranty-related costs have not been significant.

Recent Accounting Pronouncements

In June 2011, the FASB ratified ASU 2011-05 Comprehensive Income (Topic 220): Presentation of Comprehensive Income. ASU 2011-05 requires that all nonowner changes in stockholders' equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements, eliminating the option to present other comprehensive income in the statement of changes in equity. Under either choice, items that are reclassified from other comprehensive income to net income are required to be presented on the face of the financial statements where the components of net income and the components of other comprehensive income are presented. In December 2011 the FASB ratified ASU 2011-12 Comprehensive Income (Topic 220): Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05. ASU 2011-12 defers those changes in ASU 2011-05 that relate to the presentation of reclassification adjustments. These amendments are effective for reporting periods beginning after December 15, 2011, and have been applied retrospectively. These amendments have changed the manner in which the Company presents comprehensive income by reporting comprehensive income information in the condensed consolidated statements of operations and comprehensive income (loss).

2. FAIR VALUE MEASUREMENTS

Cash Equivalents and Short-term Investments

The financial instruments of the Company measured at fair value on a recurring basis are cash equivalents and short-term investments.

The Company's fixed income available-for-sale securities consist of high quality, investment grade securities. The Company values these securities based on pricing from pricing vendors, who may use quoted prices in active markets for identical assets (Level 1) or inputs other than quoted prices that are observable either directly or indirectly (Level 2) in determining fair value.

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

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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 are generally classified within Level 2 of the fair value hierarchy and include most U.S. treasury securities and most investment-grade corporate commercial paper.

The types of instruments valued based on unobservable inputs which reflect the reporting entity's own assumptions or data that market participants would use in valuing an instrument are generally classified within Level 3 of the fair value hierarchy.

In May 2011, FASB issued ASU No. 2011-04, Fair Value Measurements (Topic 820). This ASU provides additional guidance on fair value disclosures. This guidance contains certain updates to the measurement guidance as well as enhanced disclosure requirements. The most significant change in disclosures is an expansion of the information required for Level 3 measurements including enhanced disclosure for: (1) the valuation processes used by the reporting entity; and (2) the sensitivity of the fair value measurement to changes in unobservable inputs and the interrelationships between those unobservable inputs, if any. This guidance is effective for interim and annual periods beginning on or after December 15, 2011, with early adoption prohibited. The Company adopted the updated guidance which was effective for the Company on January 1, 2012. The adoption of this new guidance did not have a material impact on the Company's condensed consolidated financial statements.

Financial instruments measured at fair value on a recurring basis as of June 30, 2012 and December 31, 2011 are classified based on the valuation technique in the table below:

	June 30, 2012			Total
	Fair value measurements using			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
	(In thousands)			
Assets:				
U.S. Treasury securities	\$ 0	\$ 43,964	\$ 0	\$ 43,964
Money market accounts	4,638	0	0	4,638
Total assets at fair value	\$ 4,638	\$ 43,964	\$ 0	\$ 48,602

The above table excludes \$3.8 million of cash held in banks.

	December 31, 2011			Total
	Fair value measurements using			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
	(In thousands)			
Assets:				
U.S. Treasury securities	\$ 0	\$ 48,987	\$ 0	\$ 48,987
Money market accounts	3,617	0	0	3,617

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Total assets at fair value	\$ 3,617	\$ 48,987	\$ 0	\$ 52,604
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The above table excludes \$3.7 million of cash held in banks.

Short-term Investments

	Amortized Cost	June 30, 2012		Fair Value
		Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	
U.S. Treasury securities	\$ 43,964	\$ 0	\$ 0	\$ 43,964
Total	\$ 43,964	\$ 0	\$ 0	\$ 43,964

	Amortized Cost	December 31, 2011		Fair Value
		Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	
U.S. Treasury securities	\$ 48,970	\$ 17	\$ 0	\$ 48,987
Total	\$ 48,970	\$ 17	\$ 0	\$ 48,987

The contractual maturities of the Company's available-for-sale securities on June 30, 2012 and December 31, 2011 were all due within one year.

3. ACCOUNTS AND OTHER RECEIVABLES

	June 30, 2012	December 31, 2011
	(In thousands)	
Trade accounts receivable	\$ 2,329	\$ 525
Receivables from vendors, lessor, and other	419	962
Accounts and other receivables	\$ 2,748	\$ 1,487

4. INVENTORIES

	June 30, 2012	December 31, 2011
	(In thousands)	
Raw materials and subassemblies	\$ 223	\$ 167
Finished goods	180	256
Inventories	\$ 403	\$ 423

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5. PROPERTY AND EQUIPMENT

	June 30, 2012	December 31, 2011
	(In thousands)	
Computer equipment and purchased software	\$ 3,733	\$ 3,696
Machinery and equipment	654	882
Furniture and fixtures	546	533
Leasehold improvements	858	837
Total	5,791	5,948
Less accumulated depreciation	(4,271)	(4,211)
Property and equipment, net	\$ 1,520	\$ 1,737

6. INTANGIBLES AND OTHER ASSETS

	June 30, 2012	December 31, 2011
	(In thousands)	
Patents and trademarks	\$ 24,987	\$ 23,617
Other assets	191	204
Gross intangibles and other assets	25,178	23,821
Accumulated amortization of patents and trademarks	(10,245)	(9,768)
Intangibles and other assets, net	\$ 14,933	\$ 14,053

The Company amortizes its intangible assets related to patents and trademarks, over their estimated useful lives, generally 10 years from the date of issuance of the patents and trademarks. Amortization of intangibles excluding impairments or abandonments was as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
	(In thousands)		(In thousands)	
Amortization of Intangibles - excluding impairments or abandonments	\$ 272	\$ 217	\$ 514	\$ 414

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The table below includes estimated remaining annual amortization expense for issued patents and trademarks as of June 30, 2012.

	Estimated Amortization Expense (In thousands)
Remainder of 2012	\$ 486
2013	961
2014	854
2015	787
2016	717
Thereafter	1,935
Total	\$ 5,740

Patents in process included in patents and trademarks were as follows:

	June 30, 2012	December 31, 2011
	(In thousands)	
Patents in process	\$ 9,002	\$ 8,448

Upon issuance, in process patents will be amortized over their estimated useful lives, generally 10 years.

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

	June 30, 2012	December 31, 2011
	(In thousands)	
Accrued legal	\$ 1,019	\$ 727
Income taxes payable	98	23
Other current liabilities	661	1,304
Total other current liabilities	\$ 1,778	\$ 2,054
Deferred revenue	\$ 5,088	\$ 4,046
Customer advances	21	74
Total deferred revenue and customer advances	\$ 5,109	\$ 4,120

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8. LONG-TERM DEFERRED REVENUE

Long-term deferred revenue consisted of the following:

	June 30, 2012	December 31, 2011
	(In thousands)	
Deferred revenue for Sony Computer Entertainment	\$ 11,135	\$ 12,634
Other deferred revenue	603	595
Long-term deferred revenue	\$ 11,738	\$ 13,229

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, officers, 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 from 5 to 10 years from the date of grant. Restricted stock generally vests over one year. RSUs generally vest over 3 years. Awards granted other than an option or stock appreciation right shall reduce the common stock shares available for grant by 1.75 shares for every share issued.

	June 30, 2012
Common stock shares available for grant	3,654,744
Common stock options outstanding	3,111,411
Restricted stock awards outstanding	44,000
Restricted stock units outstanding	658,005

Employee Stock Purchase Plan

The Company has an Employee Stock Purchase Plan (ESPP). Under the ESPP, eligible employees may purchase common stock through payroll deductions at a purchase price of 85% of the lower of the fair market value of the Company's stock at the beginning of the offering period or the purchase date. Participants may not purchase more than 2,000 shares in a six-month offering period or purchase stock having a value greater than \$25,000 in any calendar year as measured at the beginning of the offering period. A total of 1,000,000 shares of common stock have been reserved for issuance under the ESPP. As of June 30, 2012, 467,547 shares had been purchased since the inception of the ESPP in 1999. Under ASC 718-10, the ESPP is considered a compensatory plan and the Company is required to recognize compensation cost related to the fair value of the award purchased under the ESPP. Shares purchased under the ESPP for the six months ended June 30, 2012 are listed below. Shares purchased under the ESPP for the six months ended June 30, 2011 are 13,412. The intrinsic value listed below is calculated as the difference between the market value on the date of purchase and the purchase price of the shares.

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	Six Months Ended June 30, 2012
Shares purchased under ESPP	10,656
Average price of shares purchased under ESPP	\$ 4.79
Intrinsic value of shares purchased under ESPP	\$ 8,999

Summary of Stock Options

The following table sets forth the summary of option activity under the Company's stock option plans for the six months ended June 30, 2012 and year ended December 31, 2011:

	Six Months Ended June 30, 2012	Year Ended December 31, 2011
Beginning outstanding balance	3,267,838	4,000,526
Granted	303,650	429,963
Exercised	(197,652)	(560,132)
Forfeited and cancelled	(262,425)	(602,519)
Ending outstanding balance	3,111,411	3,267,838
Aggregate intrinsic value of options exercised	\$ 361,000	\$ 2,485,000
Weighted average fair value of options granted	3.33	4.07

The aggregate intrinsic value is calculated as the difference between the exercise price of the underlying awards and the quoted price of the Company's common stock for the options that were in-the-money.

Information regarding stock options outstanding at December 31, 2011 and June 30, 2012 is summarized below:

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (years)	Aggregate Intrinsic Value (In millions)
December 31, 2011				
Options outstanding	3,267,838	\$ 6.61	5.53	\$ 1.3
Options vested and expected to vest using estimated forfeiture rates	3,151,950	6.62	5.44	1.3
Options exercisable	2,377,683	6.99	4.61	0.8
June 30, 2012				
Options outstanding	3,111,411	\$ 6.64	5.78	\$ 1.6
Options vested and expected to vest using estimated forfeiture rates	2,987,038	6.66	5.72	1.6
Options exercisable	2,194,758	7.03	5.14	1.1

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Summary of Restricted Stock Units

RSU activity for the six months ended June 30, 2012 and year ended December 31, 2011 was as follows:

	Six Months Ended June 30, 2012	Year Ended December 31, 2011
Beginning outstanding balance	407,765	417,923
Awarded	451,911	243,908
Released	(196,185)	(159,384)
Forfeited	(5,486)	(94,682)
Ending outstanding balance	658,005	407,765
Weighted average grant date fair value of RSUs granted	\$ 6.85	\$ 6.61
Total fair value of RSUs released	1,088,000	1,163,000
Total fair value of RSUs remaining unvested	3,705,000	2,112,000

Information regarding RSUs outstanding at December 31, 2011 and June 30, 2012 is summarized below:

	Number of Shares	Weighted Average Remaining Contractual Life (years)	Aggregate Intrinsic Value (In millions)	Fair Value (In millions)
<u>December 31, 2011</u>				
RSUs outstanding	407,765	0.95	\$ 2.1	\$ 2.1
RSUs vested and expected to vest using estimated forfeiture rates	336,454	0.92	1.7	
<u>June 30, 2012</u>				
RSUs outstanding	658,005	1.45	\$ 3.7	\$ 3.7
RSUs vested and expected to vest using estimated forfeiture rates	516,223	1.42	2.9	

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Summary of Restricted Stock Awards

Restricted stock award activity for the six months ended June 30, 2012 and year ended December 31, 2011 was as follows:

	Six Months Ended June 30, 2012	Year Ended December 31, 2011
Beginning outstanding balance	18,000	18,000
Awarded	57,750	30,000
Released	(31,750)	(21,000)
Forfeited	0	(9,000)
Ending outstanding balance	44,000	18,000
Weighted average grant date fair value of restricted stock		
awarded	\$ 5.70	\$ 6.61
Total fair value of restricted stock awards released	329,000	159,000

Stock Plan Assumptions

The assumptions used to value option grants and ESPP share purchases under the Company's Stock Plans were as follows:

Options	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Expected life (in years)	4.5	5.2	4.5	5.2
Volatility	70%	68%	70%	68%
Interest rate	0.7%	2.0%	0.7%	2.0%
Dividend yield	N/A	N/A	N/A	N/A
Employee Stock Purchase Plan				
	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Expected life (in years)	N/A	N/A	0.5	0.5
Volatility	N/A	N/A	72%	50%
Interest rate	N/A	N/A	0.1%	0.2%
Dividend yield	N/A	N/A	N/A	N/A

Table of Contents*Compensation Costs*

Total stock-based compensation recognized in the condensed consolidated statements of operations and comprehensive income (loss) is as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012 (In thousands)	2011 (In thousands)	2012 (In thousands)	2011 (In thousands)
Statement of Operations Classifications				
Sales and marketing	\$ 109	\$ 70	\$ 224	\$ 245
Research and development	204	233	413	437
General and administrative	505	678	901	1,083
Total	\$ 818	\$ 981	\$ 1,538	\$ 1,765

As of June 30, 2012, there was \$5.6 million related to stock options, restricted stock awards, and RSUs of unrecognized compensation cost, adjusted for estimated forfeitures, granted to the Company's employees and directors. This cost will be recognized over an estimated weighted-average period of approximately 2.62 years for options, 2.22 years for RSUs, and 0.92 years for restricted stock awards. Total unrecognized compensation cost will be adjusted for future changes in estimated forfeitures.

Stock Repurchase Program

On November 1, 2007, the Company announced its Board of Directors authorized the repurchase of up to \$50 million of the Company's common stock. The Company may repurchase its stock for cash in the open market in accordance with applicable securities laws. The timing 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, 2012, the Company repurchased 387,288 shares for \$2.0 million at an average cost of \$5.29, net of transaction costs through open market repurchases. During the three months and the six months ended June 30, 2011, there were no stock repurchases under this program. These amounts repurchased are classified as treasury stock on the Company's condensed consolidated balance sheet.

10. DISCONTINUED OPERATIONS

On November 17, 2008, the Company announced that it would divest its 3D product line which was part of its Touch segment. During 2009, the Company sold all of its 3D product line including inventory, fixed assets, and intangibles and recorded gains on the sale of discontinued operations of \$187,000 at the time of the sales. Negotiated consideration for the sales was \$2.7 million in the form of cash of \$320,000 and notes receivable of \$2.4 million payable through 2013, for which the proceeds are being recognized when they are received. The Company has abandoned all other 3D operations. Accordingly, the operations of the 3D product line have been classified as discontinued operations, net of income tax, in the condensed consolidated statement of operations for all periods presented. The assets sold consisted primarily of intangible assets that had no carrying value on the Company's books at the time of sale. In the three and six months ended June 30, 2012, the Company recorded gains on sales of discontinued operations net of tax of \$153,000 from payments on notes from the sale of the 3D product line. In the three months and six months ended June 30, 2011, the Company recorded gains on sales of discontinued operations net of tax of \$18,000 and \$61,000 respectively, from payments on notes from the sale of the 3D product line.

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11. INCOME TAXES

Income tax provisions from continuing operations consisted of the following:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
	(In thousands)		(In thousands)	
Income (loss) from continuing operations before provision for income taxes	\$ (2,242)	\$ (1,061)	\$ (1,908)	\$ 878
Provision for income taxes	(66)	(267)	(619)	(861)
Effective tax rate	(2.9)%	(25.2)%	(32.4)%	98.1%

The effective tax rates differ from the statutory rate primarily due to the valuation allowance, foreign withholding taxes, and unrecognized tax benefits. The income tax provision for the three and six months ended June 30, 2012 and 2011 are primarily as a result of foreign withholding tax expense.

As of June 30, 2012, the Company had unrecognized tax benefits under ASC 740 Income Taxes of approximately \$680,000 including interest of \$53,000. The total amount of unrecognized tax benefits that would affect the Company's effective tax rate, if recognized, was \$252,000. There were no material changes in the amount of unrecognized tax benefits during the six months ended June 30, 2012. 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 had 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.

The Company maintains a valuation allowance for its entire deferred tax assets at June 30, 2012 and December 31, 2011 as a result of uncertainties regarding the realization of the asset balance due to past losses, 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.

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12. NET INCOME (LOSS) PER SHARE

Basic net income (loss) per share is computed using the weighted average number of common shares outstanding for the period, excluding unvested restricted stock and RSUs. Diluted net income (loss) per share is based upon the weighted average common shares outstanding for the period plus dilutive potential shares including unvested restricted stock and RSUs and stock options using the treasury stock method. The following is a reconciliation of the numerators and denominators used in computing basic and diluted net income (loss) per share:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
(in thousands except per share amounts)				
Numerator:				
Income (loss) from continuing operations	\$ (2,308)	\$ (1,328)	\$ (2,527)	\$ 17
Gain from discontinued operations, net of tax	153	18	153	61
Net income (loss) used in computing basic and diluted net income (loss) per share	\$ (2,155)	\$ (1,310)	\$ (2,374)	\$ 78
Denominator:				
Shares used in computation of basic net income (loss) per share (weighted average common shares outstanding)	28,058	28,610	28,000	28,431
Dilutive potential common shares:				
Restricted Stock and RSUs	0	0	0	172
Stock options	0	0	0	638
Shares used in computation of diluted net income (loss) per share	28,058	28,610	28,000	29,241
Basic net income (loss) per share from:				
Continuing operations	\$ (0.08)	\$ (0.05)	\$ (0.09)	\$ 0.00
Discontinued operations	0.00	0.00	0.00	0.00
Total	\$ (0.08)	\$ (0.05)	\$ (0.09)	\$ 0.00
Diluted net income (loss) per share:				
Continuing operations	\$ (0.08)	\$ (0.05)	\$ (0.09)	\$ 0.00
Discontinued operations	0.00	0.00	0.00	0.00
Total	\$ (0.08)	\$ (0.05)	\$ (0.09)	\$ 0.00

As of June 30, 2012 and June 30, 2011, 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 for the three and six months ended June 30, 2012 and for the three months ended June 30, 2011, since their effect would have been anti-dilutive. These outstanding securities consisted of the following:

	June 30, 2012	June 30, 2011
(in thousands)		
Outstanding stock options	3,111	3,820
Unvested restricted stock awards	44	18
Unvested RSUs	658	503

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For the six months ended June 30, 2011, after including options to purchase shares of common stock using the treasury stock method, options to purchase approximately 907,000 shares of common stock with exercise prices greater than the average fair market value of the Company's common stock of \$7.21 per share were not included in the calculation because the effect would have been anti-dilutive.

13. CONTINGENCIES

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. Following the Company's restatement of its financial statements, lead plaintiff filed a consolidated complaint on April 9, 2010. Defendants moved to dismiss the action on June 15, 2010 and that motion was granted with leave to amend on March 11, 2011. Lead plaintiff filed an amended complaint on April 29, 2011. Defendants moved to dismiss the amended complaint on July 1, 2011. On December 16, 2011, the motion to dismiss was granted with prejudice and on December 19, 2011, judgment was entered in favor of defendants. On January 13, 2012, the plaintiffs filed a notice of appeal to the Ninth Circuit Court of Appeals. In May 2012, plaintiffs filed their opening appeals brief. On July 13, 2012, the Company filed its response brief.

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,

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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 Litigation* and appointed lead counsel. The court has issued an order staying this action.

Kasmer v. Immersion Corporation

On May 5, 2010, an action was filed in Delaware Chancery Court by a shareholder seeking to enforce a demand to inspect certain of the Company's records pursuant to Section 220 of the Delaware General Corporation Law, as a possible prelude to the shareholder bringing a derivative action. The Company filed an answer on June 14, 2010, questioning whether a proper purpose for the records inspection had been stated and raising other defenses concerning the scope of the demand, among other deficiencies. Following a one-day trial on December 2, 2010, the Court significantly narrowed the scope of the demand and the Company responded accordingly. On October 24, 2011, the shareholder filed a motion seeking to compel further responses to the demand. The Company believes that its responses complied with the Court's ruling and have opposed the shareholder's motion. On May 30, 2012, the same shareholder filed a putative shareholder derivative action in San Francisco Superior Court, entitled *Kasmer v. Richardson et. al.* purportedly on behalf of the Company and naming certain of its former directors and officers as individual defendants. The Complaint in that action has yet to be served on either the Company or any of the individual defendants. On June 5, 2012, the parties participated in a mediation session, and on the same day reached an agreement in principle to settle both the Delaware Chancery and San Francisco Superior Court actions. The settlement remains subject to approval.

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.

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 condensed 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.

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 not the 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

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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 and other devices. To achieve this heightened interactivity, we develop and license or manufacture a wide range of patented technologies, software solutions, and products. While we believe that our technologies, solutions, and products are broadly applicable, we are currently focusing our marketing and business development activities on the following target lines of business: mobile communications and consumer electronics, automotive, gaming, commercial and industrial, and medical. We manage these business areas under one operating and reportable segment.

In most all of our markets, such as mobile communications and consumer electronics, automotive, gaming, commercial and industrial, and medical, we primarily license our technologies and solutions to manufacturers who use them in products sold under their own brand names. In a few markets, such as medical simulation, we have sold products manufactured under our own brand name through direct sales to end users, distributors, or OEMs. From time to time, we have also engaged in development projects for third parties.

Our objective is to drive adoption of our touch technologies and solutions across markets and applications to improve the user experience with digital devices and systems. We and our wholly owned subsidiaries hold more than 1,200 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, short-term investments, patents and intangible assets, income taxes, 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 Accounting Standards Codification (ASC) 605-10-S99, Revenue Recognition (ASC 605-10-S99); ASC 605-25, Multiple Element Arrangements (ASC 605-25); and ASC 985-605, Software-Revenue Recognition (ASC 985-605). We derive our revenues from three principal sources: royalty and license fees, product sales, and development contracts. As described below, management judgments and estimates must be made and used in connection with the revenue recognized in any accounting period. Material differences may result in the amount and timing of our revenue for any period based on the judgments and estimates made by our management. Specifically, in connection with each transaction, we must evaluate whether: (i) persuasive evidence of an arrangement exists, (ii) delivery has occurred, (iii) the fee is fixed or determinable, and (iv) collectibility is probable. We apply these criteria as discussed below.

Persuasive evidence of an arrangement exists: For a license arrangement, we require a written contract, signed by both the customer and us. For a stand-alone product sale, we require a purchase order or other form of written agreement with the customer.

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Delivery has occurred. We deliver software and product to our customers physically and also deliver software electronically. For physical deliveries not related to software, our transfer terms typically include transfer of title and risk of loss at our shipping location. For electronic deliveries, delivery occurs when we provide the customer access codes or keys that allow the customer to take immediate possession of the software.

The fee is fixed or determinable. Our arrangement fee is based on the use of standard payment terms which are those that are generally extended to the majority of customers. For transactions involving extended payment terms, we deem these fees not to be fixed or determinable for revenue recognition purposes and revenue is deferred until the fees become due and payable.

Collectibility is probable. To recognize revenue, we must judge collectibility of the arrangement fees, which we do on a customer-by-customer basis pursuant to our credit review policy. We typically sell to customers with whom we have a history of successful collection. For new customers, we evaluate the customer's financial condition and ability to pay. If we determined that collectibility is not probable based upon our credit review process or the customer's payment history, we recognize revenue when payment is received.

Royalty and license revenue We license our portfolio of patents to customers in a variety of industries such as mobility, gaming, automotive, and medical devices. A majority of these are variable fee arrangements where the royalties earned by us are based on unit or sales volumes of the respective licensees. We also enter into fixed license fee arrangements. However, the terms of the royalty agreements generally require licensees to give notification of royalties due to us within 30-45 days of the end of the quarter during which their related sales occur. As we are unable to estimate the licensees' sales in any given quarter to determine the royalties due to us, we recognize royalty revenues based on royalties reported by licensees during the quarter and when all revenue recognition criteria are met. We recognize fixed license fee revenue for licenses to our intellectual property when earned under the terms of the agreements, which is generally recognized when all deliverables including services are completed or recognized on a straight-line basis over the expected term of the license. Certain royalties are based upon customer shipments or revenues and could be subject to change and may result in out of period adjustments.

Development contracts and other revenue Development contracts and other revenue are comprised of professional services (consulting services and/or development contracts). Professional services revenues are recognized under the proportional performance accounting method based on physical completion of the work to be performed or completed performance method. A provision for losses on contracts is made, if necessary, in the period in which the loss becomes probable and can be reasonably estimated. Revisions in estimates are reflected in the period in which the conditions become known. To date, such losses have not been significant.

Multiple element arrangements We enter into multiple element arrangements in which customers purchase time-based licenses, which include a combination of software and/or intellectual property licenses, professional services and in limited cases, post contract customer support. For arrangements that are software based and include software and professional services, the services are generally not essential to the functionality of the software, and customers may purchase consulting services to facilitate the adoption of our technology, but they may also decide to use their own resources or appoint other professional service organizations to perform these services. For these arrangements, including those with post contract customer support, revenue is recognized either over the period of the ongoing obligation which is generally consistent with the contractual term, or when all deliverables including services have been completed.

Also affecting revenue recognition for contracts that have multiple element arrangements are two Accounting Standards Updates (ASU). In September 2009, the Financial Accounting Standards Board (FASB) ratified ASU 2009-13 (update to ASC 605), Revenue Arrangements with Multiple Deliverables (ASU 2009-13 (update to ASC 605)). This guidance addresses criteria for separating the consideration in multiple-element arrangements. ASU 2009-13 (update to ASC 605) requires companies to

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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. ASU 2009-13 (update to ASC 605) was effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. We adopted ASU 2009-13 (update to ASC 605) as of January 1, 2011, and its application has had no impact on our condensed consolidated financial statements to date. In September 2009, the FASB ratified ASU 2009-14 (update to ASC 605), *Certain Revenue Arrangements That Include Software Elements* (ASU 2009-14 (update to ASC 605)). ASU 2009-14 (update to ASC 605) provides guidance 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 functionality. ASU 2009-14 (update to ASC 605) had an effective date that is consistent with ASU 2009-13 (update to ASC 605) above. We adopted ASU 2009-14 (update to ASC 605) as of January 1, 2011, and its application has had no impact on our condensed consolidated financial statements to date.

Product sales We recognize revenue from the sale of products and the license of associated software, if any, and expense all related costs of products sold, once delivery has occurred and customer acceptance, if required, has been achieved. We have determined that the license of software for the medical simulation products is incidental to the product as a whole. We typically grant our customers a warranty which guarantees that our products will substantially conform to our current specifications for generally three to twelve months from the delivery date pursuant to the terms of the arrangement. Historically, warranty-related costs have not been significant.

Stock-based Compensation 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, stock awards, 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. Stock-based compensation expense recognized at fair value includes the impact of estimated forfeitures. We estimate future forfeitures at the date of grant and revise the estimates if necessary, in subsequent periods if actual forfeitures differ from these estimates. 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, our expected stock price volatility over the term of the awards, the risk-free interest rate, and expected dividends, if any.

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, stock awards, and ESPP shares. Existing valuation models, including the Black-Scholes model, 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.

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See Note 9 to the condensed consolidated financial statements for further information regarding stock-based compensation.

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.

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 tax assets. 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 U.S. treasury bills 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. 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 as they are available for current operations and reasonably expected to be realized in cash or sold within one year. These investments are carried at fair market value, and using the specific identification method, any unrealized gains and losses considered to be temporary in nature are accounted for as a separate component of other comprehensive income (loss) within stockholders' equity.

For debt securities in an unrealized loss position, we are required to assess whether (i) we have the intent to sell the debt security or (ii) it is more likely than not that we will be required to sell the debt security before its anticipated recovery. If either of these conditions is met, an other-than-temporary impairment on the security must be recognized in earnings equal to the entire difference between its fair value and amortized cost basis.

For debt securities in an unrealized loss position which are deemed to be other-than-temporary where neither of the criteria in the paragraph above are present, the difference between the security's then-current amortized cost basis and fair value is separated into (i) the amount of the impairment related to the credit loss (i.e., the credit loss component) and (ii) the amount of the impairment related to all other factors (i.e., the non-credit loss component). The credit loss component is recognized in earnings. The non-credit loss component is recognized in accumulated other comprehensive loss. The credit loss component is the excess of the amortized cost of the security over the best estimate of the present value of the cash flows expected to be collected from the debt security. The non-credit component is the residual amount of the other-than-temporary impairment.

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When calculating the present value of expected cash flows to determine the credit loss component of the other-than-temporary impairment, we estimate the amount and timing of projected cash flows on a security-by-security basis. These calculations reflect our expectations of the performance of the underlying collateral and of the issuer to meet payment obligations as applicable. The expected cash flows are discounted using the effective interest rate of the security prior to any impairment. The amortized cost basis of a debt security is adjusted for credit losses recorded to earnings. The difference between the cash flows expected to be collected and the new cost basis is accreted to investment income over the remaining expected life of the security.

Further information about short-term investments may be found in Note 2 to the condensed consolidated financial statements.

Patents and Intangible Assets

We have acquired patents and other intangible assets. In addition, we capitalize the external legal, filing, and continuation or annuity fees associated with patents and trademarks. We assess the recoverability of our intangible assets, and we must make assumptions regarding estimated future cash flows and other factors to determine the fair value of the respective assets that affect our condensed consolidated financial statements. If these estimates or related assumptions change in the future, we may be required to record impairment charges for these assets. We amortize our intangible assets related to patents and trademarks, once they are issued, 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, 2012, we capitalized costs associated with patents and trademarks of \$1.6 million. Our total amortization expense (exclusive of impairments or abandonments of \$221,000) for the same period was \$513,000.

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 its 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, 2012 AND 2011

The following discussion and analysis includes our results of operations from continuing operations for the three months and six months ended June 30, 2012 and 2011. Accordingly, any gain or loss on sale or income tax provision from discontinued operations have been aggregated and reported as a gain or loss from discontinued operations and are not a component of the aforementioned continuing operations discussion.

Overview

We increased our royalty and license revenue by 1%, but our overall revenue decreased by 3% for the second quarter ended June 30, 2012 compared to the second quarter ended June 30, 2011. The increase in royalty and license revenue during such period was mainly due to increased revenue primarily from our mobility, medical, and automotive licensees, partially offset by decreased revenue from our gaming licensees. This increase in royalty and license revenue was offset by a 37% decrease in product sales mainly due to decreased sales of our Virtual IV simulation product. We increased our royalty and license revenue by 5%, but our overall revenue decreased by 2% for the six months ended June 30, 2012 compared to the six months ended June 30, 2011. The increase in royalty and license revenue during such period was mainly due to increased revenue primarily from our gaming and medical licensees. This increase was offset by a 60% decrease in product sales, mainly due to decreased sales of our Virtual IV simulation product.

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Our loss from continuing operations was \$2.3 million for the second quarter ended June 30, 2012 as compared to a loss of \$1.3 million for the second quarter ended June 30, 2011. The loss was primarily due to higher operating expenses which included an increase in general and administrative expenses, mainly resulting from increased litigation expenses of approximately \$1.5 million. Our loss from continuing operations was \$2.5 million during the six months ended June 30, 2012 as compared to income of \$17,000 for the six months ended June 30, 2011. The loss was primarily due to higher operating expenses which include an increase in general and administrative expenses, mainly resulting from increased litigation expenses of approximately \$3.0 million.

During the remainder of 2012, we expect royalty and licensing revenues to be the major component of our revenues as our technology continues to be included in more products. Intellectual property litigation will likely cause us to expend significant financial resources in the future and have an adverse effect on the results of our operations. Additionally, our success could be limited by several factors, including the current macro-economic climate, the timely release of our new technology and our licensees' products, continued market acceptance of our technology and our licensees' products, 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, 2012	June 30, 2011	Change	% Change
	(In thousands)			
Three months ended:				
Royalty and license	\$ 5,930	\$ 5,882	\$ 48	1%
Product sales	344	546	(202)	(37)%
Development contracts and other	202	254	(52)	(20)%
Total Revenues	\$ 6,476	\$ 6,682	\$ (206)	(3)%
Six months ended:				
Royalty and license	\$ 15,015	\$ 14,235	\$ 780	5%
Product sales	616	1,547	(931)	(60)%
Development contracts and other	536	668	(132)	(20)%
Total Revenues	\$ 16,167	\$ 16,450	\$ (283)	(2)%

Three Months Ended June 30, 2012 Compared to Three Months Ended June 30, 2011

Royalty and license revenue Royalty and license revenue is comprised of royalties earned on sales by our licensees and license fees charged for our intellectual property portfolio. The increase in royalty and license revenue for the second quarter ended June 30, 2012 compared to the second quarter ended June 30, 2011 was primarily due to increases in royalty and license revenue from our medical, mobility, and automotive licensees, partially offset by decreases from our gaming licensees.

Royalty and license revenue increased by 49% for medical customers mainly due to increased license fees along with additional royalties from increased sales of royalty generating devices by our licensees. Royalty and license revenue increased by 30% for automotive customers primarily due to increased volume of units sold by our licensees. Royalty and license revenue increased by 7% for mobility customers primarily due to the adoption of our technology in new products sold by certain licensees along with additional volume of units sold by certain licensees. Royalty and license revenue decreased by 22% for

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gaming customers mainly due to a decrease in units shipped by certain licensees. This decrease was primarily due to the current softness in the console gaming market, which can fluctuate based upon consumer gaming preferences and the timing of introductions of new gaming console systems. We typically experience seasonally higher revenue from our gaming and mobility customers due to the reporting of holiday sales in the first calendar quarter.

We expect royalty and license revenue to be the major component of our future revenue as our technology continues to be included in more products and as we continue our efforts to monetize our intellectual property.

Product sales Product sales are comprised primarily of medical products, actuators, design kits, and integrated circuits. The decrease in product sales was due mainly to a \$210,000 decrease in medical product sales due to a reduction in sales of our Virtual IV medical simulator product arising from reduced demand in this market. We expect product sales will remain at reduced levels in 2012 primarily as a result of softer demand in this market and our continued focus on our licensing business model.

Development contracts and other revenue Development contracts and other revenue is comprised primarily of consulting services and development contracts. Development contracts and other revenue decreased mainly due to a decrease in contracted engineering service revenue from mobility customers, partially offset by an increase in contracted engineering service revenue from our automotive customers. We continue to focus our engineering resources on development efforts that leverage our existing sales and channel distribution capabilities. Accordingly, we do not expect development contract revenue to be a significant part of total revenues in the future.

We categorize our geographic revenue information into four major regions: North America, Europe, Far East, and Rest of the World. In the second quarter ended June 30, 2012, revenue generated in North America, Europe, Far East, and Rest of the World represented 38%, 11%, 51%, and 0% of total revenue, respectively, compared to 44%, 12%, 44%, and 0% of total revenue, respectively, for the second quarter ended June 30, 2011. The shift in revenues among regions was mainly due to a decrease in royalty and license revenue and product sales in North America and a decrease in contract revenue in Europe, offset primarily by an increase in royalty and license revenue in the Far East. The decrease in North American royalty and license revenue was primarily from decreased royalties from gaming licensees partially offset by an increase in medical royalty revenue. The decrease in North American product sales was primarily due to a reduction in sales of our Virtual IV medical simulator products. The decrease in European contract revenue was primarily due to reduced contracted services and the timing of revenue recognition. The increase in royalty and license revenue from the Far East was mainly due to increased royalties from mobility and automotive licensees.

Six Months Ended June 30, 2012 Compared to Six Months Ended June 30, 2011

Royalty and license revenue The increase in royalty and license revenue for the six months ended June 30, 2012 compared to the six months ended June 30, 2011 was primarily due to increases in royalty and license revenue from our medical, gaming, and automotive licensees partially offset by decreases from our mobility licensees.

Royalty and license revenue increased by 67% for medical customers and by 17% for automotive customers primarily due to additional volume of units sold by our licensees. Royalty and license revenue increased by 9% for gaming customers primarily due to increases in royalties due to an increase in units shipped by certain licensees. The increase in shipped units primarily reflects the adoption of our technology in new applications sold by certain licensees. Royalty and license revenue decreased by 6% for mobility customers partially due to decreased volume along with the timing of revenue recognition, offset in part by out of period adjustments of approximately \$420,000, which resulted from our compliance program efforts.

Product sales The decrease in product sales was due mainly to a \$968,000 decrease in medical product sales due to a reduction in sales of our Virtual IV medical simulator product because of reduced demand in this market.

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Development contracts and other revenue Development contracts and other revenue decreased mainly due to a decrease in contracted engineering service revenue from medical customers.

In the six months ended June 30, 2012, revenue generated in North America, Europe, Far East, and Rest of the World represented 44%, 12%, 44%, and 0% of total revenue, respectively, compared to 43%, 16%, 41%, and 0% of total revenue, respectively, for the six months ended June 30, 2011. The shift in revenues among regions was mainly due to a decrease in product sales in North America and a decrease in royalty and license revenue in Europe offset by an increase in royalty and license revenue in North America and the Far East. The decrease in product sales was primarily due to a reduction in sales of our Virtual IV medical simulator products. The decrease in European royalty and license revenue was primarily due to decreased mobile device revenue arising from the timing of revenue recognition. The increase in North American royalty and license revenue was primarily from increased royalties from gaming and medical licensees. The increase in royalty and license revenue from the Far East was mainly due to increased royalties from mobility and automotive licensees.

COST OF REVENUES	June 30,		Change	% Change
	2012	2011		
(Dollars in thousands)				
Three months ended:				
Cost of revenues	\$ 214	\$ 247	\$ (33)	(13)%
% of total revenues	3%	4%	(1)%	
Six months ended:				
Cost of revenues	\$ 529	\$ 721	\$ (192)	(27)%
% of total revenues	3%	4%	(1)%	

Cost of Revenues Our cost of revenues consists primarily of direct materials, contract manufacturing, and other overhead costs for product sales, and labor related costs for development contracts and other. It excludes amortization and impairment or abandonment of intangibles. Lower product sales were the major contributor to the overall reduction of cost of revenues for the second quarter ended June 30, 2012 as compared to the second quarter ended June 30, 2011. Specifically, the decrease in cost of revenues for 2012 as compared to 2011 was primarily due to decreased direct material costs, contract manufacturing costs, and related costs of \$18,000 and a decrease in obsolescence expense of \$25,000. We expect cost of revenues will remain at reduced levels for the remainder of 2012 primarily as a result of expected continued reduced demand for medical products in 2012 and our continued focus on our licensing business model.

Lower product sales were the major contributor to the overall reduction of cost of revenues for the six months ended June 30, 2012 as compared to the six months ended June 30, 2011. Specifically, the decrease in cost of revenues for 2012 as compared to 2011 was primarily due to decreased direct material costs, contract manufacturing costs, and related costs of \$283,000 partially offset by an increase in obsolescence expense of \$67,000. The decrease in direct material, contract manufacturing, related costs, and freight expense of approximately 49% was mainly due to a decrease in related product sales.

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OPERATING EXPENSES	June 30, 2012	June 30, 2011	Change	% Change
	(Dollars in thousands)			
Three months ended:				
Sales and marketing	\$ 1,694	\$ 1,909	\$ (215)	(11)%
% of total revenue	26%	29%	3%	
Research and development	\$ 2,124	\$ 2,243	\$ (119)	(5)%
% of total revenue	33%	34%	(1)%	
General and administrative	\$ 4,361	\$ 3,061	\$ 1,300	42%
% of total revenue	67%	46%	21%	
Amortization and impairment or abandonment of intangibles	\$ 393	\$ 335	\$ 58	17%
% of total revenue	6%	5%	1%	
Six months ended:				
Sales and marketing	\$ 3,440	\$ 3,759	\$ (319)	(8)%
% of total revenue	21%	23%	(2)%	
Research and development	\$ 4,318	\$ 4,342	\$ (24)	(1)%
% of total revenue	27%	26%	1%	
General and administrative	\$ 9,132	\$ 6,172	\$ 2,960	48%
% of total revenue	56%	38%	18%	
Amortization and impairment or abandonment of intangibles	\$ 734	\$ 692	\$ 42	6%
% of total revenue	5%	4%	1%	

Sales and Marketing Our sales and marketing expenses are comprised primarily of employee compensation and benefits, sales commissions, advertising, trade shows, market development funds, travel, and an allocation of facilities costs. The decrease in sales and marketing expense for the second quarter ended June 30, 2012 as compared to the second quarter ended June 30, 2011 was primarily due to decreased compensation, benefits, and other related costs of \$118,000, mainly due to decreased sales and marketing headcount and benefits along with decreased marketing, advertising, and public relations costs of \$69,000 for current marketing initiatives. We expect that sales and marketing expenses will continue to be significant as we continue to invest in sales and marketing to further our focus on building greater market acceptance for our touch technologies.

The decrease in sales and marketing expense for the six months ended June 30, 2012 as compared to the six months ended June 30, 2011 was primarily due to decreased compensation, benefits, and other related costs of \$373,000 mainly due to decreased sales and marketing headcount and benefits, partially offset by increased travel costs of \$25,000 and increased marketing, advertising, and public relations costs of \$15,000 due to current marketing initiatives.

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Research and Development Our research and development expenses are comprised primarily of employee compensation and benefits, consulting fees, tooling and supplies, and an allocation of facilities costs. The decrease in research and development expenses for the second quarter ended June 30, 2012 as compared to the second quarter ended June 30, 2011 was primarily due to decreased compensation, benefits, and other related costs of \$71,000, decreased consulting expense of \$63,000 and decreased lab and prototyping costs of \$60,000 which were partially offset by increased recruitment expense of \$37,000 and increased travel expense of \$21,000. The decreased compensation, benefits, and other related costs were mainly due to changes in executive personnel, which contributed to reductions in compensation costs and other benefits and were partially offset by increases in compensation costs due to increased non-executive headcount. We believe that continued significant investment in research and development is critical to our future success, and we expect to make increased investments in areas of research and technology development to support future growth.

The increase in research and development expenses for the six months ended June 30, 2012 as compared to the six months ended June 30, 2011 was primarily due to increased compensation, benefits, and other related costs of \$52,000 mainly due to increased headcount, increased recruitment expense of \$41,000 and increased travel expense of \$31,000, partially offset by decreased consulting expense of \$83,000 and decreased lab and prototyping costs of \$81,000.

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. The increase in general and administrative expenses for the second quarter ended June 30, 2012 as compared to the second quarter ended June 30, 2011 was primarily due to increased legal, professional, and license fee expenses of \$1.7 million, partially offset by decreased compensation, benefits, and other related costs of \$377,000. The increased legal and professional expenses were primarily due to increased litigation expenses of \$1.5 million along with increased patent related legal costs of \$100,000. The decreased compensation, benefits, and other related costs were mainly due to decreased headcount and decreased stock compensation costs. We will continue to incur costs related to litigation, which will cause our general and administrative expenses to increase as we continue to assert our intellectual property and contractual rights and defend any lawsuits brought against us.

The increase in general and administrative expenses for the six months ended June 30, 2012 as compared to the six months ended June 30, 2011 was primarily due to increased legal, professional, and license fee expenses of \$3.7 million, partially offset by decreased compensation, benefits, and other related costs of \$677,000. The increased legal and professional expenses were primarily due to increased litigation expenses of \$3.0 million along with increased patent related legal costs of \$431,000. The decreased compensation, benefits, and other related costs were mainly due to decreased headcount and decreased stock compensation costs.

Amortization, impairment, and abandonment of Intangibles Our amortization, impairment and abandonment of intangibles are comprised primarily of patent amortization and other intangible amortization along with impairment and write off of abandoned and expired patents. Amortization, impairment and abandonment of intangibles increased for the second quarter ended June 30, 2012 as compared to the second quarter ended June 30, 2011, mainly due to increased amortization as a result of the increased number of issued patents. Amortization, impairment and abandonment of intangibles increased for the six months ended June 30, 2012 as compared to the six months ended June 30, 2011 mainly due to increased amortization as a result of the increased number of issued patents, partially offset by decreased write off of abandoned and expired patents.

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INTEREST AND OTHER INCOME	June 30,		Change	% Change
	2012	2011		
(Dollars in thousands)				
Three months ended:				
Interest and other income	\$ 68	\$ 52	\$ 16	31%
% of total revenue	1%	1%	0%	
Six months ended:				
Interest and other income	\$ 78	\$ 114	\$ (36)	(32)%
% of total revenue	0%	(1)%	(1)%	

Interest and Other Income Interest and other income consists primarily of interest income from cash and cash equivalents and short-term investments, interest on notes receivable, exchange rate gains and losses, and other income. Interest and other income increased for the second quarter June 30, 2012 as compared to the second quarter ended June 30, 2011, primarily as a result of increased interest on notes receivable, partially offset by decreased interest income as a result of reduced interest rates on cash, cash equivalents, and short-term investments and exchange rate losses. Interest and other income decreased for the six months ended June 30, 2012 as compared to the six months ended June 30, 2011, primarily as a result of decreased interest income due to reduced interest rates on cash, cash equivalents, and short-term investments and exchange rate losses, partially offset by increased interest on notes receivable.

PROVISION FOR TAXES	June 30,		Change	% Change
	2012	2011		
(Dollars in thousands)				
Three months ended:				
Provision for income taxes	\$ (66)	\$ (267)	\$ 201	75%
Income from continuing operations before income taxes	\$ (2,242)	\$ (1,061)		
Effective tax rate	(2.9)%	(25.2)%		
Six months ended:				
Provision for income taxes	\$ (619)	\$ (861)	\$ 242	28%
Income from continuing operations before income taxes	\$ (1,908)	\$ 878		
Effective tax rate	(32.4)%	98.1%		

Provision for Income Taxes The income tax provision decreased for the second quarter and the six months ended June 30, 2012 compared to the second quarter and six months ended June 30, 2011 primarily due to decreased foreign withholding tax expense.

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DISCONTINUED OPERATIONS	June 30,		Change	% Change
	2012	2011		
(Dollars in thousands)				
Three months ended:				
Gain on sales from discontinued operations (net of provision for income taxes)	\$ 153	\$ 18	\$ 135	750%
% of total revenue	2%	0%		
Six months ended:				
Gain on sales from discontinued operations (net of provision for income taxes)	\$ 153	\$ 61	\$ 92	151%
% of total revenue	1%	0%		

Discontinued Operations Gain on sales of discontinued operations net of taxes is primarily comprised of additional payments received from the sale in 2009 of our 3D family of products. The increase in the gain on sales of discontinued operations net of taxes for the second quarter and six months ended June 30, 2012 compared to the second quarter and six months ended June 30, 2011 is primarily due to increased payments received from the sale of our 3D family of products.

LIQUIDITY AND CAPITAL RESOURCES

Our cash, cash equivalents, and short-term investments consist primarily of money market funds and treasury bills and government agency securities. All of our short-term investments are classified as available-for-sale. The securities are stated at market value, with unrealized gains and losses reported as a component of accumulated other comprehensive income (loss), within stockholders' equity.

On June 30, 2012, our cash, cash equivalents, and short-term investments totaled \$52.4 million, a decrease of \$3.9 million from \$56.3 million on December 31, 2011.

Cash used in (provided by) operating activities

Net cash used in operating activities during the six months ended June 30, 2012 was \$1.0 million, a decrease of \$4.1 million from the \$3.1 million provided by operating activities during the six months ended June 30, 2011. Cash used in operating activities during 2012 was primarily the result of our net loss of \$2.4 million, a decrease of \$1.3 million due to a change in accounts and other receivables mainly due to the timing of customer billings, a decrease of \$532,000 due to a change in accrued compensation and other current liabilities, a decrease of \$502,000 due to a change in deferred revenue and customer advances primarily due to recognition of deferred revenue, and a decrease of \$264,000 due to a change in prepaid expenses and other current assets. These decreases were partially offset by an increase of \$1.1 million due to a change in accounts payable mainly from increased litigation activity, and an increase of \$359,000 primarily due to a change in other long-term liabilities due to an increase in deferred rent. Cash used in operating activities during 2012 was also affected by noncash charges of \$2.5 million, including \$1.5 million of noncash stock-based compensation, \$734,000 in amortization, impairment, and abandonment of intangibles, \$327,000 in depreciation and amortization and partially offset by a credit of \$153,000 from a gain on sale of discontinued operations.

Cash provided by (used in) investing activities

Net cash provided by investing activities during the six months ended June 30, 2012 was \$3.0 million, compared to the \$1.4 million used in investing activities during the six months ended June 30, 2011, an increased source of cash of \$4.4 million. Net cash provided by investing activities during 2012 consisted of

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maturities of short-term investments of \$35 million and proceeds from sales of discontinued operations of \$250,000. This was partially offset by purchases of short-term investments of \$30.0 million; additions to intangibles of \$1.5 million primarily due to capitalization of external patent filings and application costs; and purchases of property, plant, and equipment of \$868,000.

Cash used in (provided by) financing activities

Net cash used in financing activities during the six months ended June 30, 2012 was \$895,000 compared to the \$1.9 million provided during the six months ended June 30, 2011, an increased use of cash of \$2.8 million. Net cash used in financing activities during 2012 consisted primarily of repurchases of common stock of \$1.9 million, partially offset by exercises of stock options and the issuance of common stock under the employee stock purchase plan of \$1.0 million.

We believe that our cash, cash equivalents, and short-term investments 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, which is expected to result in the increased use of cash. Our Board has approved repurchases of our shares of common stock under the previously authorized Stock Repurchase Program which has \$23.1 million remaining. We anticipate that capital expenditures for property and equipment for the year ending December 31, 2012 will be less than \$1.5 million. We anticipate that capitalization of external patent filing and application costs for the year ending December 31, 2012 will be approximately \$3.5 million. 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 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

We presented our contractual obligations in our Annual Report on Form 10-K for the year ended December 31, 2011. Our principal commitments as of June 30, 2012 consist of obligations under operating leases and non-cancellable unconditional purchase obligations. There have been no significant changes in those obligations during the six months ended June 30, 2012.

As of June 30, 2012, we had a liability for unrecognized tax benefits totaling \$680,000, including interest of \$53,000, of which approximately \$252,000 could be payable in cash. Due to the uncertainties related to these tax matters, we are unable to make a reasonably reliable estimate of 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 \$48.6 million as of June 30, 2012, which are subject to interest rate fluctuations. An increase in interest

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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 a decrease of approximately \$252,000 in the fair value of our cash equivalents and short-term investments as of June 30, 2012.

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 policy's guidelines also limit exposure to loss by limiting the sums we can invest in any individual security and restricting investments 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 and we do not expect to have such arrangements in the foreseeable future.

ITEM 4. CONTROLS AND PROCEDURES

EVALUATION OF DISCLOSURE CONTROLS AND PROCEDURES

Based on their evaluation as of June 30, 2012, our management with the participation of our Chief Executive Officer and Chief Financial Officer, have concluded that our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended) were effective to ensure that the information required to be disclosed by us in this quarterly report on Form 10-Q was (i) recorded, processed, summarized and reported within the time periods specified in the SEC's rules and regulations and (ii) accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, to allow timely decisions regarding required disclosure.

There were no changes to internal controls over financial reporting that occurred during the quarter ended June 30, 2012 that have materially affected, or are reasonably likely to materially affect our internal controls over financial reporting.

Our management, including our Chief Executive Officer and Chief Financial Officer, does not expect that our disclosure controls and procedures or our internal controls over financial reporting will prevent all error and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any within Immersion, have been detected.

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PART II

OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

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 us 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 us and certain of our 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 us and certain current and former Immersion directors and officers as defendants and allege violations of federal securities laws based on our 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. Following our restatement of financial statements, lead plaintiff filed a consolidated complaint on April 9, 2010. Defendants moved to dismiss the action on June 15, 2010 and that motion was granted with leave to amend on March 11, 2011. Lead plaintiff filed an amended complaint on April 29, 2011. Defendants moved to dismiss the amended complaint on July 1, 2011. On December 16, 2011, the motion to dismiss was granted with prejudice and on December 19, 2011, judgment was entered in favor of defendants. On January 13, 2012, the plaintiffs filed a notice of appeal to the Ninth Circuit Court of Appeals. In May 2012, plaintiffs filed their opening appeals brief. On July 13, 2012, we filed our response brief.

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 us and naming certain of our 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 us 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 Litigation* and appointed lead counsel. The court has issued an order staying this action.

Kasmer v. Immersion Corporation

On May 5, 2010, an action was filed in Delaware Chancery Court by a shareholder seeking to enforce a demand to inspect certain of our records pursuant to Section 220 of the Delaware General Corporation Law, as a possible prelude to the shareholder bringing a derivative action. We filed our answer on June 14, 2010, questioning whether a proper purpose for the records inspection had been stated and raising other defenses concerning the scope of the demand, among other deficiencies. Following a one-day trial on December 2, 2010, the Court significantly narrowed the scope of the demand and we responded accordingly. On October 24, 2011, the shareholder filed a motion seeking to compel further responses to the demand. We believe that our responses complied with the Court's ruling and have opposed the shareholder's motion. On May 30, 2012, the same shareholder filed a putative shareholder derivative action in San Francisco Superior Court, entitled *Kasmer v. Richardson et. al.* purportedly on behalf of us and naming certain of our former directors and officers as individual defendants. The Complaint in that action has yet to be served on either us or any of the individual defendants. On June 5, 2012, the parties participated in a mediation session, and on the same day reached an agreement in principle to settle both the Delaware Chancery and San Francisco Superior Court actions. The settlement remains subject to approval.

Immersion Corporation vs. Motorola Mobility, Inc., Motorola Mobility Holdings, Inc., HTC Corporation, HTC America Holding, Inc., HTC America, Inc., HTC (B.V.I.) Corporation, Exedeia, Inc., Brightstar Corporation, and Brightpoint, Inc.

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On February 7, 2012, we filed a complaint against Motorola with the U.S. International Trade Commission (the ITC) alleging that certain Motorola mobile electronic devices, including smartphones and cellular phones, infringe six of our patents that cover various uses of haptic effects in connection with touchscreens (the ITC Complaint). The ITC Complaint requests that the ITC institute an immediate investigation into Motorola s unlicensed importation, sale for importation and/or sale after importation of mobile electronic devices, including smartphones and cellular phones, using haptic effects covered by our patents. The ITC Complaint further requests an exclusion order barring the importation, sale for importation and sale after importation of products that infringe our patents and cease and desist orders directing Motorola to cease importing, marketing, advertising, demonstrating, warehousing, distributing, selling, offering to sell and/or using mobile electronic devices incorporating haptic effects that infringe one or more of our patents. We amended the ITC Complaint on March 2, 2012 to add the following parties: HTC Corporation, HTC America Holding, Inc., HTC America, Inc., HTC (B.V.I.) Corporation, Exedea, Inc., Brightstar Corporation and Brightpoint, Inc. We subsequently withdrew HTC America Holding, Inc., HTC (B.V.I.) Corporation, Exedea, Brightstar, and Brightpoint from the ITC Complaint. The ITC instituted an investigation against Motorola Mobility, Inc., Motorola Mobility Holdings, Inc., HTC Corporation, and HTC America, Inc. on April 2, 2012.

On February 7, 2012, we filed a complaint against Motorola in the U.S. District Court for the District of Delaware (the Motorola Delaware Complaint) alleging that certain of Motorola s mobile electronic devices, including smartphones and cellular phones, infringe six of our patents that cover various uses of haptic effects. The Motorola Delaware Complaint covers the same patents as the ITC Complaint. The Motorola Delaware Complaint seeks damages and injunctive relief. The parties have stipulated to stay the case pending the completion of the ITC investigation.

On March 2, 2012, we filed a complaint against HTC Corporation, HTC America Holding, Inc., HTC America, Inc., HTC (B.V.I.) Corporation, Exedea, Inc., Brightstar Corporation and Brightpoint, Inc. (collectively, HTC) in the U.S. District Court for the District of Delaware (the HTC Delaware Complaint) alleging that certain of HTC s mobile electronic devices, including smartphones and cellular phones, infringe six of our patents that cover various uses of haptic effects. The HTC Delaware Complaint covers the same patents as the ITC Complaint. The HTC Delaware Complaint seeks damages and injunctive relief. The parties have stipulated to stay the case pending the completion of the ITC investigation.

The ITC Complaint, Motorola Delaware Complaint and HTC Delaware Complaint assert infringement of the following patents:

U.S. Patent No 6,429,846: Haptic Feedback for Touchpads and Other Touch Controls

U.S. Patent No 7,592,999: Haptic Feedback for Touchpads and Other Touch Controls

U.S. Patent No 7,969,288: Force Feedback System Including Multi-Tasking Graphical Host Environment and Interface Device

U.S. Patent No 7,982,720: Haptic Feedback for Touchpads and Other Touch Controls

U.S. Patent No 8,031,181: Haptic Feedback for Touchpads and Other Touch Controls

U.S. Patent No 8,059,105: Haptic Feedback for Touchpads and Other Touch Controls

We cannot predict the ultimate outcome of the above-mentioned federal and state actions, and we are unable to estimate any potential liability we may incur.

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ITEM 1A. RISK FACTORS

Our actual results could differ materially from our forward-looking statements. Factors that might cause or contribute to such differences include, but are not limited to those discussed below. These and many other factors described in this report could adversely affect our operations, performance and financial condition.

Company Risks

If we are unable to enter into new licensing arrangements with our existing licensees and with additional third-party manufacturers for our touch-enabling technologies, our royalty revenue may not grow.

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

the lengthy and expensive process of building a relationship with potential licensees;

the competition we may face from the internal design teams of existing and potential licensees;

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

difficulties in persuading potential licensees who may have developed their own intellectual property or licensed intellectual property from other parties in areas related to ours to license our technology as we obtain new patents and develop new products versus continuing to develop their own intellectual property or license intellectual property from other parties;

challenges in demonstrating the compelling value of our technologies and challenges associated with customers' ability to easily implement our technologies;

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

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

inability to sign new gaming licenses if the video console makers choose not to license third parties to make peripherals for their new consoles or if video console makers no longer require peripherals to play video games;

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

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inability of current or prospective licensees to ship certain mobile devices if they are involved in intellectual property infringement claims by third parties that ultimately prevents them from shipping products or that imposes substantial royalties on their products.

Our licensing cycle can be lengthy and costly and our marketing and licensing efforts may be unsuccessful.

The process of persuading customers to adopt and license our technologies can be lengthy and, even if successful, there can be no assurance that our technologies will be used in a product that is ultimately brought to market, achieves commercial acceptance, or results in significant royalties to us. We generally incur significant marketing and sales expenses prior to entering into our license agreements. The length of time it takes to establish a new licensing relationship can take many months or even years. In addition, any

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intellectual property litigation that we engage in will likely have an impact on our ability to enter into new licenses and renewals of licenses. As such, we may incur costs in any particular period before any associated revenue stream begins, if at all. If our marketing and sales efforts are very lengthy or unsuccessful, then we may face a material adverse effect on our business and results of operations as a result of delay or failure to obtain royalties.

Future revenue is difficult to predict for several reasons, and our failure to predict revenue accurately may cause our results to be below our expectations or those of analysts and result in our stock price declining.

Our lengthy and costly license negotiation cycle and any intellectual property litigation that we may engage in make our future revenue difficult to predict because we may not be successful in entering into licenses with our customers on our estimated timelines and we may be reliant on litigation timelines which are difficult to control for any results or settlements.

While some of our license agreements provide for fixed royalty payments, many of our license agreements provide for volume-based royalties, and may also be subject to adjustments based on volume. The sales volume and prices of our licensees' products in any given period can be difficult to predict. As a result, our actual results may differ substantially from analyst estimates or our forecasts in any given period.

In addition, a portion of our revenue comes from development and support services provided to our licensees, or may be part of a contractual arrangement involving multiple elements. Depending upon the nature of the services or elements, all or a portion of the revenue may be recognized ratably over the support period or length of the contract, or may be recognized according to the proportional performance accounting method under GAAP. Contract revenue accounting may result in deferral of the service fees to the completion of the contract, or may be recognized over the period in which services are performed on a proportional performance basis and product development schedules for these projects may be changed or delayed.

All of these factors make it difficult to predict future licensing revenue and may result in our results being below our previously announced guidance or analysts' estimates, which would likely cause our stock price to decline.

A limited number of customers account for a significant portion of our revenue, and the loss of major customers could harm our operating results.

Two customers accounted for approximately 32% of our total revenues for the six months ended June 30, 2012. Three customers accounted for approximately 44% of our total revenues for six months ended June 30, 2011. We cannot be certain that customers that have accounted for significant revenue in past periods, individually or as a group, will continue to generate revenue in any future period. If we fail to renew or lose a major customer or group of customers, our revenue could decline if we are unable to replace the lost revenue with revenue from other sources.

Litigation regarding intellectual property rights is expensive; could be disruptive, time consuming and result in the impairment or loss of portions of our intellectual property, and could adversely affect our business.

Intellectual property litigation, whether brought by us or by others against us, has caused us to expend, and may cause us to expend in future periods, significant financial resources as well as divert management's time and efforts. From time to time, we initiate claims against third parties that we believe infringe our intellectual property rights. On February 7, 2012, we filed a complaint against Motorola Mobility, Inc. and Motorola Mobility Holdings, Inc. (together, "Motorola") with the U.S. International

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Trade Commission and in a patent infringement complaint in the U.S. District Court for the District of Delaware which alleges that certain Motorola Android-based smartphones infringe six Immersion patents. On March 2, 2012, we added HTC Corporation, HTC America Holding, Inc., HTC America, Inc., HTC (B.V.I.) Corporation, Exedeia, Inc., Brightstar Corporation and Brightpoint, Inc. to the complaint in the U.S. International Trade Commission and filed a separate patent infringement complaint against HTC in the U.S. District Court for the District of Delaware. We subsequently withdrew HTC America Holding, Inc., HTC (B.V.I.) Corporation, Exedeia, Brightstar, and Brightpoint from the ITC Complaint. The ITC instituted an investigation against Motorola Mobility, Inc., Motorola Mobility Holdings, Inc., HTC Corporation, and HTC America, Inc. on April 2, 2012. We intend to enforce our intellectual property rights vigorously and may initiate further litigation against parties that we believe are infringing our intellectual property rights if we are unable to resolve matters satisfactorily through negotiation. Litigation brought to protect and enforce our intellectual property rights is costly and could be time-consuming, difficult to pursue in certain venues, and distracting to management and potential customers and could result in the impairment or loss of portions of our intellectual property. The time to resolution and complexity of our litigation, its relative importance to our business compared to other companies, and the potential that we may lose particular motions as well as the overall litigation all could cause our stock price to decline and materially adversely affect our business.

In addition, any litigation in which we are accused of infringement may cause product shipment delays, require us to develop non-infringing technologies, or require us to enter into royalty or license agreements even before the issue of infringement has been decided on the merits. If any litigation were not resolved in our favor, we could become subject to substantial damage claims from third parties and indemnification claims from our licensees. We could be enjoined from the continued use of the technologies at issue without a royalty or license agreement. Royalty or license agreements, if required, might not be available on acceptable terms, or at all. If a third party claiming infringement against us prevailed and we were not able to develop non-infringing technologies or license the infringed or similar technologies on a timely and cost-effective basis, our expenses could increase and our revenues could decrease.

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

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

The legal principles applicable to patents and patent licenses continue to change and evolve. For example, on September 16, 2011, President Obama signed the Leahy-Smith America Invents Act which

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codifies significant changes to the U.S. patent laws, including, among other things, changing from a first to invent to a first inventor to file system, limiting where a patentee may file a patent suit, requiring the apportionment of patent damages, replacing interference proceedings with derivation actions and creating a post-grant opposition process to challenge patents after they have been issued. The effects of these changes on our patent portfolio and business have yet to be determined, as the Patent and Trademark Office must still implement regulations relating to these changes and the courts have yet to address the new provisions. Legislation and judicial decisions that make it easier for patent licensees to challenge the validity, enforceability, or infringement of patents, or make it more difficult for patent licensors to obtain a permanent injunction, obtain enhanced damages for willful infringement, or to obtain or enforce patents, may adversely affect our business and the value of our patent portfolio. Furthermore, our prospects for future revenue growth through our royalty and licensing based businesses could be diminished.

We had an accumulated deficit of \$109 million as of June 30, 2012, have a history of losses, and may not achieve or maintain profitability in the future.

Since 1997, we have incurred losses in all but six quarters. As of June 30, 2012, we had an accumulated deficit of \$109 million. We need to generate significant ongoing revenue to achieve and maintain consistent profitability. We anticipate that we will continue to incur expenses as we:

continue to develop our technologies;

increase our sales and marketing efforts;

attempt to expand the market for touch-enabled technologies and products;

protect and enforce our intellectual property;

pursue strategic relationships;

incur costs related to pending litigation;

acquire intellectual property or other assets from third-parties; and

invest in systems and processes to manage our business.

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

We have little or no control or influence on our licensees' design, manufacturing, quality control, promotion, distribution, or pricing of their products incorporating our touch-enabling technologies, upon which we generate royalty revenue.

A key part of our business strategy is to license our intellectual property to companies that manufacture and sell products incorporating our touch-enabling technologies. Sales of those products generate royalty and license revenue for us. For the six months ended June 30, 2012 and 2011, 93% and 87%, respectively, of our total revenues were royalty and license revenues. We do not control or influence the design, manufacture, quality control, promotion, distribution, or pricing of products that are manufactured and sold by our licensees, nor can we control consolidation within an industry which could either reduce the number of licensing products available or reduce royalty rates for the combined licensees. In addition, we generally do not have commitments from our licensees that they will continue to use our technologies in current or future products. As a result, products incorporating our technologies may not be brought to market, achieve commercial acceptance, or otherwise generate meaningful royalty revenue for us. For us to generate royalty revenue, licensees that pay us per-unit royalties must manufacture and

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distribute products incorporating our touch-enabling technologies in a timely fashion and generate consumer demand through marketing and other promotional activities. If our licensees' products fail to achieve commercial success or if products are

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recalled because of quality control problems or if our licensees do not ship products incorporating our touch-enabling technologies in a timely fashion or fail to achieve strong sales, our revenues will not grow and could decline.

We have limited engineering, customer service, technical support, quality assurance and operations resources to design and fulfill favorable product delivery schedules and sufficient levels of quality in support of our different product areas. Products and services may not be delivered in a timely way, with sufficient levels of quality, or at all, which may reduce our revenue.

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

The uncertain economic environment could reduce our revenues and could have an adverse effect on our financial condition and results of operations.

The current economic conditions could materially hurt our business in a number of ways including longer sales and renewal cycles, delays in adoption of our products or technologies, increased risk of competition, higher overhead costs as a percentage of revenue, delays in signing or failing to sign customer agreements, or signing customer agreements with reduced royalty rates. In addition, our customers, potential customers, and business partners are facing similar challenges, which could materially and adversely affect the level of business they conduct with us or in the level of sales of products that include our technology.

Our business depends in part on access to third-party platforms or technologies, and if the access is withdrawn, denied, or is not available on terms acceptable to us, or if the platforms or technologies change without notice to us, our business and operating results could be adversely affected.

Our product portfolio includes current and future products designed for use with third-party platforms or technologies. Our business in these categories relies on our access to the platforms or technologies of third parties, which can be withdrawn, denied or not be available on terms acceptable to us.

Our access to third-party platforms or technologies may require paying a royalty, which lowers our product margins, or may otherwise be on terms that are not acceptable to us. In addition, the third-party platforms or technologies used to interact with our product portfolio can be delayed in production or can change without prior notice to us, which can result in our having lower margins.

If we are unable to access third-party platforms or technologies, or if our access is withdrawn, denied, or is not available on terms acceptable to us, or if the platforms or technologies are delayed or change without notice to us, our business and operating results could be adversely affected.

Because we have a fixed payment license with Microsoft, our royalty revenue from licensing in the gaming market and other consumer markets has previously declined and may further do so if Microsoft increases its volume of sales of touch-enabled gaming products and consumer products at the expense of our other licensees.

Under the terms of our present agreement with Microsoft, Microsoft receives a royalty-free, perpetual, irrevocable license to

2,072,000

\$

2,358,000

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Results of operations for Embassy and Green are included from the beginning of each fiscal period presented through the respective dates of asset disposition, and have been segregated from continuing operations and reflected as discontinued operations approximately as follows:

	Three Months Ended March 31,	
	2006	2005
Net revenues	\$	\$ 2,983,000
Earnings (loss) from operation of discontinued operations, before taxes	\$ 3,000	\$ (332,000)
Income tax (expense) benefit	(1,000)	112,000
Earnings (loss) from operation of discontinued operations	2,000	(220,000)
Gain on sale of discontinued operations, before taxes		107,000
Income tax expense		(36,000)
Gain on sale of discontinued operations		71,000
Earnings (loss) from discontinued operations	\$ 2,000	\$ (149,000)

NOTE 8 - ACCOUNTS RECEIVABLE AND ALLOWANCE FOR DOUBTFUL ACCOUNTS

Accounts receivable -net consists of:

	March 31, 2006	December 31, 2005
Trade accounts receivables	\$ 13,258,000	\$ 12,757,000
Allowance for doubtful accounts	(182,000)	(190,000)
	\$ 13,076,000	\$ 12,567,000

NOTE 9 - INVENTORIES

Inventories - net consist of:

	March 31, 2006	December 31, 2005
Raw material	\$ 2,122,000	\$ 2,209,000
Work in process	422,000	349,000
Finished goods	25,804,000	25,597,000
	28,348,000	28,155,000
Reserve for obsolete and slow-moving inventories	(2,094,000)	(1,981,000)
	\$ 26,254,000	\$ 26,174,000

NOTE 10 - GOODWILL AND OTHER INTANGIBLE ASSETS

The changes in the carrying amounts of goodwill for the three months ended March 31, 2006 are as follows:

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	Consolidated	Tools and other products	Hardware
Balance, January 1, 2006	\$ 23,821,000	\$ 2,394,000	\$ 21,427,000
Acquisition of Pacific Stair	898,000		898,000
Balance, March 31, 2006	\$ 24,719,000	\$ 2,394,000	\$ 22,325,000

Other intangible assets were as follows:

	March 31, 2006		December 31, 2005	
	Cost	Accumulated amortization	Cost	Accumulated amortization
Other intangible assets:				
Customer relationships	\$ 10,960,000	\$ 2,353,000	\$ 9,160,000	\$ 2,119,000
Vendor relationship	890,000	156,000	890,000	134,000
Non-compete and Employment agreements	810,000	598,000	760,000	557,000
Trademark/tradename	2,140,000		690,000	
Licensing	105,000	2,000	105,000	
Total	\$ 14,905,000	\$ 3,109,000	\$ 11,605,000	\$ 2,810,000

Amortization expense for intangible assets subject to amortization was approximately \$299,000 and \$276,000 for the three-month periods ended March 31, 2006 and 2005, respectively.

Amortization expense for each of the twelve-month periods ending March 31, through the twelve-month period ending March 31, 2011, is estimated to be as follows: 2007 - \$1,198,000; 2008 - \$710,000; 2009 - \$666,000; 2010 - \$665,000; and 2011 - \$663,000. The weighted average amortization period for intangible assets was 12.3 years at March 31, 2006 and 10.96 years at December 31, 2005.

NOTE 11 - WARRANTY LIABILITY

The Company offers to its customers warranties against product defects for periods ranging from one to three years, depending on the specific product and terms of the customer purchase agreement. The Company's typical warranties require it to repair or replace the defective products during the warranty period at no cost to the customer. At the time the product revenue is recognized, the Company records a liability for estimated costs under its warranties, which costs are estimated based on historical experience. The Company periodically assesses the adequacy of its recorded warranty liability and adjusts the amounts as necessary. While the Company believes that its estimated liability for product warranties is adequate, the estimated liability for the product warranties could differ materially from future actual warranty costs.

Changes in the Company's warranty liability, included in other accrued liabilities, were as follows:

	Three months ended March 31,	
	2006	2005
Balance, beginning of period	\$ 419,000	\$ 510,000
Warranties issued and changes in estimated pre-existing warranties	91,000	95,000
Actual warranty costs incurred	(96,000)	(124,000)
Balance, end of period	\$ 414,000	\$ 481,000

NOTE 12 - BUSINESS SEGMENTS

The Company has organized its business into two reportable business segments: Tools and other products, and Hardware. The Company is organized around these two distinct product segments, each of which has very different end users. For reporting purposes, Florida Pneumatic and Franklin are combined in the Tools and other products segment, Woodmark, Pacific Stair and Nationwide are combined in the Hardware segment. Results for Pacific Stair have been included since January 3, 2006. The Company evaluates segment performance based primarily on segment operating income. The accounting policies of each of the segments are the same as those described in Note 1.

The following presents financial information by segment for the three-month periods ended March 31, 2006 and 2005. Segment operating income excludes general corporate expenses, interest expense and income taxes. Identifiable assets are those assets directly owned or utilized by the particular business segment.

Three months ended March 31, 2006	Consolidated	Tools and other products	Hardware
Revenues from unaffiliated customers	\$ 26,850,000	\$ 9,463,000	\$ 17,387,000
Segment operating income	3,418,000	\$ 710,000	\$ 2,708,000
General corporate expense	(1,470,000)		
Interest expense net	(492,000)		
Earnings from continuing operations before income taxes	\$ 1,456,000		
Segment assets	\$ 85,464,000	\$ 26,169,000	\$ 59,295,000
Corporate assets and assets of discontinued operations	4,899,000		
Total assets	\$ 90,363,000		

Three months ended March 31, 2005	Consolidated	Tools and other products	Hardware
Revenues from unaffiliated customers	\$ 24,324,000	\$ 10,114,000	\$ 14,210,000
Segment operating income	3,383,000	\$ 1,022,000	\$ 2,361,000
General corporate expense	(1,084,000)		
Interest expense net	(415,000)		
Earnings from continuing operations before income taxes	\$ 1,884,000		
Segment assets	\$ 79,118,000	\$ 26,515,000	\$ 52,603,000
Corporate assets and assets of discontinued operations	10,355,000		
Total assets	\$ 89,473,000		

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

General

The Private Securities Litigation Reform Act of 1995 (the Reform Act) provides a safe harbor for forward-looking statements made by or on behalf of P&F Industries, Inc. and subsidiaries. The Company and its representatives may, from time to time, make written or verbal forward-looking statements, including statements contained in the Company's filings with the Securities and Exchange Commission and in its reports to stockholders. Generally, the inclusion of the words believe, expect, intend, estimate, anticipate, will, and similar expressions in statements that constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934 and that are intended to come within the safe harbor protection provided by those sections. Any forward-looking statements contained herein, including those related to the Company's future performance, are based upon the Company's historical performance and on current plans, estimates and expectations. All forward-looking statements involve risks and uncertainties. These risks and uncertainties could cause the Company's actual results for the 2006 fiscal year and beyond to differ materially from those expressed in any forward-looking statement made by or on behalf of the Company for a number of reasons, as previously disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2005 in response to Item 1A. to Part I of Form 10-K. Forward-looking statements speak only as of the date on which they are made. The Company undertakes no obligation to update publicly or revise any forward-looking statement, whether as a result of new information, future developments or otherwise.

Business

P&F Industries, Inc. (P&F) is a Delaware corporation incorporated on April 19, 1963. P&F conducts its business operations through two of its wholly-owned subsidiaries: Florida Pneumatic Manufacturing Corporation (Florida Pneumatic) and Countrywide Hardware, Inc. (Countrywide). P&F and its subsidiaries are herein referred to collectively as the Company. In addition, the words we, our and us refer to the Company.

Florida Pneumatic is engaged in the importation, manufacture and sale of pneumatic hand tools, primarily for the industrial, retail and automotive markets, and the importation and sale of compressor air filters. Florida Pneumatic also markets, through its Berkley Tool division (Berkley), a line of pipe cutting and threading tools, wrenches and replacement electrical components for a widely-used brand of pipe cutting and threading machines. In addition, through its Franklin Manufacturing (Franklin) division, Florida Pneumatic imports a line of door and window hardware. Countrywide conducts its business operations through Nationwide Industries, Inc. (Nationwide) and through Woodmark International, L.P. (Woodmark), a limited partnership between Countrywide and WILP Holdings, Inc., a subsidiary of Countrywide. Nationwide is an importer and manufacturer of door, window and fencing hardware. Woodmark is an importer of builders hardware, including staircase components and kitchen and bath hardware and accessories. In January 2006, Countrywide acquired substantially all of the operating assets of Pacific Stair Products, Inc. (Pacific Stair). Pacific Stair is a manufacturer of premium stair rail products and a distributor of Woodmark's staircase components to the building industry, primarily in southern California and the southwestern region of the United States.

The Company's wholly-owned subsidiary, Embassy Industries, Inc. (Embassy), was engaged in the manufacture and sale of baseboard heating products and the importation and sale of radiant heating systems until it exited that business in October 2005 through the sale of substantially all of its non-real estate assets. The Company's wholly-owned subsidiary, Green Manufacturing, Inc. (Green), was primarily engaged in the manufacture, development and sale of heavy-duty welded custom designed hydraulic cylinders until it exited that business in December 2004 through the sale of certain assets. Green also manufactured a line of access equipment for the petro-chemical industry until it exited that business in February 2005 through the sale of certain assets and a line of post hole digging equipment for the agricultural industry until it exited that business in July 2005 through the sale of certain assets. Green has effectively ceased all operating activities. The assets and liabilities and results of operations of Embassy and Green have been segregated and reported separately as discontinued operations in the Consolidated Financial Statements. Note 12 to the Notes to Consolidated Condensed Financial Statements presents financial information for the segments of the Company's business.

Overview

On January 3, 2006, Pacific Stair acquired certain assets comprising the business of the former Pacific Stair Products, and assumed certain related liabilities. The Company's consolidated results of operations include the results of operations for Pacific Stair for the three months ended March 31, 2006 within its hardware business segment. In addition, the Company's consolidated results of operations present Embassy and Green as discontinued operations.

Consolidated revenues for the quarter ended March 31, 2006 increased \$2,526,000, or 10.4%, from \$24,324,000 to \$26,850,000. Revenues increased approximately \$3,177,000, or 22.3%, at Countrywide, which includes revenues at Woodmark, Pacific Stair and Nationwide. Woodmark had first quarter revenues of \$10,977,000, increasing \$986,000, or 9.9%. Newly-acquired Pacific Stair reported first quarter revenues of \$1,666,000. Nationwide reported revenues of \$4,742,000, increasing \$523,000, or 12.4%. Revenues at Florida Pneumatic decreased \$651,000, or 6.4%, to \$9,463,000. Gross profit increased \$532,000, or 6.9%, for the quarter primarily due to an increase in revenues, which included Pacific Stair in 2006. Consolidated earnings from continuing operations decreased \$240,000, or 21.6%, from \$1,112,000 to \$872,000 for the quarter ended March 31, 2006.

Critical Accounting Policies and Estimates

The Company prepares its consolidated financial statements in accordance with accounting principles generally accepted in the United States of America. Certain of these accounting policies require the Company to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and the related disclosure of contingent assets and liabilities, revenues and expenses. On an ongoing basis, the Company evaluates estimates, including those related to bad debts, inventory reserves, goodwill and intangible assets and warranty reserves. The Company bases its estimates on historical data and experience, when available, and on various other assumptions that are believed to be reasonable under the circumstances, the combined 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.

There have been no material changes in the Company's critical accounting policies and estimates from those discussed in Item 7 of the Company's Annual Report on Form 10-K for the year ended December 31, 2005.

ACQUISITION

For acquisitions, results of operations are included in the Consolidated Condensed Financial Statements from the date of acquisition.

Pacific Stair Products, Inc.

Pursuant to an Asset Purchase Agreement (the "PSP APA"), dated December 20, 2005, between Pacific Stair Products, a California corporation ("Old PSP"), and Pacific Stair Products, Inc., a newly-formed Delaware corporation ("Pacific Stair") and a wholly-owned subsidiary of Countrywide, effective January 3, 2006, Pacific Stair purchased substantially all of the operating assets of Old PSP. The total purchase price for the assets was approximately \$5,233,000, subject to adjustments, plus the assumption of certain liabilities and obligations by Pacific Stair. The assets purchased pursuant to the PSP APA include, among others, accounts receivable, inventory, machinery and equipment and certain intangibles. Certain assets were retained by Old PSP including cash and title to any real property. The purchase price, including direct acquisition costs, represents a premium over the fair value of the assets purchased of approximately \$4,198,000, which will be allocated among goodwill and other intangible assets. Pacific Stair is a manufacturer of premium stair rail products and a distributor of staircase components to the building industry, primarily in southern California and the southwestern region of the United States. As a result of this transaction, Countrywide has increased its purchasing power and geographic distribution. The acquisition was financed through the Company's credit facility with Citibank. The consolidated condensed financial statements presented herein include the results of operations for Pacific Stair for the period from January 3, 2006 to March 31, 2006.

As part of the acquisition, the Company recorded approximately \$3,300,000 in other identifiable intangible assets, principally related to the value of customer relationships and a tradename, and approximately \$898,000 of goodwill, including direct acquisition costs, through March 31, 2006.

DISCONTINUED OPERATIONS

Embassy Industries, Inc.

Pursuant to an Asset Purchase Agreement (the "Embassy APA"), dated as of October 11, 2005, among P&F, Embassy, Mestek, Inc. ("Mestek") and Embassy Manufacturing, Inc., a wholly-owned subsidiary of Mestek ("EMI"), Embassy sold substantially all of its operating assets to EMI. The assets sold pursuant to the Embassy APA include, among others, machinery and equipment, inventory, accounts receivable and certain intangibles. Certain assets were retained by Embassy, including, but not limited to, cash and title to any real property owned by Embassy at the consummation of the sale to EMI. The consideration paid by EMI for the assets acquired pursuant to the Embassy APA was approximately \$8,433,000 plus the assumption of certain liabilities and obligations of Embassy by EMI.

Pursuant to a Lease, dated as of October 11, 2005, between Embassy, as landlord and EMI, as tenant (the "EMI Lease"), Embassy has agreed to lease certain space (approximately 60,000 rentable square feet) in the building located at 300 Smith Street, Farmingdale, New York to EMI in connection with the operation of EMI's business, at an annual rental rate of \$480,000, payable in monthly installments of \$40,000 each. The term of the EMI Lease is for a period of six (6) months commencing October 11, 2005 and terminating April 10, 2006; provided however, that, in the event EMI serves notice on Embassy by December 31, 2005, the Lease may be extended on a month to month basis to, and including, June 30,

2006. EMI has served notice on Embassy to extend the EMI Lease through May 31,

2006.

Embassy has effectively ceased all operating activities. The Company recognized a gain on the sale of these assets of approximately \$1,467,000, net of taxes, during the fourth quarter of fiscal 2005.

In January 2006, Embassy entered into a contract of sale, as amended, on its building with a non-affiliated third party for a purchase price of approximately \$6.4 million. The contract is scheduled to close on or about June 1, 2006. The Company intends to use the net proceeds from this sale to satisfy an existing mortgage on the building of approximately \$1.3 million and to reduce its short and long-term debt. The Company expects to report a pre-tax gain from the sale of the building of approximately \$5.0 million in its second fiscal quarter of 2006.

Green Manufacturing, Inc. - Agricultural Products Division

Pursuant to an Asset Purchase Agreement (the "Agricultural APA"), dated as of July 14, 2005, between Green and Benko Products, Inc. ("Benko"), Green sold certain of its assets comprising its Agricultural Products Division (the "Agricultural Division") to Benko. The assets sold pursuant to the Agricultural APA include, among others, certain machinery and equipment. Certain assets of the Agricultural Division were retained by Green, including, but not limited to, certain of the Agricultural Division's accounts receivable and inventories existing at the consummation of the sale to Benko (the "Agricultural Closing").

The purchase price paid by Benko in consideration for the assets acquired pursuant to the Agricultural APA was \$530,000, consisting of (a) a payment to Green at Agricultural Closing of \$225,000; (b) \$25,000 payable pursuant to the terms of a Promissory Note ("Agricultural Note 1"), dated July 14, 2005, payable in equal monthly amounts over a five (5) month period commencing as of the Agricultural Closing; and (c) \$280,000 payable pursuant to the terms of a Promissory Note (collectively with Agricultural Note 1, the "Agricultural Notes"), dated July 14, 2005, payable in equal monthly amounts over a four (4) year period commencing as of the Agricultural Closing. In addition, Benko assumed certain of Green's contractual obligations. The obligations of Benko under the Agricultural APA and the Agricultural Notes are guaranteed by each of a principal shareholder and an affiliate of Benko, and partially secured by certain collateral.

In connection with the transaction, Green and Benko entered into an agreement which provides for Benko to purchase from Green 100% of Benko's requirements for products of the type that constitute part of Green's inventory of raw materials and finished goods as of the acquisition date with all purchases by Benko being binding and non-cancelable at pre-established prices. The term is for a period of one year from the acquisition date. Benko shall maintain for the benefit of Green an insurance policy insuring the inventory and will bear the entire risk of loss, theft, destruction or any damage to the inventory. Benko will also be responsible for all recordkeeping with respect to the inventory. After the expiration of the term, Benko is obligated to provide Green with a list of all unpurchased inventory and return such inventory to Green. Based on the terms of the agreement, Green has effectively entered into an arrangement which provides for a transfer of its inventory to Benko prior to payment, as if it had been sold to Benko, with Green recording it as an other current receivable (based on the cost of the inventory, which approximated \$373,000) in the third quarter of 2005. This treatment is based on the fact that Green has effectively transferred control of the inventory to Benko. Benko's employees maintain control of the inventory as it is located on Benko's premises and also bears risk of loss, theft, destruction or any damage to the inventory. Also, all purchases by Benko are binding and non-cancelable at pre-established prices with Benko being Green's only customer for the one-year period.

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The Company recognized a gain on the sale of these assets of approximately \$312,000, net of taxes, in fiscal 2005.

Green Manufacturing, Inc. - Access Division

Pursuant to an Asset Purchase Agreement (the "Access APA"), dated as of February 2, 2005, between Green and Benko Products, Inc. ("Benko"), Green sold certain of its assets comprising its Access Division (the "Access Division") to Benko. The assets sold pursuant to the Access APA include, among others, certain machinery and equipment, accounts receivable ("Purchased Receivables"), inventory, intellectual property and other intangibles. Certain assets of the Access Division were retained by Green, including, but not limited to, certain of the Access Division's accounts receivable existing at the consummation of the sale to Benko (the "Access Closing").

The purchase price paid by Benko in consideration for the assets acquired pursuant to the Access APA, giving effect to certain adjustments, was approximately \$1,756,655, consisting of (a) a payment to Green at Access Closing of approximately \$880,069; (b) \$755,724 payable pursuant to the terms of a Promissory Note ("Access Note 1"), dated February 2, 2005, payable in various amounts over a twenty-one (21) month period commencing as of the Access Closing; and (c) \$120,862 payable pursuant to the terms of a Promissory Note (collectively with Access Note 1, the "Access Notes"), dated February 2, 2005, payable in various amounts over a four (4) month period commencing as of the Access Closing. Benko agreed to pay additional consideration on an annual basis for the two (2) successive twelve (12) month periods commencing as of the Access Closing, dependent on certain sales by Benko, subject to certain other conditions. In addition, Benko assumed certain of Green's contractual obligations. The obligations of Benko under the Access APA and the Access Notes are guaranteed by each of a principal shareholder and an affiliate of Benko, and partially secured by certain collateral.

The Company recognized a gain on the sale of these assets of approximately \$71,000, net of taxes, in fiscal 2005.

The following amounts related to Embassy and Green have been segregated from the Company's continuing operations and are reported as assets held for sale and assets and liabilities of discontinued operations in the consolidated condensed balance sheets:

	March 31, 2006	December 31, 2005
Assets held for sale and assets of discontinued operations:		
Prepaid expenses	\$ 82,000	\$ 77,000
Assets held for sale	600,000	623,000
Total assets held for sale and assets of discontinued operations	\$ 682,000	\$ 700,000
Liabilities of discontinued operations:		
Accounts payable and accrued expenses	\$ 733,000	\$ 991,000
Mortgage payable	1,339,000	1,367,000
Total liabilities of discontinued operations	\$ 2,072,000	\$ 2,358,000

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Results of operations for Embassy and Green are included from the beginning of each fiscal period presented through the respective dates of asset disposition, and have been segregated from continuing operations and reflected as discontinued operations approximately as follows:

	Three Months Ended March 31,	
	2006	2005
Net revenues	\$	\$ 2,983,000
Earnings (loss) from operation of discontinued operations, before taxes	\$ 3,000	\$ (332,000)
Income tax (expense) benefit	(1,000)	112,000
Earnings (loss) from operation of discontinued Operations	2,000	(220,000)
Gain on sale of discontinued operations, before taxes		107,000
Income tax expense		(36,000)
Gain on sale of discontinued operations		71,000
Earnings (loss) from discontinued operations	\$ 2,000	\$ (149,000)

RESULTS OF OPERATIONS

Quarters ended March 31, 2006 and 2005

Revenues

Revenues for the quarters ended March 31, 2006 and 2005 were approximately as follows:

Three months ended March 31,	Consolidated	Tools and other products	Hardware
2006	\$ 26,850,000	\$ 9,463,000	\$ 17,387,000
2005	\$ 24,324,000	\$ 10,114,000	\$ 14,210,000
% increase (decrease)	10.4%	(6.4)%	22.3%

Revenues from tools and other products decreased due primarily to approximately \$310,000 less in retail promotions in the period, as well as a decrease in base sales of approximately \$360,000. Base sales decreased as a result of decreased purchasing activity of approximately \$692,000 from a significant customer as part of a program to reduce its overall inventory levels, which was partially offset by a \$332,000 increase in base sales from another significant customer. Decreases in revenues of approximately \$173,000 at Franklin were due primarily to decreased shipments to a few customers related to weak in-store sales and supply-related issues. Partially offsetting these decreases were increases in automotive revenues of approximately \$66,000 and increases in Berkley revenues of approximately \$102,000.

Revenues from hardware increased at both Woodmark and Nationwide and include revenues from the newly-acquired Pacific Stair as of January 3, 2006. Woodmark's revenues increased \$986,000,

or 9.9%. Revenues from the sale of staircase components continue to increase, benefiting from better customer penetration. Further, revenues in our kitchen and bath products sold into the mobile home and remodeling markets have increased, reversing their 2005 trend, as we have strengthened relationships with certain customers. Pacific Stair's revenues were \$1,666,000 for the first quarter. Moreover, Nationwide's revenues increased by approximately \$523,000, or 12.4%, primarily attributable to an increase of approximately \$566,000, or 26%, in sales of fencing products.

All revenues are generated in U.S. dollars and are not impacted by changes in foreign currency exchange rates.

Gross Profits

Gross profits for the quarters ended March 31, 2006 and 2005 were approximately as follows:

Three months ended March 31,		Consolidated	Tools and other products	Hardware
2006	\$	8,247,000	\$ 3,064,000	\$ 5,183,000
		30.7%	32.4%	29.8%
2005	\$	7,716,000	\$ 3,140,000	\$ 4,576,000
		31.7%	31.1%	32.2%

The increase in the gross profit percentage from tools and other products was due primarily to a lower proportionate amount of retail promotional sales in the current period, which historically have lower average margins, versus the prior-year period and the strength of the U.S. dollar in relation to the Japanese yen, partially offset by the weakness of the U.S. dollar in relation to the Taiwan dollar compared to the prior-year period. The decrease in the gross profit percentage from hardware was due primarily to some cost increases from Asian suppliers due to increases in the cost of metals, competitive pricing pressures on certain stair products and the inclusion of Pacific Stair, which operates at a lower gross margin than the rest of the group. The gross margin percentage decrease was partially offset by a favorable product mix in fencing revenues and a shift by Nationwide to high-quality, lower-cost suppliers for some products.

Selling, General and Administrative Expenses

Consolidated selling, general and administrative (SG&A) expenses increased \$883,000, or 16.3%, from approximately \$5,417,000 to approximately \$6,299,000. SG&A expenses grew at a faster rate than the consolidated revenue increase for the quarter. This unusual expense growth was driven by several factors, including certain corporate non-recurring professional and tax fees, the non-recurring cost of the move of the Company's corporate headquarters, certain other significant annual corporate expenses that are not typically concentrated in the first quarter, and planned increases in sales and marketing expenses that are intended to generate additional revenue in the coming periods. SG&A expenses as a percentage of revenues increased from 22.3% to 23.5%.

Interest - Net

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Net interest expense increased \$77,000, or 18.5%, from approximately \$415,000 to approximately \$492,000, due primarily to higher average borrowings under the revolving credit loan

facility to finance working capital requirements and the acquisition of Pacific Stair in January 2006. Interest expense on borrowings under the Company's revolving credit loan facility increased by approximately \$42,000, as higher average borrowings were further impacted by higher average interest rates. Interest expense on trade financing at Florida Pneumatic increased approximately \$18,000 as a result of higher interest rates and higher average borrowings from a supplier. Interest expense on borrowings under the term loan facility remained flat due to lower average borrowings during the period due to repayments, offset by higher average interest rates. Interest expense on Woodmark's acquisition-related notes increased by approximately \$10,000 due to higher average interest rates.

Income Taxes

The effective tax rates applicable to earnings from continuing operations for the quarters ended March 31, 2006 and 2005 were 40.1% and 41.0%, respectively.

LIQUIDITY AND CAPITAL RESOURCES

The Company's cash flows from operations are cyclical, with the greatest demand in the second and third quarters followed by positive cash flows in the fourth quarter as receivables and inventories trend down. Due to its strong asset base, predictable cash flows and favorable banking relationships, the Company believes it has adequate access to capital, if and when needed. The Company monitors average days sales outstanding, inventory turns and capital expenditures to project liquidity needs and evaluate return on assets employed.

The Company gauges its liquidity and financial stability by the measurements shown in the following table:

	March 31, 2006	December 31, 2005
Working Capital	\$ 23,572,000	\$ 27,981,000
Current Ratio	2.05 to 1	2.51 to 1
Shareholders' Equity	\$ 48,443,000	\$ 47,716,000

On January 3, 2006, Pacific Stair acquired certain assets comprising the business of the former Pacific Stair Products and assumed certain related liabilities.

On June 30, 2004, Woodmark acquired certain assets comprising the business of the former Woodmark International L.P. and its wholly-owned subsidiary, the former Stair House, Inc., and assumed certain related liabilities.

In connection with the Woodmark acquisition transaction, the Company is liable for additional payments to the sellers. The amount of these payments, which would be made as of either June 30, 2007 or June 30, 2009, are to be based on increases in earnings before interest and taxes, for the year ended on the respective date, over a base of \$5,100,000. Woodmark has the option to make a payment as of June 30, 2007 in an amount equal to 48% of this increase. If Woodmark does not make this payment as of June 30, 2007, the Sellers may demand payment as of

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June 30, 2009 in an amount equal to 40% of the increase. Any such additional payments will be treated as additions to goodwill.

In connection with the sale of certain assets of Embassy in October 2005, the Company recorded a receivable of approximately \$1,233,000, comprised of a working capital adjustment of approximately

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\$433,000 and approximately \$800,000 of escrow monies due, subject to certain conditions of release. In January 2006, the Company received approximately \$833,000 in cash relating to the working capital adjustment and a partial release of escrow monies. The balance of the escrow monies due are expected to be paid to the Company in June 2007.

Embassy participated in a multi-employer pension plan until it sold substantially all of its operating assets in October 2005. This plan provided defined benefits to all of its union workers. Contributions to this plan were determined by the union contract. The Company does not administer the plan funds and does not have any control over the plan funds. As a result of Embassy's withdrawal from the plan, it has estimated and recorded a withdrawal liability of approximately \$279,000, which is expected to be payable in quarterly installments of approximately \$8,200 from May 2006 through February 2026.

In January 2006, Embassy entered into a contract of sale on its building with a non-affiliated third party for a purchase price of approximately \$6.4 million. The contract is scheduled to close on or about June 1, 2006. The Company intends to use the net proceeds from this sale to satisfy an existing mortgage on the building of approximately \$1.3 million and to reduce its short and long-term debt. The Company expects to report a pre-tax gain from the sale of the building of approximately \$5.0 million in its second fiscal quarter of 2006.

Cash decreased \$850,000, from \$1,772,000 as of December 31, 2005 to \$922,000, as of March 31, 2006. The Company's debt levels increased, from \$26,631,000 at December 31, 2005 to \$29,618,000 at March 31, 2006, primarily to fund working capital needs and the acquisition of Pacific Stair. The Company's total percent of debt to total book capitalization (debt plus equity) increased from 35.8% at December 31, 2005 to 37.9% at March 31, 2006.

Cash provided by (used in) operating activities of continuing operations for the three-month periods ended March 31, 2006 and 2005 were approximately \$2,435,000 and \$(3,080,000), respectively. The Company believes that cash on hand derived from operations and cash available through borrowings under its credit facilities will be sufficient to allow the Company to meet its foreseeable working capital needs.

During the three months ended March 31, 2006, gross accounts receivable decreased by approximately \$76,000. Increases (decreases) were approximately \$(1,820,000) and \$1,744,000 at Florida Pneumatic and Countrywide, respectively. The decrease in Florida Pneumatic's gross accounts receivable resulted from payments received from a major customer from a large promotion that occurred in the latter part of 2005. The increase at Countrywide was due primarily to increase in revenues of Woodmark and Nationwide during the current quarter, as well as the inclusion of Pacific Stair which reported approximately \$249,000 in gross accounts receivable.

During the three months ended March 31, 2006, inventories decreased by approximately \$258,000. Increases (decreases) were approximately \$396,000 and \$(654,000) at Florida Pneumatic and Countrywide, respectively. Inventory levels at Florida Pneumatic increased slightly as a result of the timing of inventory purchases. The decrease at Countrywide was due primarily to decreases at Woodmark of approximately \$1,044,000 which had built up inventories at year-end anticipating a supplier shut-down and relocation in the first quarter of 2006, offset by the inclusion of Pacific Stair inventory of approximately \$507,000.

During the three months ended March 31, 2006, short-term borrowings increased by \$4,000,000 primarily from the acquisition of Pacific Stair and the timing of working capital requirements.

During the three months ended March 31, 2006, accounts payable increased by approximately \$2,303,000. Increases were approximately \$2,121,000 and \$182,000 at Florida Pneumatic and Countrywide, respectively. The increases at Florida Pneumatic were due primarily to inventory purchases from a major foreign supplier that has granted more favorable payment terms. The increase at Countrywide was due primarily to the increase associated with the inclusion of Pacific Stair accounts payable of approximately \$104,000 and the timing of certain inventory purchases at Nationwide.

On June 30, 2004, in conjunction with the Woodmark acquisition transaction, the Company entered into a credit agreement with Citibank and another bank. This agreement, as amended from time to time, provides the Company with various credit facilities, including revolving credit loans, term loans for acquisitions and a foreign exchange line. The credit agreement expires in June 2006 and is subject to annual review by the lending banks.

The revolving credit loan facility provides a maximum of \$12,000,000, with various sublimits, for direct borrowings, letters of credit, bankers acceptances and equipment loans. There are no commitment fees for any unused portion of this credit facility. At March 31, 2006, there was \$7,000,000 outstanding against the revolving credit loan facility, and there were no open letters of credit.

The term loan facility provides a maximum commitment of \$34,000,000 to finance acquisitions subject to the approval of the lending banks. There are no commitment fees for any unused portion of this credit facility. The Company borrowed \$29,000,000 against this facility to finance the Woodmark acquisition transaction in June 2004, and there was \$16,450,000, including amounts rolled over from the prior term loan facility, outstanding against the term loan facility at March 31, 2006.

The foreign exchange line provides for the availability of up to \$10,000,000 in foreign currency forward contracts. These contracts fix the exchange rate on future purchases of Japanese yen needed for payments to foreign suppliers. The total amount of foreign currency forward contracts outstanding under the foreign exchange line at March 31, 2006, based on that day's closing spot rate, was approximately \$1,341,000.

Under its credit agreement, the Company is required to adhere to certain financial covenants. At March 31, 2006, and for the quarter then ended, the Company was in compliance with all of these covenants. Certain of the Company's mortgage agreements also require the Company to adhere to certain financial covenants. At March 31, 2006, and for the quarter then ended, the Company was in compliance with all of these covenants.

Capital spending was approximately \$501,000 and \$151,000 for the three months ended March 31, 2006 and 2005, respectively, which amounts were provided from working capital. Capital expenditures for the remainder of 2006 are expected to be approximately \$1,000,000, some of which may be financed through the Company's credit facilities. Included in the expected total for 2006 are capital expenditures relating to renovation and expansion of operating facilities, new products, expansion of existing product lines and replacement of equipment.

OFF-BALANCE SHEET ARRANGEMENTS

The Company's foreign exchange line provides for the availability of up to \$10,000,000 in foreign currency forward contracts. These contracts fix the exchange rate on future purchases of foreign currencies needed for payments to foreign suppliers. The Company has not purchased forward contracts

on New Taiwan dollars. The total amount of foreign currency forward contracts outstanding at March 31, 2006, based on that day's closing spot rate, was approximately \$1,341,000.

The Company, through Florida Pneumatic, imports a significant amount of its purchases from Japan, with payment due in Japanese yen. As a result, the Company is subject to the effects of foreign currency exchange fluctuations. The Company uses a variety of techniques to protect itself from any adverse effects from these fluctuations, including increasing its selling prices, obtaining price reductions from its overseas suppliers, using alternative supplier sources and entering into foreign currency forward contracts. The decrease in the strength of the Japanese yen versus the U.S. dollar from 2005 to 2006 had a positive effect on the Company's results of operations and its financial position. During the three-months ended March 31, 2006, the relative value of the U.S. dollar in relation to the Japanese yen was above fiscal 2005 averages. There can be no assurance as to the future trend of this value. (See Item 3 - Quantitative and Qualitative Disclosures About Market Risk.)

NEW ACCOUNTING PRONOUNCEMENTS

See Note 5 to the Notes to Consolidated Condensed Financial Statements included in Item 1 of this report.

Item 3. Quantitative And Qualitative Disclosures About Market Risk

The Company is exposed to market risks, which include changes in U.S. and international exchange rates, the prices of certain commodities and currency rates as measured against the U.S. dollar and each other. The Company attempts to reduce the risks related to foreign currency fluctuation by utilizing financial instruments, pursuant to Company policy.

The value of the U.S. dollar affects the Company's financial results. Changes in exchange rates may positively or negatively affect the Company's gross margins through its inventory purchases and operating expenses through realized foreign exchange gains or losses. The Company engages in hedging programs aimed at limiting, in part, the impact of currency fluctuations. Using primarily forward exchange contracts, the Company hedges some of those transactions that, when remeasured according to accounting principles generally accepted in the United States of America, impact the statement of operations. Factors that could impact the effectiveness of the Company's programs include volatility of the currency markets and availability of hedging instruments. All currency contracts that are entered into by the Company are components of hedging programs and are entered into not for speculation but for the sole purpose of hedging an existing or anticipated currency exposure. The Company does not buy or sell financial instruments for trading purposes. Although the Company maintains these programs to reduce the impact of changes in currency exchange rates, when the U.S. dollar sustains a weakening exchange rate against currencies in which the Company incurs costs, the Company's costs are adversely affected.

The Company accounts for changes in the fair value of its foreign currency contracts by marking them to market and recognizing any resulting gains or losses through its statement of earnings. The Company also marks its yen-denominated payables to market, recognizing any resulting gains or losses in its statement of earnings. At March 31, 2006, the Company had foreign currency forward contracts, maturing in 2006, to purchase Japanese yen at contracted forward rates. The value of these contracts at March 31, 2006, based on that day's closing spot rate, was approximately \$1,341,000, which was the approximate value of the Company's corresponding yen-denominated accounts payable. During the three month periods ended March 31, 2006 and 2005, the Company recorded in its cost of sales a net realized gain of approximately \$10,000 and a net realized loss of \$102,000, respectively, on foreign currency transactions. At March 31, 2006 and 2005, the Company had no unrealized gains or losses on foreign currency transactions.

The potential loss in value of the Company's net investment in foreign currency forward contracts resulting from a hypothetical 10 percent adverse change in foreign currency exchange rates at March 31, 2006 was approximately \$152,000.

The Company has various debt instruments that bear interest at variable rates tied to LIBOR (London InterBank Offered Rate). Any increase in LIBOR would have an adverse effect on the Company's interest costs. In addition to affecting operating results, adverse changes in interest rates could impact the Company's access to capital, certain merger and acquisition strategies and the level of capital expenditures.

The carrying amounts reported in the consolidated balance sheets for cash and cash equivalents, accounts receivable, accounts payable and short-term debt, approximate fair value as of March 31, 2006 because of the relatively short-term maturity of these financial instruments. The carrying amounts reported for long-term debt approximate fair value as of March 31, 2006 because, in general, the interest rates underlying the instruments fluctuate with market rates.

Item 4. Controls and Procedures

Evaluation of disclosure controls and procedures

An evaluation was performed, under the supervision of, and with the participation of, the Company's management, including the Principal Executive Officer and Principal Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) to the Securities and Exchange Act of 1934). Based on that evaluation, the Company's management, including the Principal Executive Officer and Principal Financial Officer, concluded that the Company's disclosure controls and procedures were not effective for the reasons discussed below related to the weaknesses in our internal control over financial reporting. To address the control weaknesses described below, the Company performed additional analysis and performed other procedures to ensure the consolidated financial statements were prepared in accordance with generally accepted accounting principles. Accordingly, management believes that the consolidated condensed financial statements included in this Quarterly Report on Form 10-Q, fairly present, in all material respects our financial condition, results of operations and cash flows for the periods presented.

P&F management is responsible for establishing and maintaining effective internal controls. Because of its inherent limitations, internal controls may not prevent or detect misstatements. A control system, no matter how well designed and operated, can only provide reasonable, not absolute, assurance that the control system's objectives will be met. Also, projections of any evaluation of effectiveness as to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with policies and procedures may deteriorate.

A material weakness is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

Description of Material Weaknesses

Management's assessment confirmed the following material weaknesses at March 31, 2006 that were previously identified at December 31, 2005 in the Company's internal control over financial reporting:

1. Deficiencies in the segregation of duties, specifically as they relate to cash management, the preparation and posting of journal entries and the general controls over information technology security and user access.
2. Significant internal control deficiencies that were considered to be, in the aggregate, a material weakness, included inadequate staffing and supervision leading to the untimely identification and resolution of certain accounting matters; and failure to perform timely reviews, substantiation and evaluation of certain general ledger account balances.

The Certifications of the Company's Principal Executive Officer and Principal Financial Officer included as Exhibits 31.1 and 31.2 to this Quarterly Report on Form 10-Q include, in paragraph 4 of such certifications, information concerning the Company's disclosure controls and procedures and internal control over financial reporting. Such certifications should be read in conjunction with the information contained in this

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Item 4 - Controls and Procedures for a more complete understanding of the matters covered by such certifications.

Planned Remediation Efforts to Address Material Weaknesses

The Company has developed remediation plans and initiated action steps during the three month period ended March 31, 2006 designed to address each of the material weaknesses in the internal control over financial reporting identified above and to implement any and all corrective actions that are required to improve the design and operating effectiveness of internal control over financial reporting, including the enhancement of the Company's policies, systems and procedures. The Company implemented the following measures to remediate the numbered control deficiencies identified above:

1. Management has implemented measures to segregate certain functions and otherwise improve cash management functions including (i) individuals that initiate a wire transfer are now prevented from transmitting the wire transfer; (ii) all wire transfers in excess of \$100,000 now require written approval and release from Corporate management; (iii) modification of its check-signing privileges such that all checks will require dual manual signatures; and (iv) all blank check stock will now be maintained in a locked cabinet that will be accessible to an individual who is not a check signer. In addition, management has implemented measures to segregate the preparation of journal entries and the subsequent posting to the General Ledger.
2. Management has initiated a review of its training and supervision policies and procedures, particularly with respect to the functions described above where significant deficiencies were noted, which is expected to include an evaluation of the specific knowledge and skills required to perform each function, an assessment of the personnel training necessary to perform such function adequately, a plan to ensure that all personnel receive the appropriate level of training, and a review and modification of the supervisory procedures over such personnel.

The Company believes that the above measures have addressed all matters identified as a material weakness by management and the independent registered public accounting firm. The Company will continue to monitor the effectiveness of its internal controls and procedures on an ongoing basis and will take further actions, as appropriate.

Changes in Internal Control Over Financial Reporting

Except as otherwise discussed herein, there have been no significant changes in the Company's internal control over financial reporting during the most recently completed fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting. However, the Company made changes to the design and operation of internal control over financial reporting during the first quarter in order to increase the design and operating effectiveness of internal controls in connection with implementing Section 404 of the Sarbanes-Oxley Act of 2002. In addition, the Company is currently implementing enhancements to the Company's internal control over financial reporting to address the material weaknesses described above.

PART II - OTHER INFORMATION**Item 1. Legal Proceedings**

The Company is a defendant or co-defendant in various actions brought about in the ordinary course of conducting its business. The Company does not believe that any of these actions are material to the financial condition of the Company.

Item 1A. Risk Factors

There were no material changes from risk factors previously disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2005 in response to Item 1A. to Part I of Form 10-K.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds*Issuer Purchases of Equity Securities*

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans (a)	Maximum Number of Shares that May Yet Be Purchased Under the Plans
January 1, 2006 through January 31, 2006	3,356	\$ 12.23	3,356	132,222
February 1, 2006 through February 28, 2006	16,675	\$ 12.84	16,675	115,547
March 1, 2006 through March 31, 2006	3,000	\$ 13.01	3,000	112,547
Total	23,031	\$ 12.55	23,031	112,547

(a) All purchases by the Company of its Class A Common Stock were made under the publicly announced repurchase plans: (1) on August 24, 2001, the Company's Board of Directors authorized the purchase of up to 125,000 shares, (2) on October 8, 2004, the Company's Board of Directors authorized the purchase of an additional 125,591 shares up to a share repurchase maximum of 150,000 shares through September 30, 2005, and (3) on September 16, 2005, the Company's Board of Directors extended the time during which the Company may repurchase such shares by an additional year to September 30, 2006.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Submission of Matters to a Vote of Security Holders

None.

Item 5. Other Information

None.

Item 6. Exhibits

See Exhibit Index immediately following the signature page.

SIGNATURE

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

P&F INDUSTRIES, INC.
(Registrant)

By /s/ Joseph A. Molino, Jr.
Joseph A. Molino, Jr.
Chief Financial Officer
(Principal Financial and Chief Accounting Officer)

Dated: May 12, 2006

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The following exhibits are either included in this report or incorporated herein by reference as indicated below:

Exhibit Number	Description of Exhibit
2.1	Asset Purchase Agreement, dated as of September 16, 1998, by and between Green Manufacturing, Inc., an Ohio corporation, and the Registrant (Incorporated by reference to Exhibit 2.1 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2003). Pursuant to Item 601(b)(2) of Regulation S-K, the Registrant agrees to furnish, supplementally, a copy of any exhibit or schedule omitted from the Asset Purchase Agreement to the Commission upon request.
2.2	Stock Purchase Agreement, dated as of May 3, 2002, by and between Mark C. Weldon and the Registrant (Incorporated by reference to Exhibit 2.1 to the Registrant's Current Report on Form 8-K dated May 3, 2002). Pursuant to Item 601(b)(2) of Regulation S-K, the Registrant agrees to furnish supplementally a copy of any exhibit or schedule omitted from the Stock Purchase Agreement to the Securities and Exchange Commission upon request.
2.3	Settlement Agreement and Amendment to Stock Purchase Agreement, dated as of July 22, 2005, by and between Mark C. Weldon and the Registrant (Incorporated by reference to Exhibit 2.3 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2005).
2.4	Contract for Purchase and Sale, dated as of May 1, 2002, between W. I. Commercial Properties, Inc., a Florida corporation, and Countrywide Hardware, Inc., a Delaware corporation (Incorporated by reference to Exhibit 4.7 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2002).
2.5	Asset Purchase Agreement, dated as of June 30, 2004, by and among WM Texas International, L.P., a Texas limited partnership formerly known as Woodmark International, L.P., SH Georgia, Inc., a Georgia corporation formerly known as Stair House, Inc., Samuel G. Sherstad, WM Texas GP, LLC, WM Texas Partners, LLC and Woodmark International, L.P., a Delaware limited partnership (Incorporated by reference to Exhibit 2.1 to the Registrant's Current Report on Form 8-K dated July 14, 2004, and amended September 10, 2004). Pursuant to Item 601(b)(2) of Regulation S-K, the Registrant agrees to furnish, supplementally, a copy of any exhibit or schedule omitted from the Asset Purchase Agreement to the Commission upon request.
2.6	Asset Purchase Agreement, dated December 13, 2004, among Rosenboom Machine & Tool, Inc., Green Manufacturing, Inc. and P&F Industries, Inc. (Incorporated by reference to Exhibit 2.1 to the Registrant's Current Report on Form 8-K dated December 17, 2004, and amended March 4, 2005). Pursuant to Item 601(b)(2) of Regulation S-K, the Registrant agrees to furnish, supplementally, a copy of any exhibit or schedule omitted from the Asset Purchase Agreement to the Commission upon request.
2.7	Amendment to Asset Purchase Agreement, dated June 8, 2005, among Rosenboom Machine & Tool, Inc., Green Manufacturing, Inc. and P&F Industries, Inc. (Incorporated by reference to Exhibit 2.7 to the Registrant's Quarterly Report on Form 10-Q for the

quarter ended June 30, 2005).

- 2.8** Asset Purchase Agreement, dated as of February 2, 2005, between Green Manufacturing, Inc. and Benko Products, Inc. (Incorporated by reference to Exhibit 2.1 to the Registrant's Current Report on Form 8-K dated February 4, 2005). Pursuant to Item 601(b)(2) of Regulation S-K, the Registrant agrees to furnish, supplementally, a copy of any exhibit or schedule omitted from the Asset Purchase Agreement to the Commission upon request.
- 2.9** Asset Purchase Agreement, dated as of October 11, 2005, between Embassy Industries, Inc. and Mestek, Inc. (Incorporated by reference to Exhibit 2.1 to the Registrant's Current Report on Form 8-K dated October 12, 2005). Pursuant to Item 601(b)(2) of Regulation S-K, the Registrant agrees to furnish, supplementally, a copy of any exhibit or schedule omitted from the Asset Purchase Agreement to the Commission upon request.
- 3.1** Restated Certificate of Incorporation of the Registrant (Incorporated by reference to Exhibit 3.1 to Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2004).
- 3.2** Amended By-laws of the Registrant (Incorporated by reference to Exhibit 3.2 to Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2004).
- 3.3** Amendment to the Amended By-laws of the Registrant (Incorporated by reference to Exhibit 3.1 to the Registrant's Current Report on Form 8-K dated March 21, 2005).
- 3.4** Amendment to the Amended By-laws of the Registrant (Incorporated by reference to Exhibit 3 to the Registrant's Current Report on Form 8-K dated September 16, 2005).
- 4.1** Rights Agreement, dated as of August 19, 2004, between the Registrant and American Stock Transfer & Trust Company, as Rights Agent (Incorporated by reference to Exhibit 1 to the Registrant's Registration Statement on Form 8-A dated August 19, 2004).
- 4.2** Credit Agreement, dated as of June 30, 2004, by and among the Registrant, Florida Pneumatic Manufacturing Corporation, Embassy Industries, Inc., Green Manufacturing, Inc., Countrywide Hardware, Inc., Nationwide Industries, Inc., Woodmark International, L.P. and Citibank, N.A., as Administrative Agent, and the lenders party thereto (Incorporated by reference to Exhibit 10.1 to the Registrant's Current Report on Form 8-K dated July 14, 2004).
- 4.3** Amendment to Credit Agreement, dated June 24, 2005, by and among the Registrant, Florida Pneumatic Manufacturing Corporation, Embassy Industries, Inc., Green Manufacturing, Inc., Countrywide Hardware, Inc., Nationwide Industries, Inc., Woodmark International, L.P. and Citibank, N.A., as Administrative Agent, and the lenders party thereto (Incorporated by reference to Exhibit 10.1 to the Registrant's Current Report on Form 8-K dated June 27, 2005).
- 4.4** Amendment No. 2 to Credit Agreement, dated December 27, 2005, by and among the Registrant, Florida Pneumatic Manufacturing Corporation, Embassy Industries, Inc., Green Manufacturing, Inc., Countrywide Hardware, Inc., Nationwide Industries, Inc.,

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Woodmark International, L.P. and Citibank, N.A., as Administrative Agent, and the lenders party thereto (Incorporated by reference to Exhibit 4.4 to the Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2005).

- 4.5** Amendment No. 3 to Credit Agreement, dated February 13, 2006, by and among the Registrant, Florida Pneumatic Manufacturing Corporation, Embassy Industries, Inc., Green Manufacturing, Inc., Countrywide Hardware, Inc., Nationwide Industries, Inc., Woodmark International, L.P., Pacific Stair Products, Inc., WILP Holdings, Inc., and Citibank, N.A., as Administrative Agent, and the lenders party thereto (Incorporated by reference to Exhibit 4.5 to the Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2005).
- 4.6** Amendment No. 4 to Credit Agreement, dated May 11, 2006, by and among the Registrant, Florida Pneumatic Manufacturing Corporation, Embassy Industries, Inc., Green Manufacturing, Inc., Countrywide Hardware, Inc., Nationwide Industries, Inc., Woodmark International, L.P., Pacific Stair Products, Inc., WILP Holdings, Inc., and Citibank, N.A., as Administrative Agent, and the lenders party thereto (Filed herein).
- 4.7** Certain instruments defining the rights of holders of the long-term debt securities of the Registrant are omitted pursuant to Section (b)(4)(iii)(A) of Item 601 of Regulation S-K. The Registrant agrees to furnish supplementally copies of these instruments to the Commission upon request.
- 10.1** Second Amended and Restated Employment Agreement, dated as of May 30, 2001, between the Registrant and Richard A. Horowitz (Incorporated by reference to Exhibit 10.1 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2001).
- 10.2** Amendment to the Second Amended and Restated Employment Agreement, dated as of October 24, 2005, between the Registrant and Richard A. Horowitz (Incorporated by reference to Exhibits 10.1 to the Registrant's Current Report on Form 8-K dated October 28, 2005).
- 10.3** Agreement, dated as of October 24, 2005, between the Registrant and Richard A. Horowitz and the 1994 Richard A. Horowitz Family Trust (Incorporated by reference to Exhibits 10.2 to the Registrant's Current Report on Form 8-K dated October 28, 2005).
- 10.4** Consulting Agreement, effective as of November 1, 2003, between the Registrant and Sidney Horowitz (Incorporated by reference to Exhibit 10.2 to the Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2003).
- 10.5** 1992 Incentive Stock Option Plan of the Registrant, as amended and restated as of March 13, 1997 (Incorporated by reference to Exhibit 10.3 to the Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2003).
- 10.6** 2002 Stock Incentive Plan of the Registrant (Incorporated by reference to Exhibit 4.7 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended March 31, 2002).
- 10.7** Contract of Sale, dated January 13, 2006, between the Registrant and J. D. Addario &

Company, Inc. (Incorporated by reference to Exhibit 10.1 to the Registrant's Current Report on Form 8-K dated January 13, 2006).

10.8 First Amendment to Contract of Sale, dated March 8, 2006, between the Registrant and J. D. Addario & Company, Inc. (Incorporated by reference to Exhibit 10.7 to the Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2005).

14.1 Code of Business Conduct and Ethics of the Registrant and its Affiliates (Incorporated by reference to Exhibit 14.1 to the Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2003).

31.1 Certification of Richard A. Horowitz, Principal Executive Officer of the Registrant, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (Filed herein).

31.2 Certification of Joseph A. Molino, Jr., Principal Financial Officer of the Registrant, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (Filed herein).

32.1 Certification of Richard A. Horowitz, Principal Executive Officer of the Registrant, Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (Filed herein).

32.2 Certification of Joseph A. Molino, Jr., Principal Financial Officer of the Registrant, Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (Filed herein).

A copy of any of the foregoing exhibits to this Quarterly Report on Form 10-Q may be obtained, upon payment of the Registrant's reasonable expenses in furnishing such exhibit, by writing to P&F Industries, Inc., 445 Broadhollow Road, Suite 100, Melville New York 11747, Attention: Corporate Secretary.