IMMERSION CORP
Form 10-K
March 16, 2007

Table of Contents

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

Form 10-K

þ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended December 31, 2006

or

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from to

Commission File Number 000-27969

Immersion Corporation
(Exact name of registrant as specified in its charter)

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

801 Fox Lane
San Jose, California 95131
(Address of principal executive offices, zip code)

(408) 467-1900
(Registrant s telephone number, including area code)

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

Title of Each Class	**Name of Each Exchange on which Registered**
Common Stock, $0.001 par value	The Nasdaq Stock Market LLC

Securities registered pursuant to Section 12(g) of the Act:
None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No þ

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No þ

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in Rule 12b-2 of the Act).

Large accelerated filer o Accelerated filer þ Non-accelerated filer o

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

The aggregate market value of the registrant s common stock held by non-affiliates of the registrant on June 30, 2006, the last business day of the registrant s most recently completed second fiscal quarter, was $96,354,146 (based on the closing sales price of the registrant s common stock on that date). Shares of the registrant s common stock held by each officer and director and each person whom owns 5% or more of the outstanding common stock of the registrant have been excluded in that such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes. Number of shares of common stock outstanding at February 23, 2007: 25,237,395

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the definitive Proxy Statements for the 2007 Annual Meeting are incorporated by reference into Part III hereof.

IMMERSION CORPORATION

2006 FORM 10-K ANNUAL REPORT

TABLE OF CONTENTS

Table of Contents

Forward-looking Statements

In addition to historical information this Annual Report on Form 10-K 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 Exchange Act). The forward-looking statements involve risks and uncertainties. Forward-looking statements are identified by words such as anticipates, believes, expects, intends, may, will, 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, those described elsewhere in this report including Risk Factors, and those described in our other reports filed with the Securities and Exchange Commission (SEC). We caution you not to place undue reliance on these forward-looking statements, which speak only as of the date of this report, and we undertake no obligation to update these forward-looking statements after the filing of this report. You are urged to review carefully and consider our various disclosures in this report and in our other reports publicly disclosed or filed with the SEC that attempt to advise you of the risks and factors that may affect our business.

PART I

Item 1. *Business*

Overview

Immersion Corporation was founded in 1993, and we consummated our initial public offering on November 12, 1999. Our common stock trades on the Nasdaq Global Market under the symbol IMMR. Immersion Corporation is a leading provider of haptic technologies that allow people to use their sense of touch more fully when operating a wide variety of digital devices. To achieve this heightened interactivity, we develop and manufacture or license a wide range of hardware and software technologies and products. While we believe that our technologies are broadly applicable, we are currently focusing our marketing and business development activities on the following target application areas: automotive, consumer, entertainment, industrial, medical simulation, mobile communications, and three-dimensional design and simulation. We manage these application areas under two operating and reportable segments: 1) Immersion Computing, Entertainment, and Industrial and 2) Immersion Medical.

In markets where our touch technologies are a small piece of a larger system, such as mobile phones and controls for automotive interfaces, we license our technologies or software products to manufacturers who integrate them into their products and sell the end product(s) under their own brand names. In some markets, we have brand visibility on consumer packaging, end-user documentation, and in software applications. In other markets, such as medical simulation, touchscreen input devices, and three-dimensional computer-aided design, we sell products manufactured by us or others under our own Immersion brand name through direct sales to end users, distributors, OEMs, and value-added resellers. At other times, we may design and manufacture products that are sold to other companies on a private label or Immersion branded basis to resell.

In all market areas, we also engage in development projects for third parties and government agencies from time to time.

Our objective is to drive adoption of our touch technologies across markets and applications to improve the user experience with digital devices and systems. We and our wholly owned subsidiaries hold more than 600 issued or pending patents in the U.S. and other countries, covering various aspects of hardware and software technologies.

Haptics and Its Benefits

The science of haptics refers to tactile and kinesthetic information that supplies a tangible representation of the environment to the human sensory system. The term force feedback has often been used to mean haptics in general, though haptics is actually comprised of two types of sensing and two types of technologies. Tactile sensing

Table of Contents

refers to an awareness through stimulation of the skin, which can be accessed through vibro-tactile technologies. Kinesthetic sensing refers to an awareness through the position of body parts and their movement, which can be accessed using force feedback technologies. Without our perception of haptic information, it would be hard to believe that something is tangible. Unlike sight and hearing, which are mainly input systems, touch is bi-directional, allowing us to both feel (take in information) and manipulate (have an effect on something).

All human senses are complementary, contributing to our perception of the environment. Without one of them, our perception would change and without touch, any motor action, such as typing, peeling an orange, or opening a door would be extremely difficult. A person s sense of touch and the haptic information it interprets is a critical part of our interactions with the world.

In the world of computers and digital devices and controls, haptic feedback is often lost. To replace the lost sensation of touch, input/output devices can create the physical forces, known as haptic feedback, force feedback, touch feedback, or tactile feedback. These forces are exerted by actuators, such as motors, which are built into devices such as joysticks, steering wheels, gamepads, and mobile phones. Actuators can also be designed into more sophisticated devices used in automotive, industrial, medical, or retail kiosk and point-of-sale systems, such as digital switches, rotary controls, and touchscreens. Our programmable haptic technologies embedded in touch-enabled devices can give users the physical sensations of interacting with rough textures, smooth surfaces, viscous liquids, compliant springs, solid barriers, deep or shallow detents, jarring vibrations, heavy masses, and rumbling engines.

As a user operates a touch-enabled device, such as a joystick, actuators within the device apply computer-modulated forces that resist, assist, and enhance the manipulations. These forces are generated based on software algorithms and mathematical models built to produce appropriate sensations. For example, when simulating the feel of interacting with a solid wall or barrier, a computer program can signal motors within a force feedback joystick to apply forces that emulate the impenetrability of the wall. The harder the user pushes, the harder the motors push back. When simulating the placement of cardiac pacing leads, a computer program can signal actuators to apply forces that would be encountered when navigating coronary pacing leads through a beating heart. These forces can be synchronized with appropriate simulations of an electrocardiogram, blood pressure, heart rate, and fluoroscopy displays. When simulating the feel of pressing a button, a computer program can signal actuators attached to a touchscreen to apply forces that emulate the button s particular press and release characteristics. Even though the user touches a screen that is flat, our technology delivers the perception that the button is pushed inward.

Our VibeTonz technology gives mobile handset user interfaces and applications the ability to precisely control a phone s vibration motor, providing a rich palette of tactile sensations that can enhance handset operation and make content more engaging. It can be used to provide confirming feedback when pressing virtual buttons on a touchscreen; to advise users of the identity of an incoming caller; to supply vibrations signifying an emotion in a text message; provide tactile alerts for call progress and message status; and to aid in general navigation and operation. Ringtones can also be haptically enhanced, allowing users to feel the beat of a particular song. Mobile games are made more engaging and enjoyable by adding vibro-tactile effects to particular events such as explosions, car crashes, and bowling strikes.

The mathematical models that control actuators may be simple modulating forces based on a function of time. These forces can produce jolts and vibrations, for example. More complex forces can emulate surfaces, textures, springs, and damping. All forces can be synchronized with audio, video, or application program logic. For example, a series of individual simulated forces can be combined to give the seamless feel of a complex interaction, like driving a sports car, which might include the centrifugal forces in the steering wheel, the vibration of the road surface, the revving of the engine, and the bass beat of a song.

We believe the programmability of our haptic products is a key differentiator over purely electro-mechanical systems and can drive the further adoption of digital devices. A programmable device can supply a tactile response appropriate to the context of operation for systems and devices of many types. These tactile cues can help users operate more intuitively or realize a more enjoyable or natural experience. Used in combination with sight and sound cues, touch feedback adds a compelling, engaging, multimodal aspect to the user interface. Our haptic products and technologies can also add a tactile quality to interactions that have been devoid of tactile confirmation, such as when using a touchpad or touchscreen. The confirmation and navigational cues obtained by programmable

Table of Contents

haptics can aid in performance and accuracy and increase user satisfaction. The addition of programmable haptics can help in the conversion from purely mechanical rotary controls to digital devices or from a mechanical keyboard, switch, or button interface to an electronic touchscreen.

Programmability also supplies more flexibility in terms of the types of responses that are possible (such as nonlinear or dynamic qualities), in upgradeability, in consistent performance that will not degrade over time, and in the potential for personalized settings.

Multiple mechanical controls can be consolidated into one versatile programmable control, which can save space and improve ergonomics. Conversely, one programmable control device can be implemented as many different types of controls with context-appropriate touch feedback, which can simplify inventory.

Industry Background

Haptic systems were first used in applications like military flight simulators. In the 1960s, combat pilots honed their flight skills in training simulators that replicated the feel of flying actual planes. Motors and actuators pushed, pulled, and shook the flight yoke, throttle, rudder pedals, and cockpit shell, reproducing many of the tactile and kinesthetic cues of real flight. Though advanced for their time, these systems were limited by the then available technology and were therefore relatively crude and low fidelity by today s standards. They also cost at least hundreds of thousands, if not millions of dollars, and therefore were not within the grasp of consumers or even most businesses.

By the late 1970s and early 1980s, computing power reached the point where rich color graphics and high-quality audio were possible. Computers evolved from primitive command-prompt, text-based systems with monochrome displays to powerful systems capable of rendering colorful graphics and animations and of playing music and sound effects. These advancements spawned entirely new businesses in the late 1980s and early 1990s.

To the consumer, this multimedia revolution opened new possibilities. Flight simulation moved from a professional pilot-only activity to a PC-based hobby for millions of real and aspiring pilots. The graphics and sound these hobbyists experienced were far superior to what the combat pilots in the 1960s had in their expensive flight simulator systems.

The multimedia revolution also made the medical simulation business possible. By the 1990s, high-end workstations enabled renderings of the human anatomy to be displayed with never before possible realism. Companies were founded to harness this new technology and turn it into safer and more effective teaching aides for medical personnel.

However, the multimedia revolution also highlighted a shortcoming in simulation products. Even though medical graphics and animations looked incredibly realistic, they could not convey what it feels like to break through a venal wall with a needle or cut through the tissue surrounding the gall bladder. In the case of flight simulation, graphics and sound could not realistically convey what it actually feels like to fight the flight yoke or flight stick out of a steep dive or through a sharply banked turn. Only hands-on experience provided this critical component of learning.

So by the mid 1990s, these new industrial and consumer multimedia products were in need of enhanced haptic technology that could provide the sensations similar to an actual hands-on experience. We were founded in 1993 to bring the critical sense of touch back into the user s experience. By combining 1) the basic concepts used in the military flight simulators of the 1960s, 2) state-of-the-art advancements in robotic controls, 3) advancements in the understanding of how the human sense of touch works, and 4) advancements in computing power, we were able to significantly reduce the cost and size of haptic solutions while increasing the quality of the simulated forces. Some of our early technology was used in the world s first consumer force feedback peripherals for computer video games, such as flight sticks and steering wheels. These products not only looked and sounded more realistic, they allowed users to

feel haptic effects that simulated, for example, textures, bouncing and hitting a ball, and vibrations from gun fire. In addition, with our technology, sophisticated medical simulators offered medical professionals the ability to practice and enhance their surgical and other procedural skills in a way not previously possible.

Table of Contents

Continued advancements in size, power, and cost reductions have pushed the adoption of haptics technology even further into those industries, as well as into new ones. Our TouchSense® intellectual property is now incorporated into computer and console gaming systems, and in products such as gamepads, joysticks, and steering wheels for Sony s PlayStation and PlayStation 2, Microsoft s Xbox and Xbox 360, and PC and Apple computers. Furthermore, more than 1,500 Immersion Medical simulators have been deployed at hospitals and medical schools throughout the United States and abroad, including Johns Hopkins University, Beth Israel Deaconess Medical Center, Mayo Clinic (Rochester, MN), Northwestern University, Rush University Medical Center, St. Mary s Hospital (London), and Stanford University.

Demand for our VibeTonz technology for adding haptic feedback to mobile handset interfaces and applications has been driven by several converging factors. With advances in processing power, data bandwidth, memory, and audio and graphic fidelity, the handset has become capable of serving as a primary messaging and entertainment terminal for many users. This has caused mobile user interfaces to become increasingly complex, even while the form factor of the underlying devices has shrunk. Haptics can help mitigate usability problems in small, visually and mechanically dense interfaces by leveraging the otherwise underutilized bandwidth of our sense of touch. Furthermore, tactile effects can greatly enhance the perceived quality and immersiveness of the mobile multimedia and gameplay experience.

Although the first touchscreens were introduced in the early 1970s, their broad acceptance and proliferation didn t occur until the mid to late 1990s. Since their introduction, advancements in computing power, operating systems, graphical user interfaces, and multimedia software, combined with gradual cost reductions, have today made the touchscreen the user interface device of choice for many applications. In 2005, we announced a TouchSense technology solution to enable enhanced tactile cues for providing a more intuitive, personal, and natural experience for the user. Instead of just feeling the passive touchscreen surface, users perceive that buttons press and release, just as physical buttons and switches do, creating a class of products we call active touchscreens.

Our haptic technologies are also now used by corporate industrial designers and by researchers from the National Aeronautics and Space Administration (NASA), Stanford University, and the Massachusetts Institute of Technology (MIT). Automobiles manufactured by BMW, Mercedes-Benz, Rolls Royce, and Volkswagen use programmable haptic controls powered by Immersion technology. In addition, we offer 3D capture and interaction products to help game developers, mechanical designers, animators, and other professionals reduce production time and streamline the workflow process. Today, we believe that as computing power increases and pushes multimedia capabilities into new areas, even more opportunities will be created for our programmable haptic technologies.

Our Solutions

Our goal is to change the way people interact with digital devices by engaging their sense of touch. Core competencies include our understanding of how interactions should feel and our knowledge of how to use technology to achieve that feeling. Our strength in both of these areas has resulted in many novel applications.

We believe that our touch-enabled products and technologies give users a more complete, intuitive, enjoyable, and realistic experience. Our patented designs include software elements such as real-time software algorithms and authoring tools, and specialized hardware elements, such as motors, sensors, transmissions, and control electronics. Together, these software and hardware elements enable tactile sensations that are context-appropriate within the application.

We have developed haptic systems for many types of hardware input/output devices such as computer mice, joysticks, mobile phones, rotary controls, touchscreens, and flexible and rigid endoscopy devices for medical simulations.

We have developed many mechanisms to convey forces to the user s hands or body. These include vibro-tactile actuators, direct drive, belt, gear, or cable driven mechanisms, and other proprietary devices that supply textures and vibration, resistance, and damping forces to the user.

To develop our real-time electronic actuator controllers, we had to address challenges such as size, accuracy, resolution, frequency, latency requirements, power consumption, and cost. Our control solutions include both closed-loop and open-loop control schemes. In closed-loop control, the firmware reads inputs from the input/output

Table of Contents

devices, and then calculates and applies the output forces in real time based upon the input data. In open-loop control, a triggering event will activate the firmware to calculate and send the output signal to the actuator in real time.

We have developed many software solutions for various operating systems and computing platforms including PC, Apple, automotive, and mobile handset operating systems. Our inventions include many generations of authoring tools for creating, visualizing, modifying, archiving, and experiencing haptic feedback.

Licensed Solutions

In markets where our touch technology is a small piece of a larger system (such as mobile phones and controls for automotive interfaces), we license our technologies or software products to manufacturers who integrate them into their products sold under their own brand names.

We offer our expertise to our licensees to help them design and integrate touch effects into their products. This expertise includes turn-key engineering and integration services, authoring tools, application programming interfaces, and the development of hardware and software technologies that are compatible with industry standards.

Turn-key Engineering and Integration Services. We offer engineering assistance including technical and design assistance and integration services that allow our licensees to incorporate our touch-enabling products and technologies into their products at a reasonable cost and in a shortened time frame. This allows them to get to market quickly by using our years of haptic development expertise. We offer product development solutions including product software libraries, design, prototype creation, technology transfer, component sourcing, development/integration kits, sample source code, comprehensive documentation, and other engineering services. In addition, we ensure a quality end-user experience by offering testing and certification services to a number of licensees.

Authoring Tools. We license authoring tools that enable software developers to quickly design and incorporate custom touch feedback into their own applications. Authoring tools allow designers to create, modify, experience, and save or restore haptic effects for a haptic device. The tools are the equivalent of a computer-aided design application for haptics. Our authoring tools support vibro-tactile haptic devices (such as mobile phones, touchscreens, and vibro-tactile gaming peripherals), as well as kinesthetic haptic devices (such as rotary devices, joysticks, and medical training systems). Various haptic effect parameters can be defined and modified and the result immediately experienced. Our authoring tools run on mainstream operating systems such as Microsoft Windows.

Application Programming Interfaces (APIs). Our APIs provide haptic-effect generation capability. This allows designers and programmers to focus on adding haptic effects to their applications instead of struggling with the mechanics of programming real-time algorithms and handling communications between computers and devices. Some of our haptic APIs are device independent (for example, they work with scroll wheels, rotary knobs, 2D joysticks, and other devices) to allow flexibility and reusability. Others are crafted to meet the needs of a particular customer or industry.

Compatible with Industry Standards. We have designed our hardware and software technologies for our licensees to be compatible with industry hardware and software standards. Our technologies operate across multiple platforms and comply with such standards as Microsoft s entertainment application programming interface DirectX and a standard communications interface, Universal Serial Bus (USB). More generally, our software driver and API technology has been designed to be platform independent and ported to a variety of operating systems including Windows, Windows CE, Mac OS X, BREW/REX (from QUALCOMM), Java (J2SE), and VxWorks.

Manufactured Product Solutions

We produce our products using both contracted and in-house manufacturing capabilities. In some markets, we manufacture and sell products under the Immersion brand name through a combination of direct sales, distributors, and value-added resellers. These products include:

- medical simulation systems used for training medical professionals in minimally invasive medical procedures including vascular access, endoscopy, laparoscopy, and endovascular;

Table of Contents

components used in our touchscreen solutions;

programmable rotary control modules for operating a wide range of devices;

digitizers used to construct detailed 3D computer models and to perform accurate part inspections;

a 3D interaction product line consisting of hand-centric hardware and software solutions for animating hand movements and allowing users to manipulate virtual objects with their hands; and

electronics and force feedback devices for arcade games, university research, and other industrial applications.

Our Strategy

We intend to maintain and enhance our position as a leading provider of touch-enabling technology by employing the following strategies:

Pursue Royalty-based Licensing Model for High Volume Applications of Our Technologies. We believe that the most effective way to proliferate our touch-enabling technologies, where touch is a small part of a larger system, is to license and embed it in high volume applications. We have licensed our intellectual property to numerous manufacturers of joysticks, gamepads, and steering wheels, and to manufacturers of video console gaming systems, all of which are targeted at consumers. In addition, our technologies have been licensed to automotive manufacturers and automotive parts suppliers for use in automotive controls. We have licensed our software products that create touch feedback effects in mobile handsets to manufacturers of mobile phones, wireless operators, and content developers. We intend to expand the number and scope of our licensing relationships in the future.

In general, our licenses permit manufacturers to produce only a particular category of product within a specified field of use. Our licensing model includes an up-front license fee and/or a per-unit royalty paid by the manufacturer that may be a fixed fee or a percentage of the selling price of the final touch-enabled product. In addition, our consumer-products licensees generally have branding obligations. The prominent display of our TouchSense or VibeTonz technology logo on retail packaging generates customer awareness for our technologies.

Pursue Product Sales in Lower-volume Applications through Multiple Channels. For lower-volume emerging applications of our technologies, such as medical simulation systems, active touchscreens, and three-dimensional and design products, our strategy is to sell products manufactured by us or others under our own Immersion brand name through direct sales to end users, distributors, OEMs, and value-added resellers. At other times, we may design and manufacture products that are sold to other companies on a private label or Immersion branded basis to resell. The Immersion Computing, Entertainment, and Industrial segment sells products that consist primarily of digitizers, such as the MicroScribe® line; specialized whole-hand sensing gloves and software, such as the CyberGlove® II wireless glove, CyberGrasp® system, and CyberForce® armature that permit simulated interaction with three-dimensional environments; and TouchSense components and software for our touchscreen and rotary control solutions. Our Immersion Medical segment currently sells medical simulation devices that simulate intravenous catheterization, endovascular interventions, and laparoscopic and endoscopic procedures.

Secure Licensees and Customers in New Markets for Touch-enabling Technology and Software Products. We believe that our touch-enabling technologies can be used in virtually all areas of computing and communication. We initially focused on computer gaming applications for personal computers and dedicated game consoles, an area in which key companies have accepted our technologies. We have broadened our focus in additional applications including automotive controls; industrial equipment controls; mobile phones; and fixed and mobile touchscreen devices, such as

remote controls and portable navigation systems; and secured several new licensees in these areas. Furthermore, we intend to pursue additional applications for our technologies.

Facilitate Development of Touch-enabled Products. Our success depends on the development of touch-enabled products by our licensees and customers. To enable that development, we offer design packages that include sample hardware, software, firmware, and related documentation, and offer our technical expertise on a consulting basis. We will continue to devote significant resources to facilitate the development of touch-enabled products by our licensees and customers.

Table of Contents

Expand Software Support for Our Touch-enabling Technologies. In addition to licensing our intellectual property or software products and supporting licensee product development efforts, we have focused on expanding software support for our touch-enabling technologies. For example, we license authoring and programming tools to customers in support of vibro-tactile haptic devices (such as mobile phones, vibro-tactile gaming peripherals, and touchscreens) as well as kinesthetic haptic devices (such as rotary devices, joysticks, and steering wheels). Using our authoring tools, various haptic-effect parameters can be defined and modified, and the result can be immediately experienced on the target device.

Our APIs provide an extensive haptic-generation capability and allow designers and programmers to focus on enabling their target applications with haptic effects instead of struggling with the mechanics of programming real-time algorithms and handling communications between computers and devices. One focus of our marketing efforts is to promote the adoption of our touch-enabling technologies by software developers in certain markets. We have developed the VibeTonz Software Development Kit (SDK) and TouchSense SDK that contain items such as programming or authoring tools, documentation, tutorials, and software files containing sample touch effects. Our software support staff also works closely with developers to assist them in developing compelling touch-enabled applications. We also worked closely with Microsoft on the Microsoft DirectX SDK, contributing to the API specification and offering our own authoring tools, documentation, tutorials, and sample program to supplement the DirectX SDK.

Expand Market Awareness. We promote adoption of our touch-enabling technologies by increasing market awareness as appropriate in our various market segments. We believe that it is important to increase awareness among potential customers and, in some markets, end users. As a part of many of our consumer-product license agreements, we require our licensees to use our trademarks and logos to create brand awareness among consumers. To generate awareness of our technologies and our licensees products, we participate in industry tradeshows, maintain ongoing contact with industry press, and provide product information on our Web site. To generate increased awareness and sales leads, we execute marketing campaigns specific to each market. These campaigns for a specific market may include public relations, direct mail, Internet marketing, advertising, tradeshows, and/or public speaking at industry events.

Develop and Protect Touch-enabling Technology. Our success depends in part on our ability to license and commercialize our intellectual property and to continue to expand our intellectual property portfolio. We devote substantial resources to research and development and are engaged in projects focused on expanding the scope and application of our technologies with particular emphasis on mobile-phone, tactile-touchscreen, and medical-simulation product offerings. We have also secured technology by acquisition and may do so again in the future. We intend to continue to invest in technology development and potential acquisitions and to protect our intellectual property rights across all of our businesses.

Immersion Computing, Entertainment, and Industrial Segment

Products and Markets

We initially licensed our intellectual property for touch-enabling technologies for consumer gaming peripherals in 1996 under the I-FORCE trademark. We have transitioned our branding to the TouchSense trademark, which extends beyond gaming to other applications of our haptics-related products and services.

Gaming

We have licensed our TouchSense intellectual property to Microsoft for use in its products and to Apple Computer for use in its Apple operating system. We have also licensed our TouchSense intellectual property to over 20 gaming

peripheral manufacturers and distributors, including Logitech and Mad Catz, to bring haptic technology to PC platforms including both Microsoft Windows and Apple operating systems, as well as to video game consoles, such as the Microsoft Xbox 360. For the years ended December 31, 2006, 2005, and 2004, 6%, 11%, and 10%, respectively, of total revenues were from Logitech.

Currently, there are consumer PC joysticks sold using TouchSense technology, including the Wingman Force 3D Pro from Logitech; the Cyborg evo Force from Saitek; and the Top Gun Afterburner Force Feedback Joystick from ThrustMaster. There are also PC steering wheel gaming peripherals licensed under the TouchSense brand,

Table of Contents

including the G25 Racing and MOMO Racing from Logitech; the RGT Force Feedback Pro Clutch Edition from Guillemot; and the R440 Force Feedback Wheel from Saitek. There are PC gamepads that use TouchSense technology, including the Cordless Rumblepad 2 and Rumblepad 2 from Logitech; the T-Mini 2-in-1 Wireless Rumble Force from ThrustMaster; and the P2500 from Saitek.

In the video game console peripheral market, we have licensed our patents for use in hundreds of spinning mass tactile feedback devices and force feedback devices from various manufacturers including Logitech, Mad Catz, Pelican, Intec, Joytech, Radica, NYKO, i-CON, Saitek, Hori, Gemini, and Griffin. These products are designed to work with one or more video game consoles including the Xbox and Xbox 360 from Microsoft; the PlayStation and PlayStation 2 from Sony; and the GameCube and N64 from Nintendo.

For the years ended December 31, 2006, 2005, and 2004, 18%, 27%, and 24%, respectively, of our total revenues were generated from PC and console gaming revenues.

In June 2006, we introduced next-generation TouchSense vibration technology to match the realism expected of next-generation video console gaming systems. The new technology provides a wider range of vibration effects that simulate the physical world. The new TouchSense technology also provides improved synchronization with audio and onscreen graphic events, backward compatibility for vibration effects in current games, authoring tools that allow developers to create a much wider range of effects in less time, and the ability to work alongside motion control and tilt sensing all without cost, power consumption, weight, or space increases for most systems.

In the arcade entertainment market, our products include steering wheel control electronics that provide industrial strength and quality force feedback that enable very realistic simulations. Our commercial-quality joystick provides a similar user experience and has been used in theme-park attractions and flight-training applications.

In the casino and bar-top amusement market, we signed an agreement with 3M Touch Systems in 2005 that allows manufacture and distribution of its MicroTouch touch screens with our TouchSense technology. Early prototypes of gaming systems with the MicroTouch touch screens were released and exhibited in November 2006 at the Global Gaming Expo (G2E).

Mobile Communications and Portable Devices

We have developed the VibeTonz System, an integrated, programmable vibro-tactile application development and runtime environment for handset OEMs, mobile operators, and application developers. The VibeTonz System enables mobile handset users to send and receive a wide range of vibro-tactile haptic effects independently from or in synchronicity with audio, video, and application program content. The VibeTonz System consists of VibeTonz Mobile Player, a lightweight and powerful vibration playback system that is embedded in the phone, and VibeTonz SDK**,** including a PC-based composition tool for creating VibeTonz effects for inclusion in content and applications such as ringtones, games, and user interface enhancements.

Of particular note, in 2006, we expanded the capabilities of the VibeTonz System to provide tactile confirmation to the user that their finger or stylus press on a device touchscreen was accepted as input. This application of our technology may be expanded into a broad range of portable devices, including global positioning/navigation systems, remote controls for home entertainment systems, medical diagnostic and therapeutic equipment, test and measurement equipment, portable terminals, and game devices and media players.

Greater market acceptance of our products for mobile phones was marked by:

Verizon Wireless offering two VibeTonz-enabled handsets for the North American mass market, the feature-rich SCH-A930 and the value-inspired SCH-A870. The launching by SK Telecom and China Unicom of the first handsets using VibeTonz technology to add tactile feedback to touchscreen interactions. The handsets launched by these two operators were SCH-B550 and SCH-W559, respectively. By the end of 2006, there were thirteen VibeTonz-enabled phones launched and approximately 4 million units shipped worldwide. In addition, new developer agreements were signed with leading mobile games publishers Punch Entertainment, SkyZone Entertainment, and Sonic Branding Solutions.

Table of Contents

Orange s offering of the first mobile phone in Europe with our VibeTonz System, the Samsung E770, which is also the first VibeTonz enabled phone for a GSM network. The phone includes four VibeTonz-enabled games from four developers, allowing built-in exposure of our vibration capabilities for mobile gaming.

Korea s leading mobile phone operator, SK Telecom, launching a multimedia phone service based entirely on VibeTonz-enhanced content. Offered to its 20 million subscribers, VibeBell provides music clips synchronized with VibeTonz vibrations. Two handsets, Samsung SCH-B450 and SCH-B550, have shipped with support for VibeBell touch-enabled media. SK Telecom subscribers who have these handsets can browse a catalog of over 1,000 vibration-enhanced Korean and Western popular song clips and download them to use as custom ringtones.

LG Electronics, the world s top manufacturer of CDMA mobile handsets and fourth in the number of handsets sold worldwide, obtaining a worldwide license for VibeTonz technology.

Wireless content provider GeoTel signing a license agreement for the VibeTonz System to create touch-enabled games, ringtones, music, and other content for KTF, the second largest wireless carrier in Korea.

Automotive

In recent years there has been a proliferation of automotive sub-systems, which are directly accessed by drivers and passengers. These include telephone, navigation, climate controls, personal comfort, and audio, video, and satellite radio entertainment systems. As a result, there has been an increase in the number of physical control devices in the automotive center stack and console, creating space and driver distraction problems.

We have developed TouchSense technology for both rotary controls and touchscreens appropriate for use in automobiles. TouchSense rotary technology can consolidate the control of multiple systems into a single module that provides the appropriate feel for each function. This allows the driver convenient access to many systems and supplies context-sensitive cues for operation. TouchSense touchscreen technology provides tactile feedback for an otherwise unresponsive surface such as an all digital switch or touchscreen. Programmable haptic touchscreen, touch surface, and rotary controls of many types can be used to provide a space-saving, aesthetic look, and a confirming response for the driver that can help reduce glance time.

We have also conducted various funded development efforts and provided tools and evaluation licenses to several major automobile manufacturers and suppliers who have expressed interest in touch-enabled automobile controls.

BMW was the first automobile manufacturer to license our TouchSense rotary technology for use in controls starting with its 2002 7 Series sedan model. BMW has also included our technology in the Rolls Royce and in some models of its 5 Series and 6 Series starting in 2003 and 3 Series in 2005. Siemens VDO Automotive has licensed our technology for use in the high-end Volkswagen Phaeton sedan. ALPS Electric, also a licensee, has produced a haptic rotary control that has been included in the Mercedes-Benz S class sedan starting in the fall of 2005. Methode Electronics, Inc., a global designer and manufacturer of electronic component and subsystem devices, and Volkswagen, Europe s largest automaker, have both licensed TouchSense technology for use in vehicles.

In 2006, SMK Corporation of Tokyo, a global manufacturer of electromechnical components, licensed TouchSense technology for use in its touch panels, including for the automotive market.

For the years ended December 31, 2006, 2005, and 2004, 9%, 8%, and 8%, respectively, of our total revenues were automotive revenues.

3D and Mechanical CAD Design

Our three-dimensional and mechanical computer-aided design products allow users to create three-dimensional computer models directly from physical objects and also to precisely measure manufactured

Table of Contents

parts. These products include the MicroScribe product line, which contains sensor and microprocessor technologies that allow users to measure or digitize physical objects simply by tracing their contours with a stylus. Third-party software records the three-dimensional measurements or geometry of the object and reproduces it on the screen as a three-dimensional computer model. In another application, third-party software compares the desired dimensions to three-dimensional measurements of an actual part to determine if it is within tolerance. Taken together, these capabilities support high-accuracy parts inspection, reverse engineering, game development, animation, filmmaking, tube bending, and some medical applications.

We manufacture and sell the CyberGlove system, a fully instrumented glove that accurately measures the movement of a user s hand and, used in conjunction with our software, maps the movement to a graphical hand on the computer screen. Users can reach in and manipulate digital objects similar to physical objects. The CyberTouch system is a CyberGlove product with a vibro-tactile feedback option that provides users with appropriate feedback when individual fingers contact digital objects. The CyberGrasp system is an option for the CyberGlove product that adds kinesthetic force feedback to the fingertips. With a CyberGrasp system, users can actually feel the shape and malleability of 3D graphical objects being held in the fingertips and manipulated on the screen. The CyberForce product is an enhanced, grounded, force feedback product. Incorporating our TouchSense technologies, a CyberForce system allows users to experience sensations similar to the CyberGrasp, but with whole-arm, whole-hand, as well as fingertip interactions.

Our software products for our whole-hand interfaces include VirtualHand® SDK, VirtualHand for MotionBuilder, and VirtualHand for V5. VirtualHand SDK is a software toolkit that helps users integrate our whole-hand glove-based interface products into specific applications. VirtualHand for MotionBuilder lets users acquire, edit, and blend motion animation in Alias MotionBuilder real-time capture software. VirtualHand for V5 leverages our relationship with Dassault Systemes by bringing our glove-based products directly into the CATIA V5 and ENOVIA V5 environments, allowing for real-time interaction with digital prototypes for the evaluation of ergonomics, assembly, and maintainability of products. Users may develop multiple digital-design iterations to replace the need for physical prototypes, thereby reducing costs and time to market.

In addition to these 3D products, we manufacture and sell specialized products such as computer peripherals that are not touch-enabled, but incorporate related advanced computer peripheral technologies. These specialized peripherals include the SoftMouse®, a high performance, nonhaptic mouse optimized for use in geographic information systems and mapmaking.

For the years ended December 31, 2006, 2005, and 2004, 17%, 17%, and 19%, respectively, of our total revenues were generated from 3D and mechanical CAD design revenues.

Sales and Distribution

Sales of these products generally do not experience seasonal fluctuations, except for royalties from gaming peripherals, which tend to be significantly higher during the year-end holiday shopping season. However, there may be variations in the timing of revenue recognition from development contracts depending on numerous factors including contract milestones and operations scheduling. Our products typically incorporate readily available commercial components. There are no unusual working capital requirements in the Computing, Entertainment, and Industrial segment. See Management s Discussion and Analysis of Financial Condition and Results of Operations as well as the notes to the consolidated financial statements for revenue information for the past three years.

In the PC and video console gaming, mobility, and automotive markets, we establish licensing relationships through our business development efforts.

In mobility, sales relationships must be established with operators, handset manufacturers, and content developers worldwide. We have signed license agreements with mobile handset manufacturers for the incorporation of the VibeTonz System into certain mobile phone handsets. We have established relationships with CDMA platform developer QUALCOMM, Incorporated and with smartphone operating system developer Symbian, Ltd. Discussions are ongoing with other handset manufacturers, operators, and content developers in the United States, Europe, and Asia.

Table of Contents

We employ a direct sales force in the United States, Europe, and Asia to license our VibeTonz software products. In gaming, our sales force is also augmented through co-marketing arrangements. As part of our strategy to increase our visibility and promote our touch-enabling technology, our consumer-products license agreements generally require our licensees to display the TouchSense or VibeTonz technology logo on their end products.

We sell our touchscreen products to OEMs and system integrators, such as 3M Touch Systems, Advanced Input Systems, and StacoSwitch, using a worldwide direct sales force. In addition, the technology is licensed to large customers in automotive and other markets.

In the automotive market, we use a worldwide direct sales force to work with vehicle manufacturers and component suppliers. We have also licensed our technology to Methode, ALPS Electric, and SMK, leading automotive component suppliers, as part of our strategy to speed adoption of our TouchSense technologies across the automotive industry.

The MicroScribe product line, along with first- and third-party hardware accessories and companion software, is sold through an international network of over 75 resellers. In addition to direct sales, our 3D whole-hand interaction products are distributed, sold, and supported by a growing worldwide network of over 20 international and domestic resellers. We have marketing relationships or contracts with leading 3D CAD/CAM and interaction companies, including Dassault Systemes, a worldwide leader in product lifecycle management software.

Competition

With respect to touch-enabled consumer products, we are aware of several companies that claim to possess touch feedback technology applicable to the consumer market. In addition, we are aware of several companies that currently market unlicensed touch feedback products in consumer markets. We have been engaged in litigation with one of these companies (see Item 3. Legal Proceedings).

Several companies also currently market touch feedback products that are competitive to ours in nonconsumer markets. These companies could also shift their focus to the consumer market. In addition, our licensees or other companies may develop products that compete with products employing our touch-enabling technologies, but are based on alternative technologies, or develop technologies that are similar or superior to our technologies, duplicate our technologies, or design around our patents. Many of our licensees, including Microsoft, Logitech, Samsung, and others have greater financial and technical resources upon which to draw in attempting to develop computer peripheral or mobile phone technologies that do not make use of our touch-enabling technologies.

With respect to our MicroScribe product line, we believe the G2 model, aimed primarily at the design, animation, and reverse engineering markets, competes favorably with other digitizing technologies, such as laser scanning and sonic systems, and with other articulated arm models, which are all of higher accuracy and higher price than these markets generally require. The MicroScribe MX model, aimed at high-accuracy manufactured parts inspection and reverse engineering markets, competes favorably on price to other coordinate measurement machine (CMM) models manufactured by Faro Technologies and Romer CimCore, which is a part of Hexagon AB. It also competes favorably with these competitors for many types of projects where accuracy measurement tolerances are greater than 0.004-inch.

SensAble Technologies currently sells high-end 3D sculpting and design products that employ haptics. We believe that SensAble s products compete on some level with our 3D interaction products. Competitors to our CyberGlove data glove include Fifth Dimension Technologies, Measurand, Motion Analysis Corporation, and Phoenix Technologies.

For licensed applications, our competitive position is partially dependent on the competitive positions of our licensees that pay a per-unit royalty. Our licensees markets are highly competitive. We believe that the principal competitive factors in our licensees markets include price, performance, user-centric design, ease-of-use, quality, and timeliness of products, as well as the manufacturer s responsiveness, capacity, technical abilities, established customer relationships, retail shelf space, advertising, promotional programs, and brand recognition. Touch-related benefits in some of these markets may be viewed simply as enhancements and compete with nontouch-enabled technologies.

Table of Contents

Our failure to obtain or maintain adequate protection for our intellectual property rights for any reason could hurt our competitive position. There is no guarantee that patents will be issued from the patent applications that we have filed or may file. Our issued patents may be challenged, invalidated, or circumvented, and claims of our patents may not be of sufficient scope or strength, or issued in the proper geographic regions, to provide meaningful protection or any commercial advantage.

Immersion Medical

Products and Markets

We have developed numerous simulation technologies that can be used for medical training and testing. By enabling a medical simulator to more fully engage users sense of touch, our technologies can support realistic simulations that are effective in teaching medical students, doctors, and other health professionals what it feels like to perform a given procedure. The use of our simulators allows these professionals to perfect their practice in an environment that poses no risks to patients, where mistakes have no dire consequences, and where animal or cadaver use is minimized.

In addition, corporations wanting to train customers or sales staff on medical procedures and on the use of new tools and medical devices engage us to develop special simulators. Examples of projects we have completed for Medtronic, Inc., Laerdal Medical AS, Terumo Cardiovascular Systems Corporation and others include simulation of venous access, minimally invasive vein harvesting, hysteroscopy, and aortic valve and pacemaker implantation.

We have four medical simulation product lines: the Virtual IV system, which simulates needle-based procedures such as intravenous catheterization and phlebotomy; the Endoscopy AccuTouch® System, which simulates endoscopic procedures, including bronchoscopy and lower and upper GI procedures; the CathLabVR™ System, which simulates endovascular interventions including cardiac pacing, angiography, angioplasty, and carotid and coronary stent placement; and the LapVR™ System, which simulates minimally invasive procedures involving abdominal and pelvic organs.

These systems are used for training and educational purposes to enable health professionals to feel simulated forces that they would experience during actual medical procedures, such as encountering an unexpected obstruction in an artery. The systems provide a realistic training environment augmented by real-time graphics that include anatomic models developed from actual patient data and high-fidelity sound that includes simulated patient responses.

All our products are comprised of a hardware system, an interface device, and software modules that include several cases of increasing difficulty, allowing users to develop their skills by experiencing a broad range of pathologies in differing anatomical conditions.

We design each product line to maximize the number of procedures that can be simulated with minimal additional customer hardware investment. These systems then enable potential additional sales of software to the installed base of hardware systems. We believe the relatively low price of our software modules provides an opportunity for repeat sales. We currently have over 25 various software modules available that replicate such medical procedures as intravenous catheterization, peripherally inserted central catheters (PICC), bronchoscopy, colonoscopy, cardiac pacing, and carotid and coronary angioplasty.

Sales and Distribution

Sales of these products may experience seasonal fluctuations related to teaching hospitals summer residency programs. In addition, there may be variations in timing of revenue recognition from the sale of systems with upgrade

rights and from development contracts. The latter may depend on numerous factors including contract milestones and timing of work performed against the contract. Most raw materials used in the manufacturing of our products are readily available commercial components. There are no unusual working capital requirements in the Medical segment. See Management s Discussion and Analysis of Financial Condition and Results of Operations as well as the notes to the consolidated financial statements for revenue information for the past three years.

Table of Contents

With respect to medical simulation products, we employ a direct sales force in the U.S. that markets simulation systems to hospitals, colleges and universities, nursing schools, medical schools, emergency medical technician training programs, the military, medical device companies, and other organizations involved in procedural medicine. We have seven regional medical sales representatives in the United States. We also have one independent sales representative in Europe and 28 resellers outside the U.S.

For the years ended December 31, 2006, 2005, and 2004, 51%, 40%, and 42%, respectively, of our total revenues were generated from medical revenues. For the years ended December 31, 2006, 2005, and 2004, 18%, 11%, and 17%, respectively, of our total revenues consisted of licensing, product revenue, or development revenues from Medtronic.

Competition

There are several companies that currently sell simulation products to medical customers. Some simulators target the same minimally invasive procedures as do ours, while others sell mannequin-based systems for emergency response training. All simulators compete at some level for the same funding in medical institutions. Competitors include Simbionix USA Corporation, Mentice Corporation, Medical Education Technologies, Inc., and Medical Simulation Corporation. The principal competitive factors are the type of medical procedure being simulated, technological sophistication, and price. We believe we compete favorably on all three.

Research and Development

Our success depends on our ability to invent, improve, and reduce the cost of our technologies, design and develop products to meet specifications based on research and our understanding of customer needs and expectations, and interact with our licensees who are integrating our technologies into theirs.

Immersion Engineering. We have assembled a multi-disciplinary team of highly skilled engineers and scientists with the experience required for development of touch-enabling technology. The team s experience includes skills related to mechanical engineering, electrical engineering, embedded system and firmware, control techniques, software, quality control, haptic content design, and project and process management. For medical simulations, we have assembled a unique team of experts who are skilled at modeling the anatomy and physiology of various medical cases, creating graphical renderings, designing haptic feedback, and devising advanced control algorithms to simulate realistic navigation for medical procedures, such as through the body s blood vessels.

Application Engineering & Technical Support. We may provide application engineering and technical support during integration of our touch-enabling technology into customer products. To facilitate the validation and adoption of touch-enabling technology, we have developed various integration kits. These kits may include actuators or actuator references, mounting samples, controller boards or schematics, software libraries and source code samples, and documentation. Our application engineers support customer use of these integration kits through phone and e-mail technical support, onsite workshops, or other means. Our application engineers and technical support staff may also help install Immersion products, train customers on their use, and provide ongoing product support, particularly for the medical training simulators and 3D products.

Licensee Interaction. To support the successful design and adoption of our technology in a licensee s product, we make efforts to ensure clear communication with our customers. Typically, collaborative development efforts are structured using a four-phase approach including Product Definition, Concept Development, Detail Design, and Production Design phases. This four-phase design process is typically used for designing new systems when the solution is not known beforehand. Each phase includes formal design reviews and documentation. The continuation of

our development effort is contingent upon successful completion and acceptance of prior phases. This method ensures that the customer s financial risk is minimized and that project deliverables remain consistent with the goals established in the Product Definition phase.

Product Development Process. For product development, we follow a product design process based on ISO 9001 guidance. This process starts with the typical marketing and product requirement stages, and once approved, moves on to product planning and design, prototyping, then alpha, beta, and first-run production development and testing stages. All these stages are supported by documentation procedures and tools, design reviews, revision

Table of Contents

management, and other quality criteria. This process helps us to decide to continue product development to reach the end product and to meet our published quality requirement, and also matches the quality and development expectations of our large accounts.

Our research and development efforts have been focused on technology development, including hardware, software, control algorithms, and design. We have entered into numerous contracts with corporations and government agencies that help fund advanced research and development. Our government contracts permit us to retain ownership of the technology developed under the contracts, provided that we supply the applicable government agency a license to use the technology for noncommercial purposes.

For the years ended December 31, 2006, 2005, and 2004, our research and development expenses were $7.6 million, $6.0 million, and $8.0 million, respectively.

Intellectual Property

We believe that intellectual property protection is crucial to our business. We rely on a combination of patents, copyrights, trade secrets, trademarks, nondisclosure agreements with employees and third-parties, licensing arrangements, and other contractual agreements with third parties to protect our intellectual property.

We and our wholly owned subsidiaries hold more than 600 issued or pending patents in the U.S. and other countries covering various aspects of our hardware and software technologies. Some of our current U.S. patents begin to expire starting in 2007.

Where we feel it is appropriate, we will engage the legal system to protect our intellectual property rights. For example, we filed a complaint against Sony Computer Entertainment, Inc. and Sony Computer Entertainment of America, Inc. (collectively Sony Computer Entertainment) on February 11, 2002 in the U.S. District Court for the Northern District Court of California. On September 21, 2004, a jury returned a verdict favorable to us in our patent infringement suit against Sony Computer Entertainment. Judgment was entered in our favor and we were awarded $82.0 million in past damages, and pre-judgment interest in the amount of $8.9 million, for a total of $90.9 million. Additionally, the Court issued a permanent injunction (stayed pending appeal) against the manufacture, use, sale, or import into the United States of the infringing Sony PlayStation system. Sony Computer Entertainment had appealed the judgment to the United States Court of Appeals for the Federal Circuit. On March 1, 2007, Immersion and Sony Computer Entertainment announced that the companies agreed to conclude their patent litigation at the U.S. Court of Appeals for the Federal Circuit. They also agreed to enter into a new business agreement to explore the inclusion of our technology in PlayStation format products. See Item 3. Legal Proceedings for further details and discussion of the litigation proceedings and resolution.

Investor Information

You can access financial and other information in the Investor Relations section of our Web site at www.immersion.com. We make available, on our Web site, free of charge, copies of our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act as soon as reasonably practicable after filing such material electronically or otherwise furnishing it to the SEC.

The charters of our audit committee, our compensation committee, and our nominating committee, and our code of Business Conduct and Ethics (including code of ethics provisions that apply to our principal executive officer, principal financial officer, controller, and senior financial officers) are also available at our Web site under Corporate Governance. These items are also available to any stockholder who requests them by calling +1 408.467.1900.

The SEC maintains an Internet site that contains reports, proxy, and information statements, and other information regarding issuers that file electronically with the SEC at www.sec.gov.

Table of Contents

Employees

As of December 31, 2006, we had 140 full-time and 5 part-time employees, including 54 in research and development, 42 in sales and marketing, and 49 in legal, finance, administration, and operations. As of that date, we also had 11 independent contractors. None of our employees is represented by a labor union, and we consider our employee relations to be positive.

Executive Officers

The following table sets forth information regarding our executive officers as of March 1, 2007.

Name	Position with the Company	Age
Victor Viegas	President, Chief Executive Officer, and Director	49
Stephen Ambler	Chief Financial Officer and Vice President, Finance	47
Richard Vogel	Senior Vice President and General Manager, Immersion Medical	53

Mr. Victor Viegas has served as our Chief Executive Officer, President, and member of the Board of Directors since October 2002. From February 2002 to February 2005, he also served as President, Chief Operating Officer, and Chief Financial Officer having joined Immersion in August 1999 as Chief Financial Officer, Vice President, Finance. From June 1996 to August 1999, he served as Vice President, Finance and Administration and Chief Financial Officer of Macrovision Corporation, a developer and licensor of video and software copy protection technologies. From October 1986 to June 1996, he served as Vice President of Finance and Chief Financial Officer of Balco Incorporated, a manufacturer of advanced automotive service equipment. He holds a Bachelor of Science degree in Accounting and a Master of Business Administration degree from Santa Clara University. Mr. Viegas is also a Certified Public Accountant in the State of California.

Mr. Stephen Ambler joined Immersion in February 2005 as Chief Financial Officer and Vice President, Finance responsible for finance, operations, and human resources. From April 2001 to January 2005, Mr. Ambler served as Chief Financial Officer and Vice President, Finance of Bam! Entertainment, Inc., a producer of interactive video games. From April 1994 to March 2001, he served as Director of Finance and Administration for Europe and then Chief Financial Officer, Secretary, and Senior Vice President, Finance of Insignia Solutions PLC, a wireless solutions software company. From December 1992 to March 1994, he served as Financial Controller and Company Secretary for Ampex Great Britain Limited, a producer of recording equipment and magnetic tape for the television and defense industries. From May 1988 to December 1992, he served as Financial Controller and then Finance Director of Carlton Cabletime Limited, a supplier of cable television equipment. Mr. Ambler holds a diploma in Accounting Studies from Oxford Polytechnic in England and is qualified as a Chartered Accountant in England and Wales.

Mr. Richard Vogel joined Immersion in March 2004 as Senior Vice President and General Manager of our wholly owned subsidiary, Immersion Medical, in Gaithersburg, Maryland. From September 2000 to February 2004, Mr. Vogel served as President and Chief Executive Officer of SpectraLife, a medical device company specializing in products for the management of diabetes. From July 1996 to August 2000, he served as Senior Vice President and General Manager of the New Technologies Division of Kinetic Concepts, Inc., a manufacturer of electronic medical devices and specialty surfaces for surgery and wound care. From November 1989 to February 1996, he served as Vice President, European Operations and Chief Operating Officer of Vestar, Inc. a biopharmaceutical company specializing in anti-infectives and oncology products. From August 1983 to November 1989, Mr. Vogel served in a variety of

general managerial positions of increasing responsibility for the Lederle (pharmaceuticals) and Davis & Geck (medical devices) divisions of the American Cyanamid Company. Mr. Vogel holds a Bachelor of Arts degree from Middlebury College in Vermont and a Master of Business Administration degree from the Harvard Business School.

Table of Contents

Item 1A. ***Risk Factors***

You should carefully consider the following risks and uncertainties, as well as other information in this report and our SEC filings, before you invest in our common stock. Investing in our common stock involves risk. If any of the following risks or uncertainties actually occur, our business, financial condition, or results of operations could be materially adversely affected. The following risks and uncertainties are not the only ones facing us. Additional risks and uncertainties of which we are unaware or that we currently believe are immaterial could also materially adversely affect our business, financial condition, or results of operations. In any case, the trading price of our common stock could decline, and you could lose all or part of your investment. See also the Forward-looking Statements discussion in Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations.

Factors That May Affect Future Results

Company Risks

We had an accumulated deficit of $137 million as of December 31, 2006, have a history of losses, will experience losses in the future, and may not achieve or maintain profitability.

Since 1997, we have incurred losses in every fiscal quarter. We will need to generate significant ongoing revenue to achieve and maintain profitability. We anticipate that our expenses will increase in the foreseeable future as we:

protect and enforce our intellectual property;

continue to develop our technologies;

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

increase our sales and marketing efforts; and

pursue strategic relationships.

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

Our current litigation undertakings are expensive, disruptive, and time consuming, and will continue to be, until resolved, and regardless of whether we are ultimately successful, could adversely affect our business.

We are involved in litigation with Internet Services LLC (ISLLC), a cross-claim defendant in the lawsuit against Sony Computer Entertainment. ISLLC s appeal from the lawsuit judgment had been consolidated with Sony Computer Entertainment s appeal of the lawsuit judgment against it at the United States Court of Appeals for the Federal Circuit. We are also litigating a separate lawsuit involving claims for breach of contract and rescission against ISLLC in the U.S. District Court for the Northern District of California.

In addition, we are involved in litigation with Mr. Craig Thorner in the U.S. District Court for the Northern District of California relating to our allegations of breach of contract with respect to Thorner s license to a third party of

U.S. Patent No. 5,684,722 and his allegations of breach of contract, breach of the implied covenant of good faith and fair dealing, promissory fraud, breach of fiduciary duty, negligent misrepresentation, and rescission.

Due to the inherent uncertainties of litigation, we cannot accurately predict how these cases will ultimately be resolved. We anticipate that the litigation will continue to be costly, and there can be no assurance that we will be able to recover the costs we incur in connection with the litigation. We expense litigation costs as incurred, and only accrue for costs that have been incurred but not paid to the vendor as of the financial statement date. The litigation has diverted, and is likely to continue to divert, the efforts and attention of some of our key management and personnel. As a result, until such time as it is resolved, the litigation could adversely affect our business. Further, any unfavorable outcome could adversely affect our business. For additional background on litigation, please see Note 19 to the condensed consolidated financial statements and the section titled Item 3. Legal Proceedings.

Table of Contents

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

Intellectual property litigation, whether brought by us or by others against us, has caused us to expend, and may cause us to expend in future periods, significant financial resources as well as divert management s time and efforts. From time to time, we initiate claims against third parties that we believe infringe our intellectual property rights. We intend to enforce our intellectual property rights vigorously and may initiate litigation against parties that we believe are infringing our intellectual property rights if we are unable to resolve matters satisfactorily through negotiation. Litigation brought to protect and enforce our intellectual property rights could be costly, time-consuming, and distracting to management and could result in the impairment or loss of portions of our intellectual property. In addition, any litigation in which we are accused of infringement may cause product shipment delays, require us to develop non-infringing technologies, or require us to enter into royalty or license agreements even before the issue of infringement has been decided on the merits. If any litigation were not resolved in our favor, we could become subject to substantial damage claims from third parties and indemnification claims from our licensees. We and our licensees 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 could not develop non-infringing technologies or license the infringed or similar technologies on a timely and cost-effective basis, our expenses would increase and our revenues could decrease.

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

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

The legal principles applicable to patents and patent licenses continues to change and evolve. 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.

Table of Contents

The terms in our agreements may be construed by our licensees in a manner that is inconsistent with the rights that we have granted to other licensees, or in a manner that may require us to incur substantial costs to resolve conflicts over license terms.

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

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

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

Product liability claims could be time-consuming and costly to defend and could expose us to loss.

Our products or our licensees products may have flaws or other defects that may lead to personal or other injury claims. If products that we or our licensees sell cause personal injury, property injury, financial loss, or other injury to our or our licensees customers, the customers or our licensees may seek damages or other recovery from us. Any claims against us would be time-consuming, expensive to defend, and distracting to management, and could result in damages and injure our reputation, the reputation of our technology and services, and/or the reputation of our products, or the reputation of our licensees or their products. This damage could limit the market for our and our licensees products and harm our results of operations.

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

If the settlement on our current class action lawsuit falls through, the continuing lawsuit could be expensive, disruptive, and time consuming to defend against, and if we are not successful, could adversely affect our business.

We are involved in legal proceedings relating to a class action lawsuit filed on November 9, 2001, related to In re Initial Public Offering Securities Litigation. The named defendants are Immersion and three of our current or former officers or directors and certain underwriters of our November 12, 1999 IPO. Subsequently, two of the individual defendants stipulated to a dismissal without prejudice. We and most of the issuer defendants have settled with the plaintiffs. However, the settlement requires approval by the Court, which cannot be assured, after class members are given the opportunity to object to the settlement or opt out of the settlement.

If our facilities were to experience catastrophic loss, our operations would be seriously harmed.

Our facilities could be subject to a catastrophic loss such as fire, flood, earthquake, power outage, or terrorist activity. A substantial portion of our research and development activities, manufacturing, our corporate headquarters, and other critical business operations are located near major earthquake faults in San Jose, California, an area with a history of seismic events. An earthquake at or near our facilities could disrupt our operations, delay

Table of Contents

production and shipments of our products or technologies, and result in large expenses to repair and replace the facility. While we believe that we maintain insurance sufficient to cover most long-term potential losses at our facilities, our existing insurance may not be adequate for all possible losses. In addition, California has experienced problems with its power supply in recent years. As a result, we have experienced utility cost increases and may experience unexpected interruptions in our power supply that could have a material adverse effect on our sales, results of operations, and financial condition.

Industry and Technology Risks

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

A key part of our business strategy is to license our intellectual property to companies that manufacture and sell products incorporating our touch-enabling technologies. Sales of those products generate royalty and license revenue for us. For the years ended December 31, 2006, 2005, and 2004, 26%, 37%, and 37%, respectively, of our total revenues were royalty and license revenues. However, we do not control or influence the design, manufacture, quality control, promotion, distribution, or pricing of products that are manufactured and sold by our licensees. In addition, we generally do not have commitments from our licensees that they will continue to use our technologies in current or future products. As a result, products incorporating our technologies may not be brought to market, meet quality control standards, achieve commercial acceptance, or generate meaningful royalty revenue for us. For us to generate royalty revenue, licensees that pay us per-unit royalties must manufacture and distribute products incorporating our touch-enabling technologies in a timely fashion and generate consumer demand through marketing and other promotional activities. Products incorporating our touch-enabling technologies are generally more difficult to design and manufacture, which may cause product introduction delays or quality control problems. If our licensees fail to stimulate and capitalize upon market demand for products that generate royalties for us, or if products are recalled because of quality control problems, our revenues will not grow and could decline. Alternatively, if a product that incorporates our touch-enabling technologies achieves widespread market acceptance, the product manufacturer may elect to stop making it rather than pay us royalties based on sales of the product.

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

Most of our current gaming royalty revenues come from third-party peripheral makers who make licensed gaming products designed for use with popular video game console systems from Microsoft, Sony, and Nintendo. Video game console systems are closed, proprietary systems, and video game console system makers typically impose certain requirements or restrictions on third-party peripheral makers who wish to make peripherals that will be compatible with a particular video game console system. These requirements and restrictions could be in the form of hardware technical specifications, software technical specifications, security specifications or other security mechanisms, component vendor specifications, licensing terms and conditions, or other forms. If third-party peripheral makers cannot or are not allowed to obtain or satisfy these requirements or restrictions, our gaming royalty revenues could be significantly reduced. Furthermore, should a significant video game console maker choose to omit touch-enabling capabilities from its console system or somehow restrict or impede the ability of third parties to make touch-enabling peripherals, it may very well lead our gaming licensees to stop making products with touch-enabling capabilities, thereby significantly reducing our gaming royalty revenues. Sony removed the vibration feature that was available on the PlayStation and PlayStation 2 systems from the new PlayStation 3 system. This course of action by Sony may have material adverse consequences on our current and future gaming royalty revenues since our gaming royalties

have primarily been from licensed third-party controller products with vibration or force feedback capabilities that require some degree of vibration and/or force feedback support or compatibility in the video console system to be viable products. We do not know if this situation might

Table of Contents

change in the life of the PlayStation 3 console system, or whether or to what extent the PlayStation 3 console will be compatible with third-party peripherals containing force feedback capability in the future.

Both the recently launched Microsoft Xbox 360 and Nintendo Wii include touch-enabling capabilities. For the Microsoft Xbox 360 video console system launched in November 2005, Microsoft has, to date, not yet broadly licensed third parties to produce peripherals for its Xbox 360 game console and has excluded third parties from producing Xbox 360 wireless controllers. Wireless game controllers account for a significant portion of our royalty revenue, including revenue from Logitech and Mad Catz. To the extent Microsoft does not license these rights to third parties, Microsoft s share of all aftermarket game controller sales will likely remain high or increase, which we expect will result in a decrease in our gaming royalty revenue. Additionally, Microsoft is now making touch-enabled wheels covered by their royalty-free, perpetual, irrevocable license to our worldwide portfolio of patents that are in competition with our licensees products for which we earn per unit royalties.

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

Under the terms of our present agreement with Microsoft, Microsoft receives a royalty-free, perpetual, irrevocable license to our worldwide portfolio of patents. This license permits Microsoft to make, use, and sell hardware, software, and services, excluding specified products, covered by our patents. We also granted to Microsoft a limited right, under our patents relating to touch technologies, to sublicense specified rights, excluding rights to excluded products and peripheral devices, to third-party customers of Microsoft s or Microsoft s subsidiaries products (other than Sony Corporation, Sony Computer Entertainment Inc., Sony Computer Entertainment of America Inc., and their subsidiaries). In exchange, for the grant of these rights and the rights included in a separate Sublicense Agreement, Microsoft paid us a one-time payment of $20.0 million. We will not receive any further revenues or royalties from Microsoft under our current agreement with Microsoft. Microsoft has a significant share of the market for touch-enabled console gaming computer peripherals and is pursuing other consumer markets such as mobile phones, PDAs, and portable music players Microsoft has significantly greater financial, sales, and marketing resources, as well as greater name recognition and a larger customer base than some of our other licensees. In the event that Microsoft increases its share of these markets, our royalty revenue from other licensees in these market segments might decline.

We generate revenues from touch-enabling components that are sold and incorporated into third- party products. We have little or no control or influence over the design, manufacturing, promotion, distribution, or pricing of those third- party products.

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

Medtronic accounts for a significant portion of our revenues and a reduction in sales to Medtronic, or a reduction in development work for Medtronic, may reduce our total revenue.

Medtronic accounts for a significant portion of our revenue. For the years ended December 31, 2006, 2005, and 2004, 18%, 11%, and 17%, respectively, of our total revenues were derived from Medtronic. If our product sales to Medtronic decline, and/or Medtronic reduces the development activities we perform, then our total revenue may decline.

Table of Contents

Logitech accounts for a significant portion of our revenue and the failure of Logitech to achieve sales volumes for its gaming peripheral products that incorporate our touch-enabling technologies may reduce our total revenue.

Logitech accounts for a significant portion of our revenue. Logitech is a supplier of aftermarket game console controllers, joysticks, and steering wheels, many of which incorporate our technology. In the past, during transitions to next-generation console systems, sales of aftermarket game console controllers have dropped significantly, reducing licensing royalties we earn. The gaming industry is currently transitioning to the latest next-generation console systems, and we have experienced a significant decline in revenues we earn from Logitech since this transition commenced. For the years ended December 31, 2006, 2005, and 2004, 6%, 11%, and 10%, respectively, of our total revenues were derived from Logitech. Revenues from Logitech may decline further if its aftermarket game console peripheral sales decline further, or if it is unable to obtain or expand its license rights to sell touch-enabled controllers, steering wheels, or joysticks for the Sony PlayStation 3, the Nintendo Wii, or the Microsoft Xbox 360. Also, competition with Microsoft may dampen demand for Logitech products. Any decrease in sales of aftermarket peripherals that include our technology by Logitech will reduce our gaming royalty revenues. Sony s decision not to include certain vibration features in the PlayStation 3 system may significantly adversely affect Logitech s ability or desire to include our technologies in products compatible with the PlayStation 3, which in return may materially adversely affect our royalty revenue from Logitech.

Touch interface product royalties will be reduced if BMW were to abandon its iDrive system or remove our technology from the iDrive.

Our largest royalty stream from touch interface products is currently from BMW for its iDrive controller. Press reviews of this system have been largely negative and critical of the system s complex user interface, which we did not design. Nevertheless, this negative press may cause BMW to abandon the iDrive controller or to redesign it and/or remove our technology from it at any time. If our technology is not incorporated in the BMW vehicles our business may suffer.

We depend on third-party suppliers, and our revenue and/or results of operations could suffer if we fail to manage supplier issues properly.

Our operations depend on our ability to anticipate our needs for components and products for a wide variety of systems, products, and services, and on our suppliers ability to deliver sufficient quantities of quality components, products, and services at reasonable prices in time for us to meet critical schedules. We may experience a shortage of, or a delay in receiving, certain supplies as a result of strong demand, capacity constraints, supplier financial weaknesses, disputes with suppliers, other problems experienced by suppliers, or problems faced during the transition to new suppliers. If shortages or delays persist, the price of these supplies may increase, we may be exposed to quality issues, or the supplies may not be available at all. We may not be able to secure enough supplies at reasonable prices or of acceptable quality to build products or provide services in a timely manner in the quantities or according to the specifications needed. We could lose time-sensitive sales, incur additional freight costs, or be unable to pass on price increases to our customers. If we cannot adequately address supply issues, we might have to reengineer some products or service offerings, resulting in further costs and delays. We intend to purchase certain products from a limited source in China. If the supply of these products were to be delayed or constrained, or of insufficient quality, we may be unable to find a new supplier on acceptable terms, or at all, or our ability to ship these new products could be delayed, any of which could harm our business, financial condition, and operating results.

Additionally, our use of single source suppliers for certain components could exacerbate our supplier issues. We obtain a significant number of components from single sources due to technology, availability, price, quality, or other considerations. In addition, new products that we introduce may use custom components obtained from only one

source initially, until we have evaluated whether there is a need for additional suppliers. The performance of such single source suppliers may affect the quality, quantity, and price of supplies to us. Accordingly, our revenue and/or results of operations could be adversely impacted by such events.

Table of Contents

Compliance with new directives that restrict the use of certain materials may increase our costs and limit our revenue opportunities.

On July 1, 2006, the European Union s RoHS Directive became effective. This Directive eliminates most uses of lead, cadmium, hexavalent-chromium, mercury, and certain fire retardants in electronics placed on the market after the effective date. Since the introduction of the European Union s RoHS Directive, other regions of the world have announced or implemented similar regulations. In order to sell products into regions that adopt these or similar regulations, we have to assess each product and determine whether they comply with the requirements of the regulations or whether they are exempt from meeting the requirements of the regulations. If we determine that a product is not exempt and does not comply with adopted regulations, we will have to make changes to the product or its documentation if we want to sell that product into the region once the regulations become effective. Making such changes may be costly to perform and may have a negative impact on our results of operations. In addition, there can be no assurance that the national enforcement bodies of the regions adopting such regulations will agree with our assessment that certain of our products and documentation comply with or are exempt from the regulations. If products are determined not to be compliant or exempt, we will not be able to ship them in the region that adopts such regulations until such time that they are compliant, and this may have a negative impact on our revenue and results of operations.

Because personal computer peripheral products that incorporate our touch-enabling technologies currently must work with Microsoft s operating system software, our costs could increase and our revenues could decline if Microsoft modifies its operating system software.

Our hardware and software technologies for personal computer peripheral products that incorporate our touch-enabling technologies are currently compatible with Microsoft s Windows 2000, Windows Me, and Windows XP operating systems, including DirectX, Microsoft s entertainment API. Modifications and new versions of Microsoft s operating system and APIs (including DirectX and the Windows Vista launched in early 2007) may require that we and/or our licensees modify the touch-enabling technologies to be compatible with Microsoft s modifications or new versions, and this could cause delays in the release of products by our licensees. If Microsoft modifies its software products in ways that limit the use of our other licensees products, our costs could increase and our revenues could decline.

Reduced spending by corporate or university research and development departments may adversely affect sales of our three-dimensional products.

Any economic downturn could lead to a reduction in corporate or university budgets for research and development in sectors, including the automotive and aerospace sectors, which use our three-dimensional and professional products. Sales of our three-dimensional and professional products, including our CyberGlove line of whole-hand sensing gloves and our MicroScribe line of digitizers, could be adversely affected by cuts in corporate research and development budgets.

Competition between our products and our licensees products may reduce our revenue.

Rapid technological change, short product life cycles, cyclical market patterns, declining average selling prices, and increasing foreign and domestic competition characterize the markets in which we and our licensees compete. We believe that competition in these markets will continue to be intense and that competitive pressures will drive the price of our products and our licensees products downward. These price reductions, if not offset by increases in unit sales or productivity, will cause our revenues to decline.

We face competition from unlicensed products as well. Our licensees or other third parties may seek to develop products using our intellectual property or develop alternative designs that attempt to circumvent our intellectual property, which they believe do not require a license under our intellectual property. These potential competitors may have significantly greater financial, technical, and marketing resources than we do, and the costs associated with asserting our intellectual property rights against such products and such potential competitors could be significant. Moreover, if such alternative designs were determined by a court not to require a license under our intellectual property rights, competition from such unlicensed products could limit or reduce our revenues.

Table of Contents

We have experienced significant change in our business, and our failure to manage the complexities associated with the changing economic environment and technology landscape could harm our business.

Any future periods of rapid economic and technological change may place significant strains on our managerial, financial, engineering, and other resources. Our failure to effectively manage these resources during periods of rapid economic or technological change may harm our business.

The market for certain touch-enabling technologies and touch-enabled products is at an early stage and if market demand does not develop, we may not achieve or sustain revenue growth.

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

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

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

If we fail to increase sales of our medical simulation devices, our financial condition and operations may suffer.

Many medical institutions do not budget for simulation devices. To increase sales of our simulation devices, we must, in addition to convincing medical institution personnel of the usefulness of the devices, persuade them to include a significant expenditure for the devices in their budgets. If these medical institutions are unwilling to budget for simulation devices or reduce their budgets as a result of cost-containment pressures or other factors, we may not be able to increase or maintain sales of medical simulators at a satisfactory rate. A decrease in sales or any failure to increase sales of our medical simulation products will harm our business.

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

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

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

- the fact that we may compete with the internal design teams of existing and potential licensees;

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

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

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

Table of Contents

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

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

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

difficulty in signing new gaming licensees given the fact that Sony has not included vibration features in the PlayStation 3 or related products; and

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

A majority of our current royalty revenue has been derived from the licensing of our portfolio of touch-enabling technologies for video game console and personal computer gaming peripherals, such as gamepads, joysticks, and steering wheels. Though substantially smaller than the market for dedicated gaming console peripherals, the market for gamepads, joysticks, and steering wheels for use with personal computers is declining and is characterized by declining average selling prices. If the console peripheral market also experiences declines in sales and selling prices, we may not achieve royalty revenue growth.

If we fail to protect and enforce our intellectual property rights, our ability to license our technologies and generate revenues would be impaired.

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

our pending patent applications may not result in the issuance of patents;

our patents may not be broad enough to protect our proprietary rights; and

effective patent protection may not be available in every country in which we or our licensees do business.

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

laws and contractual restrictions may not be sufficient to prevent misappropriation of our technologies or deter others from developing similar technologies; and

policing unauthorized use of our patented technologies, trademarks, and other proprietary rights would be difficult, expensive, and time-consuming, particularly outside of the United States of America.

Certain terms or rights granted in our license agreements or our development contracts may limit our future revenue opportunities.

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

Table of Contents

If we are unable to continually improve and reduce the cost of our technologies, companies may not incorporate our technologies into their products, which could impair our revenue growth.

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

If we fail to develop new or enhanced technologies for new applications and platforms, we may not be able to create a market for our technologies or our technologies may become obsolete, and our ability to grow and our results of operations might be harmed.

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

we fail to develop new technologies or products;

the technologies we develop infringe on third-party patents or other third-party rights;

our new technologies fail to gain market acceptance; or

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

We have limited engineering, quality assurance and manufacturing resources to design and fulfill timely product deliverables and deliver 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, quality assurance, and manufacturing resources are deployed against a variety of different projects and programs to provide sufficient levels of quality necessary for channels and customers. Success in various markets may depend on timely deliveries and overall levels of sustained quality. Failure to provide product and program deliverables and quality levels in a timely way, or at all, may disrupt channels and customers and reduce our revenues.

The higher cost of products incorporating our touch-enabling technologies may inhibit or prevent their widespread adoption.

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

Third-party validation studies may not demonstrate all the benefits of our medical training simulators, which could affect customer motivation to buy.

In medical training, validation studies are generally used to confirm the usefulness of new techniques, devices, and training methods. For medical training simulators, several levels of validation are generally tested: content, concurrent, construct, and predictive. A validation study performed by a third party, such as a hospital, a teaching institution, or even an individual healthcare professional, could result in showing little or no benefit for one or more types of validation for our medical training simulators. Such validation study results published in medical journals could impact the willingness of customers to buy our training simulators, especially new simulators that have not

Table of Contents

previously been validated. Due to the time generally required to complete and publish additional validation studies (usually more than a year), the negative impact on sales revenue could be significant.

Medical licensing and certification authorities may not recommend or require use of our technologies for training and/or testing purposes, significantly slowing or inhibiting the market penetration of our medical simulation technologies.

Several key medical certification bodies, including the American Board of Internal Medicine (ABIM) and the American College of Cardiology (ACC), have great influence in recommending particular medical methodologies, including medical training and testing methodologies, for use by medical professionals. In the event that the ABIM and the ACC, as well as other, similar bodies, do not endorse medical simulation products in general, or our products in particular, as a training and/or testing tool, market penetration for our products could be significantly and adversely affected.

We have limited distribution channels and resources to market and sell our medical simulators, touch interface products, and three-dimensional simulation and digitizing products, and if we are unsuccessful in marketing and selling these products, we may not achieve or sustain product revenue growth.

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

Competition in the medical market may reduce our revenue.

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

Competition in the mobility or touchscreen markets may increase our costs and reduce our revenue.

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

Automobiles incorporating our touch-enabling technologies are subject to lengthy product development periods, making it difficult to predict when and whether we will receive per unit automotive royalties.

The product development process for automobiles is very lengthy, sometimes longer than four years. We do not earn per unit royalty revenue on our automotive technologies unless and until automobiles featuring our technologies are shipped to customers, which may not occur until several years after we enter into an agreement with an automobile manufacturer or a supplier to an automobile manufacturer. Throughout the product development process, we face the risk that an automobile manufacturer or supplier may delay the incorporation of, or

Table of Contents

choose not to incorporate, our technologies into its automobiles, making it difficult for us to predict the per unit automotive royalties we may receive, if any. After the product launches, our royalties still depend on market acceptance of the vehicle or the option packages if our technology is an option (for example, a navigation unit), which is likely to be determined by many factors beyond our control.

We might be unable to retain or recruit necessary personnel, which could slow the development and deployment of our technologies.

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

We believe that our future success will also depend largely on our ability to attract, integrate, and retain sales, support, marketing, and research and development personnel. Competition for such personnel is intense, and we may not be successful in attracting, integrating, and retaining such personnel. Given the protracted nature of if, how, and when we collect royalties on new design contracts, it may be difficult to craft compensation plans that will attract and retain the level of salesmanship needed to secure these contracts. Our stock option program is a long-term retention program that is intended to attract, retain, and provide incentives for talented employees, officers and directors, and to align stockholder and employee interests. Our stock option plan expires in June of 2007. The adoption of a new stock plan requires stockholder approval. Additionally some of our executive officers and key employees hold stock options with exercise prices considerably above the current market price of our common stock. Each of these factors may impair our ability to retain the services of our executive officers and key employees. Our technologies are complex and we rely upon the continued service of our existing engineering personnel to support licensees, enhance existing technologies, and develop new technologies.

Investment Risks

Our convertible debentures provide for various events of default and change of control transactions that would entitle the selling stockholders to require us to repay the entire amount owed in cash. If an event of default or change of control occurs, we may be unable to immediately repay the amount owed, and any repayment may leave us with little or no working capital in our business.

Our convertible debentures provide for various events of default, such as the termination of trading of our common stock on the Nasdaq Global Market and specified change of control transactions. If an event of default or change of control occurs prior to maturity, we may be required to redeem all or part of the convertible debentures, including payment of applicable interest and penalties. Some of the events of default include matters over which we may have some, little, or no control. Many other events of default are described in the agreements we executed when we issued the convertible debentures. If an event of default or a change of control occurs, we may be required to repay the entire amount, plus liquidated damages, in cash. Any such repayment could leave us with little or no working capital for our business. We have not established a sinking fund for payment of our outstanding convertible debentures, nor do we anticipate doing so.

Our quarterly revenues and operating results are volatile, and if our future results are below the expectations of public market analysts or investors, the price of our common stock is likely to decline.

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

These factors include:

- the establishment or loss of licensing relationships;
- the timing and recognition of payments under fixed and/or up-front license agreements;

Table of Contents

the timing of work performed under development agreements;

the timing of our expenses, including costs related to litigation, stock-based awards, acquisitions of technologies, or businesses;

the timing of introductions and market acceptance of new products and product enhancements by us, our licensees, our competitors, or their competitors;

our ability to develop and improve our technologies;

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

seasonality in the demand for our products or our licensees products.

Our stock price may fluctuate regardless of our performance.

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

Provisions in our charter documents and Delaware law could prevent or delay a change in control, which could reduce the market price of our common stock.

Provisions in our certificate of incorporation and bylaws may have the effect of delaying or preventing a change of control or changes in our management. In addition, certain provisions of Delaware law may discourage, delay, or prevent someone from acquiring or merging with us. These provisions could limit the price that investors might be willing to pay in the future for shares.

Issuance of the shares of common stock upon conversion of debentures, exercise of stock options, and exercise of warrants will dilute the ownership interest of existing stockholders and could adversely affect the market price of our common stock.

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

Our major stockholders retain significant control over us, which may lead to conflicts with other stockholders over corporate governance matters and could also affect the volatility of our stock price.

We currently have, have had in the past, and may have in the future, stockholders who retain greater than 10%, or in some cases greater than 20%, of our outstanding stock. Acting together, these stockholders would be able to exercise significant influence over matters that our stockholders vote upon, including the election of directors and mergers or other business combinations, which could have the effect of delaying or preventing a third party from acquiring control over or merging with us. Further, if any individuals in this group elect to sell a significant portion or all of their holdings of our common stock, the trading price of our common stock could experience volatility.

Table of Contents

We may engage in acquisitions that could dilute stockholders interests, divert management attention, or cause integration problems.

As part of our business strategy, we have in the past and may in the future, acquire businesses or intellectual property that we feel could complement our business, enhance our technical capabilities, or increase our intellectual property portfolio. If we consummate acquisitions through cash and/or an exchange of our securities, our stockholders could suffer significant dilution. Acquisitions could also create risks for us, including:

unanticipated costs associated with the acquisitions;

use of substantial portions of our available cash to consummate the acquisitions;

diversion of management s attention from other business concerns;

difficulties in assimilation of acquired personnel or operations; and

potential intellectual property infringement claims related to newly acquired product lines.

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

If we fail to comply with Nasdaq Stock Market maintenance criteria for continued listing on the Nasdaq Global Market, our common stock could be delisted.

To maintain the listing of our common stock on the Nasdaq Global Market, we are required to comply with one of two sets of maintenance criteria for continued listing. Under the first set of criteria, among other things, we must maintain stockholders equity of at least $10 million, the market value of our publicly held common stock (excluding shares held by our affiliates) must be at least $5 million, and the minimum bid price for our common stock must be at least $1.00 per share. Under the second set of criteria, among other things, the market value of our common stock must be at least $50 million or we must have both $50 million in assets and $50 million in revenues, the market value of our publicly held shares must be at least $15 million, and the minimum bid price for our common stock must be at least $1.00 per share. As of December 31, 2006, our most recent balance sheet date, we had a deficit in stockholders equity, and therefore would not have been in compliance with the first set of listing criteria as of that date. Although we were in compliance with the second set of criteria, should the price of our common stock decline to the point where the aggregate value of our outstanding common stock falls below $50 million, the value of our publicly held shares falls below $15 million, or the bid price of our common stock falls below $1.00 per share, our shares could be delisted from the Nasdaq Global Market. If we are unable to comply with the applicable criteria and our common stock is delisted from the Nasdaq Global Market, it would likely be more difficult to affect trades and to determine the market price of our common stock. In addition, delisting of our common stock could materially affect the market price and liquidity of our common stock and our future ability to raise necessary capital.

Failure to maintain effective internal controls in accordance with section 404 of the Sarbanes-Oxley Act could have a material adverse effect on our business and stock price.

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

Legislative actions, higher insurance cost, and potential new accounting pronouncements are likely to impact our future financial position and results of operations.

There have been regulatory changes and new accounting pronouncements including the Sarbanes-Oxley Act of 2002, and the recently enacted Statement of Financial Accounting Standards (SFAS) No. 123 revised 2004 (SFAS No. 123R), Share-Based Payment, which have had an effect on our financial position and results of operations. Under SFAS No. 123R, we have been required since January 1, 2006, to adopt a different method of

Table of Contents

determining the compensation expense of our employee stock options. SFAS No. 123R has had a significant adverse effect on our reported financial conditions and may impact the way we conduct our business.

In June 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48 (FIN 48), Accounting for Uncertainty in Income Taxes. FIN 48 clarifies the application of Statement No. 109, Accounting for Income Taxes, (SFAS No. 109) by defining criteria that must be met for any part of a benefit related to an individual tax position to be recognized in the financial statements. FIN 48 also provides guidance on measurement, derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition and is effective for us beginning January 1, 2007. We are currently evaluating the effect that the adoption of FIN 48 will have on our financial position and results of operations.

There may potentially be new accounting pronouncements or additional regulatory rulings that also have an impact on our future financial position and results of operations. These and other potential changes could materially increase the expenses we report under generally accepted accounting principles, and adversely affect our operating results.

Item 1B. ***Unresolved Staff Comments***

We have received comment letters from the staff of the Division of Corporation Finance of the SEC relating to a routine review of our periodic and current reports under the Exchange Act. The letters dated August 2, 2006 and December 20, 2006 pertain to our Annual Report on Form 10-K for the year ended December 31, 2005, and Form 8-K dated May 4, 2006 previously filed under the Exchange Act. We are in the process of responding to and resolving these SEC comments. We cannot ultimately predict the date of resolution of the unresolved comments, the results of the SEC staff review, or the resulting impact of additional review, if any, to our SEC filings.

Item 2. ***Properties***

We lease a facility in San Jose, California of approximately 48,000 square feet, which serves as our corporate headquarters and includes our sales, marketing, administration, research and development, manufacturing, and distribution functions for the Immersion Computing, Entertainment, and Industrial operating segment. Products produced in San Jose include our MicroScribe G2 and MX digitizers, our CyberGlove line of whole-hand sensing gloves and three-dimensional software products, the SoftMouse, and several of our professional and industrial products, including rotary encoders, components to enable tactile feedback in touchscreens, and various arcade products. The lease for this property expires in June 2010.

We lease a facility in Montreal, Quebec, Canada of approximately 6,400 square feet, for our subsidiary, Immersion Canada, Inc. The facility is used for administration and research and development functions. The lease for this property expires in October 2010.

We lease a facility in Gaithersburg, Maryland of approximately 18,900 square feet, for the Immersion Medical operating segment. The facility is used for sales, marketing, administration, research and development, manufacturing, and distribution functions for the Endoscopy AccuTouch System, the CathLab VR System, Virtual IV System, and the Lap VR System. The lease for this property expires in May 2009.

We lease office space in Kangnam-Ku, Seoul, Korea. The facility is used for sales and marketing support and research and development functions. This lease expires in September 2007.

We believe that our existing facilities are adequate to meet our current needs.

Item 3. ***Legal Proceedings***

In re Immersion Corporation

We are involved in legal proceedings relating to a class action lawsuit filed on November 9, 2001, In re Immersion Corporation Initial Public Offering Securities Litigation, No. Civ. 01-9975 (S.D.N.Y.), related to In re Initial Public Offering Securities Litigation, No. 21 MC 92 (S.D.N.Y.). The named defendants are Immersion and three of our current or former officers or directors (the Immersion Defendants), and certain underwriters of our

Table of Contents

November 12, 1999 initial public offering (IPO). Subsequently, two of the individual defendants stipulated to a dismissal without prejudice.

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

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

We and most of the issuer defendants have settled with the plaintiffs. In this settlement, plaintiffs have dismissed and released all claims against the Immersion Defendants, in exchange for a contingent payment by the insurance companies collectively responsible for insuring the issuers in all of the IPO cases, and for the assignment or surrender of certain claims we may have against the underwriters. The Immersion Defendants will not be required to make any cash payments in the settlement, unless the pro rata amount paid by the insurers in the settlement exceeds the amount of the insurance coverage, a circumstance which we believe is remote. The settlement will require approval of the Court, which cannot be assured, after class members are given the opportunity to object to the settlement or opt out of the settlement.

In September 2005, the Court granted preliminary approval of the settlement. The Court held a hearing to consider final approval of the settlement on April 24, 2006, and took the matter under submission. The court will resume consideration of whether to grant final approval to the settlement following further appellate review, if any, of the decision in In re Initial Public Offering Securities Litigation, 471 F.3d 24, 2006 WL 3499937 (2d Cir. Dec. 5, 2006).

Immersion Corporation vs. Microsoft Corporation, Sony Computer Entertainment Inc. and Sony Computer Entertainment of America, Inc.

On February 11, 2002, we filed a complaint against Microsoft Corporation, Sony Computer Entertainment, Inc., and Sony Computer Entertainment of America, Inc. in the U.S. District Court for the Northern District Court of California alleging infringement of U.S. Patent Nos. 5,889,672 and 6,275,213. The case was assigned to United States District Judge Claudia Wilken. On April 4, 2002, Sony Computer Entertainment and Microsoft answered the complaint by denying the material allegations and alleging counterclaims seeking a judicial declaration that the asserted patents were invalid, unenforceable, or not infringed. Under the counterclaims, the defendants were also seeking damages for attorneys fees. On October 8, 2002, we filed an amended complaint, withdrawing the claim under the U.S. Patent No. 5,889,672 and adding claims under a new patent, U.S. Patent No. 6,424,333.

On July 28, 2003, we announced that we had settled our legal differences with Microsoft, and both parties agreed to dismiss all claims and counterclaims relating to this matter as well as assume financial responsibility for their respective legal costs with respect to the lawsuit between us and Microsoft.

On August 16, 2004, the trial against Sony Computer Entertainment commenced. On September 21, 2004, the jury returned its verdict in favor of us. The jury found all the asserted claims of the patents valid and infringed. The jury awarded us damages in the amount of $82.0 million. On January 10, 2005, the Court awarded us prejudgment interest on the damages the jury awarded at the applicable prime rate. The Court further ordered Sony Computer Entertainment to pay us a compulsory license fee at the rate of 1.37%, the ratio of the verdict amount to the amount of sales of infringing products, effective as of July 1, 2004 and through the date of Judgment. On February 9, 2005,

Table of Contents

the Court ordered that Sony Computer Entertainment provide us with sales data 15 days after the end of each quarter and clarified that Sony Computer Entertainment will make the ordered payment 45 days after the end of the applicable quarter. Sony Computer Entertainment has made quarterly payments to us pursuant to the Court s orders.

On February 9, 2005, Sony Computer Entertainment filed a Notice of Appeal to the United States Court of Appeals for the Federal Circuit to appeal the Court s January 10, 2005 order, and on February 10, 2005 Sony Computer Entertainment filed an Amended Notice of Appeal to include an appeal from the Court s February 9, 2005 order.

On January 5 and 6, 2005, the Court held a bench trial on Sony Computer Entertainment s remaining allegations that the 333 patent was not enforceable due to alleged inequitable conduct. On March 24, 2005, the Court resolved this issue, entering a written order finding in our favor.

On March 24, 2005, Judge Wilken also entered judgment in our favor and awarded us $82.0 million in past damages, and pre-judgment interest in the amount of $8.9 million, for a total of $90.9 million. We were also awarded certain court costs. Court costs do not include attorneys fees. Additionally, the Court issued a permanent injunction against the manufacture, use, sale, or import into the United States of the infringing Sony Computer Entertainment PlayStation system consisting of the PlayStation consoles, Dual Shock controllers, and the 47 games found by the jury to infringe our patents. The Court stayed the permanent injunction pending appeal to the United States Court of Appeals for the Federal Circuit. The Court further ordered Sony Computer Entertainment to pay a compulsory license fee at the rate of 1.37% for the duration of the stay of the permanent injunction at the same rate and conditions as previously awarded in its interim January 10, 2005 and February 9, 2005 Orders. On April 7, 2005, pursuant to a stipulation of the parties, the Court entered an Amended Judgment to clarify that the Judgment in favor of us and against Sony Computer Entertainment also encompassed Sony Computer Entertainment s counterclaims for declaratory relief on invalidity and unenforceability, as well as non-infringement.

Sony Computer Entertainment had filed further motions seeking judgment as a matter of a law (JMOL) or for a new trial, and a motion for a stay of an accounting and execution of the Judgment. On May 17, 2005, Judge Wilken denied these motions.

On April 27, 2005, the Court granted Sony Computer Entertainment s request to approve a supersedeas bond, secured by a cash deposit with the Court in the amount of $102.5 million, to obtain a stay of enforcement of the Court s Amended Judgment pending appeal. On May 17, 2005, the Court issued a minute order stating that in lieu of the supersedeas bond the Court would allow Sony Computer Entertainment to place the funds on deposit with the Court in an escrow account subject to acceptable escrow instructions. The parties negotiated escrow instructions, and on June 12, 2006, the Court granted the parties stipulated request to withdraw the funds from the Court and deposit them in an escrow account with JP Morgan Chase. Sony Computer Entertainment has withdrawn the funds from the Court and deposited them in the JP Morgan Chase escrow account.

On June 16, 2005, Sony Computer Entertainment filed a Notice of Appeal from the District Court Judgment to the United States Court of Appeals for the Federal Circuit. The appeals of the January and February orders regarding the compulsory license have been consolidated with the appeal of the Judgment. Sony Computer Entertainment s Opening Brief was filed on October 21, 2005; we filed an Opposition Brief on December 5, 2005. Due to the cross appeal by ISLLC (see below), the Federal Circuit allowed us to file a Substitute Opposition Brief on February 17, 2006 responding to the briefs filed by both Sony Computer Entertainment and ISLLC. On March 15, 2006, we filed a further substitute brief in response to a Federal Circuit order clarifying the maximum number of words we were allowed given ISLLC s cross appeal. Sony Computer Entertainment filed its Reply Brief on April 27, 2006 and ISLLC s Reply Brief was filed on May 15, 2006. On October 3, 2006, a hearing for oral argument was held before a three-judge panel of the United States Court of Appeals for the Federal Circuit.

On July 21, 2005, Sony Computer Entertainment filed a motion in the District Court before Judge Wilken seeking relief from the final judgment under Rule 60(b) of the Federal Rules of Civil Procedure on the grounds of alleged fraud and newly discovered evidence of purported prior art, which Sony Computer Entertainment contends we concealed and withheld attributable to Mr. Craig Thorner, a named inventor on three patents that Sony Computer Entertainment urged as a basis for patent invalidity during the trial. A hearing on this motion was held before Judge Wilken on January 20, 2006. On March 8, 2006, the Court entered an Order which denied Sony

Table of Contents

Computer Entertainment s motion pursuant to Rule 60(b) of the Federal Rules of Civil Procedure in its entirety. On April 7, 2006, Sony Computer Entertainment filed a Notice of Appeal to the United States Court of Appeals for the Federal Circuit to appeal this ruling and filed its opening brief on June 16, 2006. Our opposition brief was filed on August 30, 2006, and Sony Computer Entertainment filed its reply brief on October 2, 2006. On January 8, 2007, a hearing for oral argument was held before a three-judge panel of the United States Court of Appeals for the Federal Circuit.

On May 17, 2005, Sony Computer Entertainment filed a Request for Inter Partes Reexamination of the 333 Patent with the United States Patent and Trademark Office (PTO). On May 19, 2005, Sony Computer Entertainment filed a similar Request for reexamination of the 213 Patent. On July 6, 2005, we filed a Petition to dismiss, stay, or alternatively to suspend both of the requests for reexamination, based at least on the grounds that a final judgment has already been entered by a United States District Court, and that the PTO s current inter partes reexamination procedures deny due process of law. The PTO denied the first petition, and we filed a second petition on September 9, 2005. On November 17, 2005, the PTO granted our petition, and suspended the inter partes reexaminations until such time as the parallel court proceedings warrant termination or resumption of the PTO examination and prosecution proceedings. On December 13, 2005, Sony Computer Entertainment filed a third petition requesting permission to file an additional inter partes reexamination on the claims of the 333 and 213 Patents for which reexamination was not requested in Sony Computer Entertainment s original requests for reexamination. The PTO dismissed this third petition on March 22, 2006. On December 13, 2005, Sony Computer Entertainment also filed ex parte reexamination requests on a number of claims of the 213 and 333 patents, including all of the claims litigated in the District Court action, in addition to others. On March 13, 2006, the PTO granted the ex parte reexam request only with respect to the requested claims that were not litigated, and the ex parte reexamination is proceeding with respect to the claims that were not the subject of litigation. On April 11, 2006, Sony Computer Entertainment filed a fourth petition to the PTO requesting that the currently suspended inter partes proceeding and the ex parte proceeding be merged into a single proceeding. We filed our opposition to this petition on May 3, 2006, and the PTO denied the fourth petition on July 3, 2006.

On December 13, 2005, Sony Computer Entertainment filed a lawsuit against the PTO in the U.S. District Court for the Eastern District of Virginia claiming that the PTO erred in suspending the inter partes reexamination on November 17, 2005. The case was assigned to U.S. District Judge Ellis. We moved to intervene in the lawsuit, and on March 31, 2006, the Court granted our motion to intervene of right. The Court entered a scheduling order which precluded discovery and set an expedited briefing schedule for motions for summary judgment. After briefing, Judge Ellis held a hearing on the summary judgment motions on April 21, 2006. The Court granted summary judgment in our and the PTO s favor on all grounds on May 22, 2006. Sony Computer Entertainment has not appealed this judgment.

On March 1, 2007, Sony Computer Entertainment withdrew and moved to dismiss its appeals from the District Court s April 7, 2005, Amended Judgment (and all interlocutory orders merged in the Amended Judgment). On March 2, 2007, Sony Computer Entertainment withdrew and moved to dismiss its appeal from the District Court s March 8, 2006, order denying Sony Computer Entertainment s motion for relief from final judgment under Rule 60(b) of the Federal Rules of Civil Procedure. On March 8, 2007, the Federal Circuit dismissed the Sony Computer Entertainment Rule 60(b) appeal. On March 14, 2007 the Federal Circuit dismissed the Sony Computer Entertainment appeal of Amended Judgment (and all interlocutory orders merged in the Amended Judgment). In accordance with the Amended Judgment we will receive funds totaling approximately $97.2 million inclusive of the award for past damages for sales and other activities with respect to the infringing Sony Computer Entertainment PlayStation system consisting of the PlayStation consoles, Dual Shock controllers, and the 47 games found by the jury to infringe our patents, pre-judgment interest and costs, and post-judgment interest. Additionally, we will retain the $32.3 million of compulsory license fees and interest thereon previously paid to us by Sony Computer Entertainment ($27.9 million in long-term deferred revenue at December 31, 2006 and $4.4 million received subsequent to year end).

Internet Services LLC Litigation

On October 20, 2004, ISLLC, our licensee and the cross-claim defendant against whom Sony Computer Entertainment had filed a claim seeking declaratory relief, filed claims against us in our lawsuit against Sony Computer Entertainment, alleging that we breached a contract with ISLLC by suing Sony Computer

Table of Contents

Entertainment for patent infringement relating to haptically-enabled software whose topics or images are allegedly age-restricted, for judicial apportionment of damages between ISLLC and us of the damages awarded by the jury and for a judicial declaration with respect to ISLLC s rights and duties under agreements with us. On December 29, 2004, the Court issued an order dismissing ISLLC s claims against Sony Computer Entertainment with prejudice and dismissing ISLLC s claims against us without prejudice to ISLLC filing a new complaint if it can do so in good faith without contradicting, or repeating the deficiency of, its complaint.

On January 12, 2005, ISLLC filed Amended Cross-Claims and Counterclaims against us that contained similar claims. ISLLC also realleged counterclaims against Sony Computer Entertainment. On January 28, 2005, we filed a motion to dismiss ISLLC s Amended Cross-Claims and a motion to strike ISLLC s Counterclaims against Sony Computer Entertainment. On March 24, 2005 the Court issued an order dismissing ISLLC s claims with prejudice as to ISLLC s claim seeking a declaratory judgment that it is an exclusive licensee under the 213 and 333 patents and as to ISLLC s claim seeking judicial apportionment of the damages verdict in the Sony Computer Entertainment case. The Court s order further dismissed ISLLC s claims without prejudice as to ISLLC s breach of contract and unjust enrichment claims.

ISLLC filed a notice of appeal of those orders with the United States Court of Appeals for the Federal Circuit on April 18, 2005. ISLLC s appeal has been consolidated with Sony Computer Entertainment s appeal. ISLLC filed its Opening Brief in December 2005. As noted above, the United States Court of Appeals for the Federal Circuit allowed us to file a Substitute Opposition Brief on March 15, 2006 responding to the briefs filed by both Sony Computer Entertainment and ISLLC. Briefing for the appeal was completed upon ISLLC s filing of its Reply Brief on May 15, 2006. As noted above, on October 3, 2006, a hearing for oral argument was held before a three-judge panel of the United States Court of Appeals for the Federal Circuit. The matter was taken under submission, pending a decision.

On February 8, 2006, ISLLC filed a lawsuit against us in the Superior Court of Santa Clara County. ISLLC s complaint seeks a share of the damages awarded to us in the March 24, 2005 Judgment and of the Microsoft settlement proceeds, and generally restates the claims already adjudicated by the District Court. On March 16, 2006, we answered the complaint, cross claimed for breach of contract by ISLLC and rescission of the contract, and removed the lawsuit to federal court. The case was assigned to Judge Wilken as a case related to the previous proceedings involving Sony Computer Entertainment and ISLLC. ISLLC filed its answer to our cross claims on April 27, 2006. ISLLC also moved to remand the case to Superior Court. On July 10, 2006, Judge Wilken issued an order denying ISLLC s motion to remand. On September 5, 2006, Judge Wilken granted the stipulated request by the parties to stay discovery and other proceedings in the case pending the disposition of ISLLC s appeal from the Court s previous orders. On December 1, 2006, the parties again stipulated to continue the stay and reschedule the Case Management conference until April 13, 2007, pending the Federal Circuit s disposition on the appeal.

We intend to defend ourselves vigorously against ISLLC s allegations. The parties participated in a court-ordered mediation on March 12, 2007, but were unsuccessful in resolving the matter.

Immersion Corporation vs. Thorner

On March 24, 2006, we filed a lawsuit against Mr. Craig Thorner in Santa Clara County Superior Court. The complaint alleges claims for breach of contract with respect to Thorner s license to a third party of U.S. Patent No. 5,684,722, which we have alleged is in violation of contractual obligations to it. The case was removed to federal court by Mr. Thorner, and has been assigned to Judge Jeremy Fogel. On May 1, 2006, Mr. Thorner filed an answer to our claims and asserted counterclaims against us seeking, among other things, a portion of the proceeds from our license with Microsoft, under theories of alleged breach of contract, breach of the implied covenant of good faith and fair dealing, fraud, promissory fraud, breach of fiduciary duty, and negligent misrepresentation. On July 28, 2006, we filed a motion for judgment on the pleadings seeking the dismissal of Mr. Thorner s breach of contract and fraud

claims which allege a right to a portion of the proceeds from our license with Microsoft. On September 1, 2006, the Court held a hearing on our motion. On September 12, 2006, the Court issued an order granting our motion for judgment on the pleadings as to Mr. Thorner s alleged claims for breach of contract and fraud. The Court dismissed Mr. Thorner s breach of contract and fraud claims, and allowed Mr. Thorner leave to

Table of Contents

amend his claim for alleged breach of contract with respect to alleged violations of our reporting requirements that do not flow from the failure to report the Microsoft Settlement Agreement.

The parties participated in a court-ordered mediation on November 7, 2006, but were not successful in resolving the matter. The parties are in the process of conducting discovery.

On November 22, 2006, Thorner brought a motion for summary judgment arguing that our breach of contract claim was barred by the doctrine of judicial estoppel as a result of a statement made in connection with the Sony Computer Entertainment Rule 60 (b) motion. On January 26, 2007, the Court held a hearing on Thorner s motion. On January 29, 2007, the Court issued an order denying Thorner s summary judgment motion, ruling that our breach of contract claim was not barred by judicial estoppel. On February 5, 2007, with leave of Court, we filed a First Amended Complaint in the action to add Thorner s company, Virtual Reality Feedback Corporation (VRF), as a party-defendant. On February 9, 2007, Thorner filed an Amended Answer and Counterclaims. The Amended Counterclaims against us dropped the previously-dismissed counterclaims based on Thorner s claims for a share of our settlement with Microsoft, but alleged other counterclaims for alleged Breach of Contract, Breach of the Implied Covenant of Good Faith and Fair Dealing, Promissory Fraud, Breach of Fiduciary Duty, Negligent Misrepresentation and Rescission. Thorner alleged in part that we breached our agreement with Thorner by failing to pay royalties for Vibetonz Studio SDK and Immersion Studio for Gaming; that we breached alleged duties to Thorner to license the 722 patent; and that Thorner s agreement with us should be rescinded. Thorner s Amended Counterclaim does not specify an amount of damages sought but alleges that Thorner has been damaged in an amount to be proven at trial. We dispute Thorner s allegations and intend to vigorously oppose them.

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

No matters were submitted to a vote of security holders in the fourth quarter of fiscal 2006.

Table of Contents

PART II

Item 5. *Market for Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities*

Our common stock is traded on the Nasdaq Global Market under the symbol IMMR. The following table sets forth, for the periods indicated, the high and low sales prices for our common stock on such market.

	High	Low
Fiscal year ended December 31, 2006		
Fourth Quarter	$ 7.39	$ 6.49
Third Quarter	$ 7.16	$ 5.03
Second Quarter	$ 9.11	$ 5.49
First Quarter	$ 8.68	$ 6.21
Fiscal year ended December 31, 2005		
Fourth Quarter	$ 7.50	$ 6.11
Third Quarter	$ 7.13	$ 5.23
Second Quarter	$ 6.34	$ 4.87
First Quarter	$ 7.93	$ 5.45

On February 23, 2007, the closing price was $7.58 and there were 174 holders of record of our common stock. Because many of such shares are held by brokers and other institutions on behalf of stockholders, we are unable to estimate the total number of stockholders represented by these record holders.

Dividend Policy

We have never declared or paid any cash dividends on our common stock and we do not anticipate paying cash dividends in the foreseeable future. We currently intend to retain any earnings to fund future growth, product development, and operations.

Item 6. *Selected Financial Data*

The following selected consolidated financial data is qualified in its entirety by, and should be read in conjunction with, Management s Discussion and Analysis of Financial Condition and Results of Operations and the consolidated financial statements and notes thereto included elsewhere in this Annual Report on Form 10-K.

	Years Ended December 31,				
	2006	2005	2004	2003	2002
	(In thousands, except per share data)				
STATEMENTS OF OPERATIONS DATA:					
Revenues	$ 27,853	$ 24,277	$ 23,763	$ 20,223	$ 20,235
Cost and expenses(1)	36,806	36,177	44,155	35,073	35,270

Operating loss(1)	(8,953)	(11,900)	(20,392)	(14,850)	(15,035)
Net loss(1)(2)	(10,424)	(13,085)	(20,738)	(16,974)	(16,530)
Basic and diluted net loss per share	$ (0.42)	$ (0.54)	$ (0.91)	$ (0.83)	$ (0.83)
Shares used in calculating basic and diluted net loss per share	24,556	24,027	22,698	20,334	19,906

Table of Contents

	2006	2005	December 31, 2004	2003	2002
			(In thousands)		
BALANCE SHEET DATA:					
Cash and cash equivalents	$ 32,012	$ 28,171	$ 25,538	$ 21,738	$ 8,717
Working capital	33,657	28,885	23,088	22,032	8,898
Total assets	50,015	44,760	42,250	37,913	25,301
Long-term debt, less current portion	18,122	17,490	16,917	16	51
Long-term customer advance from Microsoft	15,000	15,000	15,000	27,050	
Total stockholders equity (deficit)	(22,992)	(16,795)	(5,967)	(1,219)	13,948

(1) Includes a charge for impairment of goodwill of $3.8 million related to Immersion Computing, Entertainment, and Industrial operating segment in 2002.

(2) Includes amounts written off of cost-method investments of $1.2 million in 2002.

Item 7. ***Management s Discussion and Analysis of Financial Condition and Results of Operations***

The following discussion should be read in conjunction with the consolidated financial statements and notes thereto.

This Management s Discussion and Analysis of Financial Condition and Results of Operations 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, 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 in Item 1A, Risk Factors, those described elsewhere in this report, and those described in our other reports filed with the SEC. We caution you not to place undue reliance on these forward-looking statements, which speak only as of the date of this report, and we undertake no obligation to release the results of any revisions to these forward-looking statements that could occur after the filing of this report.

Critical Accounting Policies and Estimates

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

39

Table of Contents

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

Revenue Recognition

We recognize revenues in accordance with applicable accounting standards, including Staff Accounting Bulletin (SAB) No. 104, Revenue Recognition, Emerging Issues Task Force (EITF) Issue No. 00-21 (EITF No. 00-21), Accounting for Revenue Arrangements with Multiple Deliverables, and American Institute of Certified Public Accountants (AICPA) Statement of Position (SOP) 97-2, Software Revenue Recognition, as amended. Revenue is recognized when persuasive evidence of an arrangement exists, delivery has occurred or service has been rendered, the fee is fixed and determinable, and collectibility is probable. We derive our revenues from three principal sources: royalty and license fees, product sales, and development contracts.

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

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

License Revenue Model	Revenue Recognition
Perpetual license of intellectual property portfolio based on per unit royalties, no services contracted.	Based on royalty reports received from licensees. No further obligations to licensee exist.
Time-based license of intellectual property portfolio with up-front payments and/or annual minimum royalty requirements, no services contracted. Licensees have certain rights to updates to the intellectual property portfolio during the contract period.	Based on straight-line amortization of annual minimum/up-front payment recognized over contract period or annual minimum period.
Perpetual license of intellectual property portfolio or technology license along with contract for development work.	Based on cost-to-cost percentage-of-completion accounting method over the service period. Obligation to licensee exists until development work is complete.
License of software or technology, no modification necessary, no services contracted.	Up-front revenue recognition based on SOP 97-2 criteria or EITF No. 00-21, as applicable.

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

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

Table of Contents

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

Multiple element arrangements We enter into revenue arrangements in which the customer purchases a combination of patent, technology, and/or software licenses, products, professional services, support, and extended warranties (multiple element arrangements). When VSOE of fair value exists for all elements, we allocate revenue to each element based on the relative fair value of each of the elements.

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

Stock-based Compensation

We account for stock-based compensation in accordance with SFAS No. 123R. We adopted the provisions of SFAS No. 123R on January 1, 2006. We elected the modified-prospective method, under which prior periods are not revised for comparative purposes. Under the fair value recognition provisions of this statement, stock-based compensation cost is measured at the grant date based on the fair value of the award and is recognized as expense on a straight-line basis over the requisite service period, which is the vesting period.

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

Expected term We estimate the expected term of options granted by using the simplified method as prescribed by SAB No. 107.

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

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

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

Forfeitures We are required to estimate future forfeitures at the time of grant and revise those estimates in subsequent periods if actual forfeitures differ from those estimates. We use historical data to estimate pre-vesting option forfeitures and record stock-based compensation expense only for those awards that are expected to vest. Changes in estimated forfeitures will be recognized through a cumulative catch-up adjustment in the period of change and will also impact the amount of compensation expense to be recognized in future periods.

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

Table of Contents

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

See Note 11 to the consolidated financial statements for further information regarding the SFAS No. 123R disclosures.

Long-term Liabilities

In 2003, we executed a series of agreements with Microsoft as described in Note 9 to the consolidated financial statements that provided for settlement of our lawsuit against Microsoft as well as various licensing, sublicensing, and equity and financing arrangements. We accounted for the proceeds received under the agreements as a long-term customer advance based on certain provisions that would result in payment of funds to Microsoft. Upon Microsoft s election to convert its shares of our Series A Preferred Stock into common stock, we reduced the long-term customer advance from Microsoft to the minimum amount we would be obligated to pay Microsoft upon a settlement with Sony Computer Entertainment. The remainder of the consideration was transferred to common stock in 2004. Under a settlement with Sony Computer Entertainment, we would be obligated to pay Microsoft a minimum of $15.0 million for any amounts received from Sony up to $100.0 million, plus 25% of any amounts over $100.0 million up to $150.0 million, and 17.5% of any amounts over $150.0 million. We believe that we are not obligated under our agreements with Microsoft to make any payment to Microsoft relating to the conclusion of our patent litigation with Sony Computer Entertainment. However, it is uncertain that Microsoft will accept our position or that we will ultimately prevail with our position.

In December 2004, we executed a series of agreements as described in Note 7 to the consolidated financial statements that provided for the issuance of 5% Senior Subordinated Convertible Debentures (5% Convertible Debenture), and warrants, and that granted certain registration rights to the holders of the 5% Convertible Debentures. We accounted for the issuance of our 5% Convertible Debentures and related warrants in accordance with EITF No. 98-5, Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios and other related accounting guidance. We estimated the relative fair value of the various instruments included in the agreements entered into in December 2004 and allocated the relative fair values to be as follows: warrants $1.7 million, Put Option $0.1 million, Registration Rights $0.1 million, issuance costs $1.3 million, 5% Convertible Debentures $16.8 million. The 5% Convertible Debentures are being accreted to $20.0 million over their five-year life, resulting in additional interest expense. The value of the warrants is included in Stockholders Deficit, the value of the Put Option and Registration Rights are recorded as liabilities and are subject to future value adjustments, and the value of the 5% Convertible Debentures is recorded as long-term debt.

Long-term Deferred Revenue

In addition to normal items of deferred revenue due after one year, we have included Sony Computer Entertainment compulsory license fees and interest earned thereon in long-term deferred revenue due to the contingent nature of the court-ordered payments (see Note 8 to the consolidated financial statements). Upon the conclusion of our patent litigation at the U.S. Court of Appeals for the Federal Circuit the contingency on these funds has lapsed. We are currently evaluating the impact of this on our consolidated statement of operations and consolidated balance sheets.

Table of Contents

Recovery of Accounts Receivable

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

Inventory Reserves

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

Product Return and Warranty Reserves

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

Intangible Assets

We have acquired patents and other intangibles. In addition, we capitalize the external legal and filing fees associated with patents and trademarks. We assess the recoverability of our intangible assets, and we must make assumptions regarding estimated future cash flows and other factors to determine the fair value of the respective assets that affect our consolidated financial statements. If these estimates or related assumptions change in the future, we may be required to record impairment charges for these assets. We amortize our intangible assets related to patents and trademarks, once they issue, over their estimated useful lives, generally 10 years. Future changes in the estimated useful life could affect the amount of future period amortization expense that we will incur. During 2006, we capitalized costs associated with patents and trademarks of $1.6 million. Our total amortization expense for the same period for all intangible assets was $969,000.

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 their application. There are also areas in which management s judgment in selecting any available alternative would not produce a materially different result.

Table of Contents

Results of Operations

Overview of 2006

During 2006, we achieved several milestones, including growth in all of our key market areas, except gaming. This growth was due, in part, to changing our medical business to a product sales based business model and our continued investment in a strengthened and more focused sales and marketing effort across our business segments. In addition,

As market acceptance of medical simulation has increased, our medical product sales grew 47% in 2006 over the year ended December 31, 2005 and accounted for 84% of total Immersion Medical revenue for the year. This growth is also a result of increases in business with Medtronic and Laerdal, and the release of new products and modules.

In 2006, we signed a new handset licensee, LG Electronics. In addition, we saw the first commercial shipment of a VibeTonz enabled touchscreen phone during the fourth quarter of 2006.

Revenue for the touch