

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(MARK ONE)

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

For the quarterly period ended June 30, 2004

OR

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

For the transition period from _____ to _____.

Commission file number 000-27969

IMMERSION CORPORATION

(Exact name of registrant as specified in its charter)

Delaware

94-3180138

(State or other jurisdiction of incorporation or organization)

(I.R.S. Employer Identification No.)

801 Fox Lane, San Jose, California 95131

(Address of principal executive offices)(Zip Code)

(408) 467-1900

(Registrant's telephone number, including area code)

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

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

Yes No

Number of shares of Common Stock outstanding at August 6, 2004: 23,340,658

IMMERSION CORPORATION

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

| | <u>June 30, 2004</u> | <u>December 31, 2003</u> |
|--|--------------------------|------------------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 18,214 | \$ 21,738 |
| Accounts receivable, (net of allowances for doubtful accounts of: 2004, \$140; and 2003, \$147) | 2,728 | 4,927 |
| Inventories | 2,242 | 2,099 |
| Prepaid expenses and other current assets | 710 | 1,099 |
| Total current assets | <u>23,894</u> | <u>29,863</u> |
| Property and equipment, net | 1,294 | 1,454 |
| Intangibles and other assets, net | 6,847 | 6,596 |
| Total assets | <u>\$ 32,035</u> | <u>\$ 37,913</u> |
| LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT) | | |
| Current liabilities: | | |
| Accounts payable | \$ 2,673 | \$ 1,752 |
| Accrued compensation | 1,263 | 864 |
| Other current liabilities | 1,429 | 2,066 |
| Deferred revenue and customer advances | 2,705 | 3,116 |
| Current portion of long-term debt | 10 | 10 |
| Current portion of capital lease obligation | 11 | 23 |
| Total current liabilities | <u>8,091</u> | <u>7,831</u> |
| Long-term debt, less current portion | 11 | 16 |
| Long-term deferred revenue, less current portion | 7,351 | 4,235 |
| Long-term customer advance from Microsoft (Note 6) | 15,069 | 27,050 |
| Total liabilities | <u>30,522</u> | <u>39,132</u> |
| Contingencies (Note 10) | | |
| Stockholders' equity (deficit): | | |
| Common stock — \$0.001 par value; 100,000,000 shares authorized; shares issued and outstanding: 2004, 23,287,952 and 2003, 20,670,541 | 103,537 | 89,903 |
| Warrants | 1,974 | 1,974 |
| Deferred stock compensation | (7) | (130) |
| Accumulated other comprehensive income | 22 | 33 |
| Accumulated deficit | <u>(104,013)</u> | <u>(92,999)</u> |
| Total stockholders' equity (deficit) | <u>1,513</u> | <u>(1,219)</u> |
| Total liabilities and stockholders' equity (deficit) | <u>\$ 32,035</u> | <u>\$ 37,913</u> |

See accompanying Notes to Condensed Consolidated Financial Statements.

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|--------------------------------|-------------------|------------------------------|-------------------|
| | 2004 | 2003 | 2004 | 2003 |
| Revenues: | | | | |
| Royalty and license | \$ 1,899 | \$ 804 | \$ 3,730 | \$ 1,637 |
| Product sales | 2,879 | 2,465 | 5,323 | 4,613 |
| Development contracts and other | 736 | 873 | 1,816 | 1,628 |
| Total revenues | <u>5,514</u> | <u>4,142</u> | <u>10,869</u> | <u>7,878</u> |
| Costs and expenses: | | | | |
| Cost of product sales (exclusive of amortization of intangibles shown separately below) | 1,540 | 1,462 | 2,761 | 2,568 |
| Sales and Marketing (exclusive of amortization of deferred stock compensation) | 2,826 | 1,885 | 5,288 | 3,676 |
| Research and development (exclusive of amortization of deferred stock compensation) | 2,077 | 1,739 | 3,966 | 3,428 |
| General and administrative (exclusive of amortization of deferred stock compensation) | 3,589 | 2,860 | 8,467 | 5,016 |
| Amortization of intangibles and deferred stock compensation * | 358 | 611 | 871 | 1,260 |
| Total costs and expenses | <u>10,390</u> | <u>8,557</u> | <u>21,353</u> | <u>15,948</u> |
| Operating loss | (4,876) | (4,415) | (10,484) | (8,070) |
| Interest and other income | 39 | 2 | 85 | 13 |
| Interest and other expense | (9) | (31) | (615) | (44) |
| Net loss | <u>\$ (4,846)</u> | <u>\$ (4,444)</u> | <u>\$ (11,014)</u> | <u>\$ (8,101)</u> |
| Basic and diluted net loss per share | <u>\$ (0.21)</u> | <u>\$ (0.22)</u> | <u>\$ (0.50)</u> | <u>\$ (0.40)</u> |
| Shares used in calculating basic and diluted net loss per share | <u>23,198</u> | <u>20,179</u> | <u>21,994</u> | <u>20,162</u> |
| * Amortization of intangibles and deferred stock compensation | | | | |
| Amortization of intangibles | \$ 356 | \$ 398 | \$ 748 | \$ 817 |
| Deferred stock compensation — sales and marketing | — | — | — | 3 |
| Deferred stock compensation — research and development | 2 | 212 | 123 | 437 |
| Deferred stock compensation — general and administrative | — | 1 | — | 3 |
| Total | <u>\$ 358</u> | <u>\$ 611</u> | <u>\$ 871</u> | <u>\$ 1,260</u> |

See accompanying Notes to Condensed Consolidated Financial Statements.

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

| | Six Months Ended June 30, | |
|---|------------------------------|-----------------|
| | 2004 | 2003 |
| Cash flows from operating activities: | | |
| Net loss | \$(11,014) | \$(8,101) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | |
| Depreciation and amortization | 426 | 563 |
| Amortization of intangibles | 748 | 817 |
| Amortization of deferred stock compensation | 123 | 443 |
| Amortization of discounts on notes payable | — | 1 |
| Interest and other expense - Microsoft | 598 | — |
| Fair value adjustment for warrant liability | — | (2) |
| Loss on disposal of equipment | 3 | 1 |
| Noncash interest expense | — | 16 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | 2,194 | 718 |
| Inventories | (143) | (187) |
| Prepaid expenses and other current assets | 408 | 561 |
| Accounts payable | 1,088 | (614) |
| Accrued compensation and other current liabilities | (235) | 421 |
| Deferred revenue and customer advances | 2,705 | 35 |
| Net cash used in operating activities | <u>(3,099)</u> | <u>(5,328)</u> |
| Cash flows from investing activities: | | |
| Intangibles and other assets | (1,019) | (729) |
| Purchases of property and equipment | (276) | (148) |
| Net cash used in investing activities | <u>(1,295)</u> | <u>(877)</u> |
| Cash flows from financing activities: | | |
| Issuance of common stock | 66 | 11 |
| Exercise of stock options | 1,202 | 14 |
| Dividends paid on Series A Redeemable Convertible Preferred Stock (Note 6) | (212) | — |
| Payments on notes payable and capital leases | (18) | (85) |
| Net cash provided by (used in) financing activities | <u>1,038</u> | <u>(60)</u> |
| Effect of exchange rates on cash and cash equivalents | (168) | 596 |
| Net decrease in cash and cash equivalents | <u>(3,524)</u> | <u>(5,669)</u> |
| Cash and cash equivalents: | | |
| Beginning of the period | 21,738 | 8,717 |
| End of the period | <u>\$ 18,214</u> | <u>\$ 3,048</u> |
| Supplemental disclosure of cash flow information : | | |
| Cash paid for taxes | <u>\$ 160</u> | <u>\$ —</u> |
| Cash paid for interest | <u>\$ 2</u> | <u>\$ 43</u> |

See accompanying Notes to Condensed Consolidated Financial Statements.

IMMERSION CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2004

(Unaudited)

1. SIGNIFICANT ACCOUNTING POLICIES

Description of Business - Immersion Corporation (the "Company") was incorporated in May 1993 in California and reincorporated in Delaware in 1999 and provides technologies that let users interact with digital devices using their sense of touch.

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

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with the instructions for Form 10-Q and, therefore, do not include all information and footnotes necessary for a complete presentation of the financial position, results of operations, and cash flows, in conformity with accounting principles generally accepted in the United States of America. These unaudited condensed consolidated financial statements should be read in conjunction with the Company's audited consolidated financial statements included in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2003. In the opinion of management, all adjustments consisting of only normal recurring items necessary for the fair presentation of the financial position and results of operation for the interim periods have been included.

The results of operations for the interim period ended June 30, 2004 are not necessarily indicative of the results to be expected for the full year.

Stock-Based Compensation - The Company accounts for its stock-based awards to employees using the intrinsic value method in accordance with Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees," and its related interpretations. The Company accounts for stock-based awards to non-employees in accordance with Emerging Issues Task Force ("EITF") 96-18. Pro forma disclosures required under Statement of Financial Accounting Standard ("SFAS") No. 123, "Accounting for Stock-Based Compensation," as if the Company had adopted the fair value based method of accounting for stock options are as follows (in thousands, except per share amounts):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|--------------------------------|-------------------|------------------------------|-------------------|
| | 2004 | 2003 | 2004 | 2003 |
| Net loss — as reported | \$ (4,846) | \$ (4,444) | \$ (11,014) | \$ (8,101) |
| Add: Stock-based employee compensation included in reported net loss | 2 | 213 | 123 | 443 |
| Less: Stock-based compensation expense determined using fair value method | (1,882) | (1,084) | (3,655) | (2,115) |
| Net loss — pro forma | <u>\$ (6,726)</u> | <u>\$ (5,315)</u> | <u>\$ (14,546)</u> | <u>\$ (9,773)</u> |
| Basic and diluted loss per common share — as reported | \$ (0.21) | \$ (0.22) | \$ (0.50) | \$ (0.40) |
| Basic and diluted loss per common share — pro forma | \$ (0.29) | \$ (0.26) | \$ (0.66) | \$ (0.48) |

Recent Accounting Pronouncements – On March 31, 2004, the Financial Accounting Standards Board ("FASB") issued its Exposure Draft, "Share-Based Payment," which is a proposed amendment to SFAS No. 123, "Accounting for Stock-Based Compensation." Generally, the approach in the Exposure Draft is similar to the approach described in SFAS No. 123. However, the Exposure Draft would require all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values. The FASB expects to issue a

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final standard late in 2004 that would be effective for the Company's 2005 fiscal year. The pro forma impact of the adoption of SFAS No. 123 on the Company's historical financial statements is included in the footnotes to the financial statements. The Company expects to continue to grant stock-based compensation to employees and the impact of the adoption of the new standard, when and if issued, may have a material impact on the Company's future results of operations.

In March 2004, the EITF reached a final consensus on Issue No. 03-01, "The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments," to provide additional guidance in determining whether investment securities have an impairment that should be considered other-than-temporary. The adoption of this Issue will not have an effect on the Company's operating results or financial condition.

2. INVENTORIES

| | June 30, 2004 | December 31, 2003 |
|---------------------------------|------------------|----------------------|
| | (In thousands) | |
| Raw materials and subassemblies | \$1,821 | \$1,539 |
| Work in process | 166 | 247 |
| Finished goods | 255 | 313 |
| Total | <u>\$2,242</u> | <u>\$2,099</u> |

3. PROPERTY AND EQUIPMENT

| | June 30, 2004 | December 31, 2003 |
|---|------------------|----------------------|
| | (In thousands) | |
| Computer equipment and purchased software | \$ 2,364 | \$ 2,251 |
| Machinery and equipment | 2,115 | 2,010 |
| Furniture and fixtures | 1,326 | 1,320 |
| Leasehold improvements | 692 | 692 |
| Total | <u>6,497</u> | <u>6,273</u> |
| Less accumulated depreciation | <u>(5,203)</u> | <u>(4,819)</u> |
| Property and equipment, net | <u>\$ 1,294</u> | <u>\$ 1,454</u> |

4. INTANGIBLES AND OTHER ASSETS

| | June 30, 2004 | December 31, 2003 |
|--|------------------|----------------------|
| | (In thousands) | |
| Patents and technology | \$ 9,553 | \$ 8,535 |
| Other intangibles | 5,748 | 5,748 |
| Other assets | 90 | 110 |
| Gross intangibles and other assets | 15,391 | 14,393 |
| Accumulated amortization of patents and technology | <u>(3,592)</u> | <u>(3,226)</u> |
| Accumulated amortization of other intangibles | <u>(4,952)</u> | <u>(4,571)</u> |
| Intangibles and other assets, net | <u>\$ 6,847</u> | <u>\$ 6,596</u> |

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The estimated annual amortization expense for intangible assets as of December 31, 2003 is \$1.7 million in 2004, \$1.5 million in 2005, \$1.0 million in 2006, \$0.9 million in 2007, \$0.5 million in 2008, \$0.4 million in 2009, and \$1.4 million thereafter.

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

| | June 30, 2004 | December 31, 2003 |
|--|------------------|----------------------|
| | (In thousands) | |
| Accrued legal | \$ 318 | \$ 945 |
| Other current liabilities | 1,111 | 1,121 |
| Total other current liabilities | <u>\$1,429</u> | <u>\$2,066</u> |
| Deferred revenue | \$2,666 | \$3,032 |
| Customer advances | 39 | 84 |
| Total current deferred revenue and customer advances | <u>\$2,705</u> | <u>\$3,116</u> |

6. LONG-TERM CUSTOMER ADVANCE FROM MICROSOFT

On July 25, 2003, the Company contemporaneously executed a series of agreements with Microsoft Corporation ("Microsoft") that (1) settled the Company's lawsuit against Microsoft, (2) granted Microsoft a worldwide royalty-free, irrevocable license to the Company's portfolio of patents (the "License Agreement") in exchange for a payment of \$19.9 million, (3) provided Microsoft with sublicense rights to pursue certain license arrangements directly with third parties including Sony Computer Entertainment which, if consummated, would result in payments to the Company (the "Sublicense Rights"), and conveyed to Microsoft the right to a payment of cash in the event of a settlement within certain parameters of the Company's patent litigation against Sony Computer Entertainment of America, Inc. and Sony Computer Entertainment, Inc. (collectively, "Sony Computer Entertainment", the "Participation Rights") in exchange for a payment of \$0.1 million, (4) issued Microsoft shares of the Company's Series A Redeemable Convertible Preferred Stock ("Series A Preferred Stock") for a payment of \$6.0 million, and (5) granted the Company the right to sell debentures of \$9.0 million to Microsoft under the terms and conditions established in newly authorized 7% Senior Redeemable Convertible Debentures ("7% Debentures") with annual draw down rights over a 48 month period.

Under these agreements, in the event of a settlement of the Sony Computer Entertainment litigation under certain terms, the Company will be required to make a cash payment to Microsoft of (i) an amount to be determined based on the settlement proceeds, and (ii) any funds received from Microsoft under the 7% Debentures. As discussed in Note 10, the Company intends to continue its patent litigation against Sony Computer Entertainment.

On April 2, 2004, Microsoft Corporation elected to convert 2,185,792 shares of Series A Preferred Stock into 2,185,792 shares of common stock pursuant to Section 5 (c) of the Certificate of Designation of the Powers, Preferences and Rights of Series A Redeemable Convertible Preferred Stock. This conversion eliminated certain obligations, such as the mandatory redemption buy-back provision, the obligation to make dividend payments, and certain operational limitations.

In the event of a settlement of the Sony Computer Entertainment litigation, the Company will realize and retain net cash proceeds received from Sony Computer Entertainment only to the extent that settlement proceeds exceed the amounts due Microsoft for its Participation Rights and any outstanding 7% Debentures and interest as specified above. Under certain circumstances related to a Company initiated settlement with Sony Computer Entertainment, the Company would be obligated to pay Microsoft a minimum of \$15.0 million. In the event of an unfavorable judicial resolution or a dismissal or withdrawal by Immersion of the lawsuit meeting certain conditions, the Company would not be required to make any payments to Microsoft except pursuant to the payment provisions relating to any outstanding 7% Debentures.

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Under the terms of the Senior Redeemable Convertible Debentures agreement, the Company can sell up to \$3.0 million of the 7% Debentures the first year and \$2.0 million per year for the following three years. Debenture proceeds may only be used to finance the Sony Computer Entertainment litigation. The 7% Debentures are callable by Microsoft after 3 years at 110%. They are also callable by Microsoft upon settlement of the Sony Computer Entertainment litigation at 125% of par. The 7% Debentures are convertible into common stock at 364 shares/\$1,000 face value (based on \$2.745 per share). Under certain specified circumstances, including the acquisition of the Company, any outstanding 7% Debentures would become immediately due and payable.

The \$26.0 million received from Microsoft, as described above, plus an additional \$1.4 million related to accretion and cumulative dividends had been reflected as a liability in the financial statements as of March 31, 2004. Upon the conversion of the Series A Preferred Stock, in April 2004, the Company reduced the Long-Term Customer Advance from Microsoft to the minimum obligation the Company would be obligated to pay Microsoft upon a settlement with Sony Computer Entertainment. The remainder of consideration of \$12.4 million was transferred to common stock when Microsoft elected to convert the Series A Preferred Stock to common stock.

7. NET LOSS PER SHARE

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|--------------------------------|-------------------|------------------------------|-------------------|
| | 2004 | 2003 | 2004 | 2003 |
| Numerator: | | | | |
| Net loss | <u>\$ (4,846)</u> | <u>\$ (4,444)</u> | <u>\$(11,014)</u> | <u>\$ (8,101)</u> |
| Denominator: | | | | |
| Shares used in computation, basic and diluted (weighted average common shares outstanding) | <u>23,198</u> | <u>20,179</u> | <u>21,994</u> | <u>20,162</u> |
| Net loss per share, basic and diluted | <u>\$ (0.21)</u> | <u>\$ (0.22)</u> | <u>\$ (0.50)</u> | <u>\$ (0.40)</u> |

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

| | June 30, | |
|---------------------------|-----------|-----------|
| | 2004 | 2003 |
| Outstanding stock options | 8,141,049 | 7,604,928 |
| Warrants | 351,543 | 480,943 |

8. COMPREHENSIVE LOSS

The following table sets forth the components of comprehensive loss:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|--------------------------------|------------------|------------------------------|------------------|
| | 2004 | 2003 | 2004 | 2003 |
| | (In thousands) | | (In thousands) | |
| Net loss | \$(4,846) | \$(4,444) | \$(11,014) | \$(8,101) |
| Foreign currency translation adjustment | (7) | 23 | (11) | 40 |
| Total comprehensive loss | <u>\$(4,853)</u> | <u>\$(4,421)</u> | <u>\$(11,025)</u> | <u>\$(8,061)</u> |

9. SEGMENT INFORMATION, OPERATIONS BY GEOGRAPHIC AREA, AND SIGNIFICANT CUSTOMERS

The Company designs, develops, produces, markets, and licenses products based on touch-enabling technology. These devices are used in computer entertainment, medical, automotive, and other professional computing applications. The Company has two operating and reportable segments. The Company's chief operating decision maker ("CODM") is the Chief Executive Officer. The CODM allocates resources to and assesses the performance of each operating segment using information about their revenue and operating profit before interest and taxes. A description of the types of products and services provided by each operating segment is as follows:

Immersion Computing, Entertainment and Industrial develops and markets TouchSense® and force-feedback technology that enables software and hardware developers to bring realism into their computing and entertainment experience and industrial applications. Immersion Medical develops, manufactures, and markets medical training simulators that recreate realistic healthcare environments.

The following tables display information about our reportable segments:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|--------------------------------|------------------|------------------------------|------------------|
| | 2004 | 2003 | 2004 | 2003 |
| | (In thousands) | | (In thousands) | |
| Revenues: | | | | |
| Immersion Computing, Entertainment and Industrial | \$ 3,161 | \$ 2,811 | \$ 6,564 | \$ 5,034 |
| Immersion Medical | 2,374 | 1,854 | 4,369 | 3,502 |
| Intersegment eliminations | (21) | (523) | (64) | (658) |
| Total | <u>\$ 5,514</u> | <u>\$ 4,142</u> | <u>\$ 10,869</u> | <u>\$ 7,878</u> |
| Net Loss: | | | | |
| Immersion Computing, Entertainment and Industrial | \$(3,901) | \$(3,741) | \$ (9,379) | \$(7,118) |
| Immersion Medical | (966) | (655) | (1,679) | (1,061) |
| Intersegment eliminations | 21 | (48) | 44 | 78 |
| Total | <u>\$(4,846)</u> | <u>\$(4,444)</u> | <u>\$(11,014)</u> | <u>\$(8,101)</u> |

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| | June 30, 2004 | December 31, 2003 |
|---|------------------|----------------------|
| (In thousands) | | |
| Total Assets: | | |
| Immersion Computing, Entertainment and Industrial | \$ 43,932 | \$ 47,543 |
| Immersion Medical | 3,850 | 5,136 |
| Intersegment eliminations | (15,747) | (14,766) |
| Total | <u>\$ 32,035</u> | <u>\$ 37,913</u> |

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

The Company operates primarily in the United States and in Canada where it operates through its wholly owned subsidiary, Immersion Canada. Segment assets and expenses relating to the Company's corporate operations are not allocated but are included in Immersion Computing, Entertainment and Industrial as that is how they are considered for management evaluation purposes. As a result, the segment information may not be indicative of the financial position or results of operations that would have been achieved had these segments operated as unaffiliated entities. Management measures the performance of each segment based on several metrics, including net loss. These results are used, in part, to evaluate the performance of, and allocate resources, to each of the segments.

REVENUE BY PRODUCT LINES

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|--------------------------------|----------------|------------------------------|----------------|
| | 2004 | 2003 | 2004 | 2003 |
| (In thousands) | | | | |
| Revenues: | | | | |
| Consumer, Computing and Entertainment | \$1,243 | \$ 718 | \$ 2,461 | \$1,378 |
| 3D and Professional Products | 1,476 | 1,188 | 2,950 | 2,217 |
| Automotive | 336 | 202 | 854 | 409 |
| Other | 103 | 180 | 267 | 372 |
| Subtotal Immersion Computing, Entertainment and Industrial | <u>3,158</u> | <u>2,288</u> | <u>6,532</u> | <u>4,376</u> |
| Immersion Medical | <u>2,356</u> | <u>1,854</u> | <u>4,337</u> | <u>3,502</u> |
| Total | <u>\$5,514</u> | <u>\$4,142</u> | <u>\$10,869</u> | <u>\$7,878</u> |

REVENUE BY REGION

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

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| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|-------------------|--------------------------------|------|------------------------------|------|
| | 2004 | 2003 | 2004 | 2003 |
| North America | 75% | 68% | 72% | 70% |
| Europe | 20% | 18% | 19% | 18% |
| Far East | 5% | 13% | 8% | 11% |
| Rest of the world | —% | 1% | 1% | 1% |
| Total | 100% | 100% | 100% | 100% |

The Company derived 73% and 68% of its total revenues from the United States for the three months ended June 30, 2004 and 2003 respectively. The Company derived 71% and 68% of its total revenues from the United States for the six months ended June 30, 2004 and 2003 respectively. Revenues from other countries represented less than 10% individually for the periods presented.

The majority of the Company's long-lived assets were located in the United States. Long-lived assets included net property and equipment and long-term investments and other assets. Long-lived assets that were outside the United States constituted less than 10% of the total at June 30, 2004 and December 31, 2003.

SIGNIFICANT CUSTOMERS

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|------------|--------------------------------|------|------------------------------|------|
| | 2004 | 2003 | 2004 | 2003 |
| Customer A | * | * | * | 10% |
| Customer B | 23% | * | 20% | * |
| Customer C | 10% | * | * | * |
| Total | 33% | 0% | 20% | 10% |

* Revenue derived from customer represented less than 10% for the period.

As of June 30, 2004, one customer accounted for 18% of the Company's accounts receivable. No other customer accounted for more than 10% of the Company's accounts receivable for the periods presented.

10. CONTINGENCIES

In re Immersion Corporation

The Company is 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 the Company and three of its current or former officers or directors (the "Immersion Defendants") and certain underwriters of the Company's November 12, 1999 initial public offering ("IPO"). Subsequently, two of the individual defendants stipulated to a dismissal without prejudice.

The operative amended complaint is brought on purported behalf of all persons who purchased the common stock of the Company from the date of the IPO through December 6, 2000. It alleges liability under Sections 11 and 15 of the

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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 the Company, as well as in all other cases (except for 10 cases). The motion was denied as to the claim under Section 10(b) as to the Company, on the basis that the complaint alleged that the Company had made acquisition(s) following the IPO. The motion was granted as to the claim under Section 10(b), but denied as to the claim under Section 20(a), as to the remaining individual defendant.

The Company and most of the issuer defendants 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 the Company 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 the Company believes 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.

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

On February 11, 2002, the Company 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 are also seeking damages for attorneys' fees. On October 8, 2002, the Company filed an amended complaint, withdrawing the claim under the '672 patent and adding claims under a new patent, U.S. Patent No. 6,424,333.

On October 10, 2002, the Court entered an Amended Case Management Order that set, among other dates in the case, April 25, 2003 for a hearing to construe the claims of the asserted patents and April 5, 2004 for the start of trial. On October 28, 2002, Sony Computer Entertainment and Microsoft answered the amended complaint and alleged similar counterclaims for declaratory relief that the asserted patents are invalid, unenforceable, or not infringed. On March 21, 2003, Sony Computer Entertainment filed a motion for summary judgment of non-infringement. At Immersion's request, the Court ordered this motion stricken, without prejudice to its being refiled at a later date after the Court rules on claim construction. On April 25, 2003, the Court held the scheduled claim construction hearing. On July 9, 2003, the Court issued an Order Modifying Case Management Order that reset certain scheduled dates in the case, including setting April 12, 2004 as the start of trial. On October 2, 2003, the Court issued its Claim Construction Order construing certain terms of the patents asserted in the lawsuit. On January 16, 2004, Sony Computer Entertainment filed a motion for summary judgment of invalidity and that Sony Computer Entertainment Inc. should be dismissed as a party. Immersion filed a motion for summary judgment seeking to dismiss Sony's defenses that the asserted patents are unenforceable. On February 27, 2004, the Court held a hearing on these motions. On March 2, 2004, the Court issued a written ruling on the summary judgment motions. The Court denied Sony's motion for summary judgment of invalidity. The Court granted all but one of Immersion's motions and dismissed several Sony defenses. On March 23, 2004 the Court rescheduled the trial from April 12, 2004 to April 19, 2004. On April 13, 2004, the Court held a pretrial conference to address various pretrial matters. Due to a scheduling conflict with another matter on the Court's calendar, the Court tentatively rescheduled the trial date to May 24, 2004, with a tentative backup date of August 16, 2004. On May 18, 2004, the Court rescheduled the trial date to August 16, 2004. This date continues to be subject to the Court's calendar. There are also several additional pretrial matters which are scheduled for hearing before the Court on August 13, 2004.

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On July 28, 2003, the Company announced that it had settled its legal differences with Microsoft, and Immersion and Microsoft 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 Immersion and Microsoft. The Company continues to pursue its claims of infringement against Sony Computer Entertainment. In the event the Company settles its lawsuit with Sony Computer Entertainment, the Company will be obligated to pay certain sums to Microsoft as described in Note 6. If Sony Computer Entertainment were successful in its counterclaims and the Company's patents involved in this litigation were deemed invalid and/or unenforceable, the assets relating to the patents that were deemed invalid and/or unenforceable would be impaired, and the Company may be required to pay Sony Computer Entertainment's attorneys' fees.

Due to the inherent uncertainties of litigation, the Company cannot accurately predict the ultimate outcome of the litigation. The Company anticipates that the litigation will continue to be costly, and there can be no assurance that the Company will be able to recover the costs it incurs in connection with the litigation. The Company expenses litigation costs as incurred and only accrues 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 the Company's key management and personnel. As a result, until such time as it is resolved, the litigation could adversely affect the Company's business. Further, any unfavorable outcome could adversely affect the Company's business.

Other Contingencies

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

In the normal course of business, the Company provides indemnifications of varying scope to customers against claims of intellectual property infringement made by third parties arising from the use of the Company's intellectual property, technology, or products. Historically, costs related to these guarantees have not been significant, and the Company is unable to estimate the maximum potential impact of these guarantees on its future results of operations. The Company has recently received a claim from one of its major licensees requesting indemnification from a patent infringement allegation. The Company has reviewed this demand and believes that it is without merit. Such claim could result in litigation, however, which could be costly and time-consuming to defend. Further, the Company's business could be adversely affected if the Company was unsuccessful in defending against the claim.

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

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

This Quarterly Report on Form 10-Q includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. The forward-looking statements involve risks and uncertainties. Forward-looking statements are identified by words such as "anticipates," "believes," "expects," "intends," "may," "will," and other similar expressions. However, these words are not the only way we identify forward-looking statements. In addition, any statements, which refer to expectations, projections, or other characterizations of future events, or circumstances are forward-looking statements. Actual results could differ materially from those projected in the forward-looking statements as a result of a number of factors, including those set forth below in Management's Discussion and Analysis of Financial Condition and Results of Operations and Factors That May Affect Future Results, those described elsewhere in this report, and those described in our other reports filed with the SEC. We caution you not to place undue reliance on these forward-looking statements, which speak only as of the date of this report, and we undertake no obligation to update these forward-looking statements

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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 filed with the SEC that attempt to advise you of the risks and factors that may affect our business.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Our discussion and analysis of our financial condition and results of operations are based upon our condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States (“GAAP”). The preparation of these condensed consolidated financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, expenses, and related disclosure of contingent assets and liabilities. On an ongoing basis, we evaluate our estimates, including those related to revenue recognition, bad debts, warranty obligations, patents and intangible assets, inventories, contingencies, and litigation. We base our estimates 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.

We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our condensed consolidated financial statements:

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, “Accounting for Revenue Arrangements with Multiple Deliverables,” and the American Institute of Certified Public Accountants’ (the “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. 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 related to the value of the services does not exist. Examples of our typical license models are as follows:

| 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. | Based on straight-line amortization of an annual minimum/up-front payment recognized over contract period or annual minimum period. No further obligations to licensee exist. |
| 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. | Up-front revenue recognition based on SOP 97-2 criteria or EITF 00-21, as applicable. |

We generally license and recognize revenue from our licensees under the above license models or a combination thereof. 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. If the information received from our licensees regarding royalties is incorrect or inaccurate, it could adversely affect revenue in future periods. To date all information received from our licensees has caused no material reduction in future period revenues. 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

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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® G2 product line for 14 days after purchase. We recognize revenue at the time of shipment of a MicroScribe system and provide an accrual for potential returns based on historical experience. No other general right of return is offered on our products. 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. Our revenue recognition policies are significant because our revenue is 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.

We have executed a series of agreements with Microsoft Corporation as described in Note 6 to our condensed consolidated financial statements that provide for settlement of our lawsuit against Microsoft as well as various licensing, sublicensing, and equity and financing arrangements. We have 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 the conversion of the Series A Preferred Stock, in April 2004, we reduced the Long-Term Customer Advance from Microsoft to the minimum obligation we would be obligated to pay Microsoft upon a settlement with Sony Computer Entertainment. The remainder of consideration was transferred to common stock when Microsoft elected to convert the Series A Preferred Stock to common stock.

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 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.

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

We have acquired patents and other intangibles. Our business acquisitions typically result in goodwill and other intangible assets. In addition, we capitalize the external legal and filing fees associated with patents and trademarks. We assess the recoverability of our goodwill and other intangible assets, and we must make assumptions regarding estimated future cash flows and other factors to determine the fair value of the respective assets that affect our consolidated financial statements. If these estimates or related assumptions change in the future, we may be required to record impairment charges for these assets. We amortize our intangible assets related to patents and trademarks, once they issue, over their estimated useful lives, generally 10 years. Future changes in the estimated useful life could affect the amount of future period amortization expense that we will incur. During the three months ended and the six months ended June 30, 2004, we capitalized external costs associated with patents and trademarks of \$0.5 million and \$1.0 million respectively, and our amortization expense for the same period, for those capitalized costs, was \$40,000 and \$77,000 respectively.

The above listing is not intended to be a comprehensive list of all of our accounting policies. In many cases, the accounting treatment of a particular transaction is specifically dictated by generally accepted accounting principles in the United States of America, 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. See our condensed consolidated financial statements included elsewhere in this Quarterly Report which contains accounting policies and other disclosures required by GAAP.

OVERVIEW

We are a leading provider of haptic technology that brings the sense of touch to a wide variety of markets. We develop, manufacture, license, and support a wide range of hardware and software technologies that let users interact with digital devices using their sense of touch. We focus on four application areas — mobility; gaming; industrial; and medical. 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 technology is a small piece of a larger system (such as mobile phones, consumer gaming peripherals, and automotive interfaces), we license our technologies to third party manufacturers who integrate our

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technology into their products and resell it under their own brand names. In other markets, where our touch technology is a complete system (like medical simulation systems and three-dimensional and professional products) or electronic components, we manufacture and sell products under our own Immersion brand name, through direct sales, distributors, and value added resellers. In all market areas, we also engage in development projects for third parties and government agencies from time to time.

Our objective is to proliferate our technologies across markets, platforms, and applications so that touch and feel become as common as color, graphics, and sound in modern user interfaces. Immersion and its wholly owned subsidiaries hold more than 230 issued patents and more than 270 pending patent applications worldwide, covering various aspects of hardware and software technologies.

RESULTS OF OPERATIONS FOR THE THREE MONTHS AND SIX MONTHS ENDED JUNE 30, 2004 AND 2003

Overview of the Three Months and Six Months Ended June 30, 2004

We experienced a 33% increase in revenue during the three months ended June 30, 2004 as compared to the three months ended June, 30 2003 and a 38% increase in revenue for the first six months of fiscal 2004 as compared to the first six months of fiscal 2003. All revenue categories contributed to the six-month year-over-year growth. Investments made in the sales and marketing area are contributing to our ability to penetrate new and existing markets and build greater market acceptance for our touch technology. Increased royalty and license revenue due to increased sales of both PC and console gaming peripherals by our licensees and license fees from our license and development contract with Medtronic also contributed to the revenue growth during the first six months of 2004. During the three months ended June 30, 2004, we continued our litigation against Sony Computer Entertainment and incurred litigation costs of \$2.0 million, an increase of \$0.4 million from the three months ended June 30, 2003. Litigation costs increased by \$2.8 million to \$5.2 million in the first six months of fiscal 2004 as compared to the same period last year. Although our net loss in the first six months ended June 30, 2004 was \$11.0 million, it should be noted that in addition to the \$5.2 million in litigation expenses, the loss included \$0.6 million in preferred stock accretion and accrued dividends related to our previously outstanding Series A Preferred Stock held by Microsoft. As a result of Microsoft's conversion of all such shares of Series A Preferred Stock into common stock in April 2004, we do not expect to incur any preferred stock accretion and dividend expense in the future.

As of June 30, 2004, our cash and cash equivalents were \$18.2 million. During April 2004, we extended an existing prepayment arrangement with a licensee, resulting in the receipt of an additional \$5.0 million in cash, which helped offset our cash consumption due to our operating loss.

During the remainder of 2004, we expect to see continued growth in our business segments as our technology gains further acceptance. However, our success could be limited by several factors, including the timely release of our new products or our licensees' products, continued market acceptance of our products and technology, the introduction of new products by existing or new competitors, and the cost of ongoing litigation. For a further discussion of these and other risk factors, see the section titled "Factors That May Affect Future Results."

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| REVENUES | June 30, | | Change |
|---------------------------------|-------------------|----------------|--------|
| | 2004 | 2003 | |
| | (\$ In thousands) | | |
| Three months ended: | | | |
| Royalty and license | \$ 1,899 | \$ 804 | 136% |
| Product sales | 2,879 | 2,465 | 17% |
| Development contracts and other | 736 | 873 | (16)% |
| Total Revenue | <u>\$ 5,514</u> | <u>\$4,142</u> | 33% |
| Six months ended: | | | |
| Royalty and license | \$ 3,730 | \$1,637 | 128% |
| Product sales | 5,323 | 4,613 | 15% |
| Development contracts and other | 1,816 | 1,628 | 12% |
| Total Revenue | <u>\$10,869</u> | <u>\$7,878</u> | 38% |

Three Months ended June 30, 2004 and 2003

Total Revenue. Our total revenue for the second quarter of fiscal 2004 increased by \$1.4 million or 33% from the second quarter of fiscal 2003.

Royalty and license revenue. Royalty and license revenue is comprised of royalties earned on sales by our TouchSense licensees and license fees charged for our intellectual property portfolio. Royalty and license revenue for the three months ended June 30, 2004 increased \$1.1 million or 136% from the three months ended June 30, 2003. The increase in royalty and license revenue is a combination of an increase in gaming royalties of \$548,000, an increase in medical and license fees of \$446,000, and an increase in automotive royalties of \$101,000. The increase in gaming royalties is mainly due to Microsoft's exit from the PC gaming peripherals market and the resulting increase in market share experienced by some of our third party licensees who pay us per unit royalties. We anticipate this year over year growth to continue until the end of fiscal 2004. Additionally, in the console peripheral business, many of our third-party licensees from whom we earn per unit royalties are enjoying the benefits of new premium product introductions and significant market share growth at the expense of first-party peripheral makers (i.e., Sony, Microsoft, and Nintendo). Third-party peripheral makers' market share tends to increase as consoles near end of life. Next generation consoles are expected to be introduced in early 2006 and hence we are currently seeing an increase in third-party royalties that will likely decline once the new consoles are introduced and market share is shifted back to first-party peripheral makers. The increase in royalty and license revenue from our medical licensees is primarily due to license revenue recognized on our license and development agreements with Medtronic. We have had a series of licensing and development agreements with Medtronic since 1998, and we will continue to seek additional arrangements in the future. Automotive royalties increased due to an increase in the number of vehicles manufactured with our technology incorporated in them.

Product sales. Product sales for the three months ended June 30, 2004 increased by \$414,000 or 17% as compared to the three months ended June 30, 2003. The increase in product sales was mainly due to an increase in our professional and industrial product sales and our medical product sales. Increased sales of our force feedback electronics for arcade gaming contributed to an increase in professional and industrial product sales for the three months ended June 30, 2004 as a result of a customer's successful product introduction which began during the third quarter of 2003. Medical product sales consist of sales of our virtual reality medical simulators in the vascular, endoscopic, endovascular, and laparoscopic product lines. Medical sales increased for the three months ended June 30, 2004 as compared to the three months ended June 30, 2003 primarily due to increased sales in our endovascular and laparoscopic product lines.

Development contract and other revenue. Development contract and other revenue is comprised of revenue on commercial and government contracts. Development contract and other revenue decreased by \$137,000 or 16% during the three months ended June 30, 2004, as compared to the three months ended June 30, 2003. The decrease is attributable to a decrease in revenue from government contracts in the medical area resulting from a decrease in the work performed against those contracts due to resource availability and work scheduling as well as the completion of one

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contract during the first quarter of 2004, partially offset by an increase in commercial medical development contracts namely due to our license and development agreements with Medtronic and new industrial and mobility contracts entered into during the second quarter of fiscal 2004.

We categorize our geographic information into four major regions: North America, Europe, Far East, and Rest of the World. In the second quarter of fiscal 2004, revenue generated in North America, Europe, Far East, and Rest of the World represented 75%, 20%, 5%, and 0%, respectively, compared to 68%, 18%, 13%, and 1%, respectively, for the second quarter of fiscal 2003. The shift in revenues among regions is mainly due to an increase in gaming royalties, medical royalties, and medical development contract revenues from customers in North America offset by decreased medical development contract revenue from a customer in the Far East.

Six Months ended June 30, 2004 and 2003

Total Revenue. Our total revenue for the first six months of fiscal 2004 increased by \$3.0 million or 38% from the first six months of fiscal 2003.

Royalty and license revenue. The increase in royalty and license revenue of \$2.1 million or 128% for the six-month period ended June 30, 2004 as compared to the six-month period ended June 30, 2003 is attributable to an increase in gaming royalties from the sales, by our licensees, of both console and PC gaming peripherals, an increase in medical license fees primarily from our license and development agreements with Medtronic, and an increase in automotive royalties due to an increase in the number of vehicles manufactured with our technology incorporated in them.

Product sales. Product sales increased by \$710,000 or 15% for the six-month period ended June 30, 2004 as compared to the six-month period ended June 30, 2003. The increase in product sales was mainly due to an increase in our professional and industrial product sales including increased force feedback electronics for arcade gaming and increased sales of our SoftMouse product for the six months ended June 30, 2004 as compared to the six months ended June 30, 2003.

Development contract and other revenue. Development contract revenue increased by \$188,000 or 12% for the six months ended June 30, 2004 as compared to the six months ended June 30, 2003. The increase is due to an increase in commercial contracts mainly in the medical, automotive, and mobility sectors in the amount of \$775,000 offset by a decrease of \$584,000 in government contracts. Increased medical development contracts with Medtronic and new automotive and mobility contracts entered into during the first half of fiscal 2004 were offset by a decrease in revenue from government contracts in the medical area resulting from a decrease in the work performed against those contracts due to resource availability and work scheduling.

In the first six months of fiscal 2004, revenue generated in North America, Europe, Far East and Rest of the World represented 72%, 19%, 8%, and 1% respectively compared to 70%, 18%, 11%, and 1% respectively, for the first six months of fiscal 2003. The shift in revenues among regions is mainly due to an increase in gaming royalties, medical royalties, and medical development contract revenues from customers in North America offset by decreased medical development contract revenue from a customer in the Far East.

| COST OF PRODUCT SALES | June 30, | | Change |
|----------------------------|-------------------|---------|--------|
| | 2004 | 2003 | |
| | (\$ In thousands) | | |
| Three months ended: | | | |
| Cost of product sales | \$1,540 | \$1,462 | 5% |
| % of total product revenue | 53% | 59% | |
| Six months ended: | | | |
| Cost of product sales | \$2,761 | \$2,568 | 8% |
| % of total product revenue | 52% | 56% | |

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Cost of Product Sales. Our cost of product sales consists primarily of materials, labor and overhead. There is no cost of product sales associated with royalty revenue or development contract revenue. Cost of product sales increased by \$78,000 or 5% for the three months ended June 30, 2004 as compared to the three months ended June 30, 2003 due to increased product sales and increased price and cost variances, offset by decreased write offs for excess and obsolete inventory and decreased overhead costs. Product sales increased by 17% during the three months ended June 30, 2004 compared to the three months ended June 30, 2003 thereby resulting in an increase in direct material and labor costs for the period. Price and cost variances increased \$59,000 for the three months ended June 30, 2004 as compared to the three months ended June 30, 2003. Write offs for excess and obsolete inventory decreased by \$134,000, during the three months ended June 30, 2004, revisions were made to certain products to improve product quality during the three months ended June 30, 2003. Overhead costs decreased by \$64,000 due to decreased insurance and facilities costs mainly resulting from reduced rates for such expenses during 2004. Cost of product sales as a percentage of total product revenue decreased to 53% for the three months ended June 30, 2004 from 59% for the three months ended June 30, 2003 in part due to decreased write offs for excess and obsolete inventory and decreased overhead costs.

Cost of product sales increased by \$193,000 or 8% for the first six months ended June 30, 2004 compared to the first six months ended June 30, 2003. The increase is a combination of increased direct material and labor costs associated with the increased product sales of 15%, increased price and cost variances of \$93,000, offset by decreased overhead costs of \$159,000, and decreased inventory write offs for excess and obsolete inventory of \$131,000. Cost of product sales as a percentage of total product revenue decreased to 52% for the six months ended June 30, 2004 as compared to 56% for the six months ended June 30, 2003.

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| OPERATING EXPENSES AND OTHER | June 30, | | Change |
|---|-------------------|---------|--------|
| | 2004 | 2003 | |
| | (\$ In thousands) | | |
| Three months ended: | | | |
| Sales and marketing | \$2,826 | \$1,885 | 50% |
| % of total revenue | 51% | 46% | |
| Research and development | \$2,077 | \$1,739 | 19% |
| % of total revenue | 38% | 42% | |
| General and administrative | \$3,589 | \$2,860 | 25% |
| % of total revenue | 65% | 69% | |
| Amortization of intangibles and deferred stock compensation | \$ 358 | \$ 611 | (41)% |
| % of total revenue | 6% | 15% | |
| Six months ended: | | | |
| Sales and marketing | \$5,288 | \$3,676 | 44% |
| % of total revenue | 49% | 47% | |
| Research and development | \$3,966 | \$3,428 | 16% |
| % of total revenue | 36% | 44% | |
| General and administrative | \$8,467 | \$5,016 | 69% |
| % of total revenue | 78% | 64% | |
| Amortization of intangibles and deferred stock compensation | \$ 871 | \$1,260 | (31)% |
| % of total revenue | 8% | 16% | |

Sales and Marketing. Our sales and marketing expenses are comprised primarily of employee headcount and related compensation and benefits, advertising, public relations, trade shows, brochures, market development funds, travel, and an allocation of facilities costs. Sales and marketing expenses increased by \$941,000 or 50% in the second quarter of fiscal 2004 compared to the comparable period in 2003. The increase in expenses is due to our expansion of our sales and marketing team and investment in initiatives focusing on medical and mobile phone market opportunities and upgrading our corporate marketing function, offset by decreased bad debt expense. The increase in the second three months of fiscal 2004 included increased headcount and related compensation, benefits, and overhead of \$787,000, increased travel of \$97,000 to support the sales and marketing efforts noted above, and an increase in market research, shows and exhibits, and advertising of \$88,000, offset by a decrease in bad debt expense of \$30,000. During the latter half of 2003 and the beginning of 2004, we reorganized and redeployed our sales and marketing teams to capitalize on our leading technology and progress with strategic customers in order to better execute our sales strategy and build greater market acceptance for our touch technology. We hired a number of new sales and marketing employees beginning with the latter half of 2003 and anticipate increased compensation expense related to these recent hires in the future. We anticipate increased and continued investment in sales and marketing in future periods to exploit market

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opportunities for our technology.

Sales and Marketing expenses increased by \$1.6 million or 44% in the first six months of fiscal 2004 compared to the same period last year. The increase was mainly the result of increased compensation, benefits, and overhead of \$942,000, increased professional consulting of \$280,000, increased travel of \$156,000, increased market research, shows and exhibits, and advertising of \$113,000, and comparative increased bad debt expense of \$108,000 due to reversals of bad debt expense during the first three months of fiscal 2003.

Research and Development. Our research and development expenses are comprised primarily of headcount and related compensation and benefits, consulting fees, tooling and supplies, and an allocation of facilities costs. Research and development expenses increased by \$338,000 or 19% in the second quarter of fiscal 2004 compared to the same period in 2003. The increase was mainly due to an increase in compensation, benefits, and overhead of \$190,000, in part related to creating a department to focus on human interface and usability of our technology, an increase in supplies and materials and prototyping expenses of \$92,000, and increased travel costs of \$26,000. We believe that continued investment in research and development is critical to our future success, and we expect these expenses may increase in absolute dollars in future periods but decrease as a percentage of revenue.

Research and development expenses increased by \$538,000 or 16% in the first six months of fiscal 2004 compared to the same period last year. The increase was mainly due to an increase in compensation, benefits, and overhead of \$310,000, an increase in supplies and materials and prototyping expenses of \$81,000, an increase of travel of \$43,000, and an increase in outside professional consulting of \$89,000.

General and Administrative. Our general and administrative expenses are comprised primarily of employee headcount and related compensation and benefits, legal and professional fees, office supplies, travel, and an allocation of facilities costs. General and administrative expenses increased by \$729,000 or 25% in the second quarter of fiscal 2004 compared to the same period in 2003. The increase is primarily attributable to an increase in legal and professional fees of \$497,000, mostly related to the litigation against Sony Computer Entertainment, increased compensation, benefits, and overhead of \$166,000 and increased public company expenses of \$27,000. We expect that the dollar amount of general and administrative expenses to continue to be a significant component of our operating expenses as we incur continued costs related to the Sony Computer Entertainment litigation, costs to protect and defend our intellectual property, and compliance costs associated with Sarbanes-Oxley and new Nasdaq listing requirements.

General and administrative expenses increased \$3.5 million or 69% in the first six months of fiscal 2004 as compared to the same period last year. The increase is due to increased legal and professional fees of \$3.1 million mainly due to our litigation against Sony Computer Entertainment, increased compensation, benefits, and overhead of \$207,000, and increased public company expenses of \$63,000.

Amortization of Intangibles and Deferred Stock Compensation. Our amortization of intangibles and deferred stock compensation is comprised primarily of patent amortization, other intangible amortization, and deferred stock compensation. Amortization of intangibles and deferred stock compensation decreased by \$253,000 or 41% in the second quarter of fiscal 2004 compared to the same period in 2003. The decrease is mainly attributable to a \$211,000 decrease in deferred stock compensation amortization due to the expiration of certain option vesting periods and a decrease in intangible amortization of \$42,000, as certain intangibles have reached full amortization.

Amortization of intangibles and deferred stock compensation decreased by \$389,000 or 31% in the first six months of fiscal 2004 compared to the same period last year. The decrease is mainly attributable to \$320,000 decrease in deferred stock compensation amortization due to the expiration of certain option vesting periods and a decrease in intangible amortization of \$69,000, as certain intangibles have reached full amortization.

Interest and Other Income. Interest and other income consists primarily of interest income and dividend income from cash and cash equivalents. Interest and other income increased by \$37,000 in the second quarter of fiscal 2004 compared to the same period in 2003 as a result of interest earned on our increased cash and cash equivalents for the period, which were mainly due to the \$26.0 million received in the third quarter of 2003 from Microsoft for a license to our portfolio of patents and their investment in our Series A Preferred Stock.

Interest and other income increased by \$72,000 in the first six months of fiscal 2004 compared to the same period last year as a result of interest earned on our increased cash and cash equivalents for the period, which were mainly due to the \$26.0 million received in the third quarter of 2003 from Microsoft.

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Interest and Other Expense. Interest and other expense consists primarily of interest expense on our notes payable and capital leases. Interest and other expense decreased by \$22,000 for the three months ended June 30, 2004 compared to the three months ended June 30, 2003. The reduction in interest and other expense was mainly attributable to lower interest expense associated with reduced debt obligations outstanding during the second quarter of fiscal 2004 compared to the same period in 2003.

Interest and other expense for the six months ended June 30, 2004 consists primarily of accretion and dividend expense on our long-term customer advance from Microsoft as well as interest expense on our notes payable and capital leases. Interest and other expense increased by \$571,000 in the first six months of fiscal 2004 compared to the same period last year. The increase in interest and other expense was mainly attributable to accretion of \$500,000 in payments which may be due to Microsoft and dividend expense on our Series A Preferred Stock of \$98,000, as further discussed in Note 6 to the condensed consolidated financial statements, offset by a reduction in interest expense associated with reduced debt obligations outstanding during the first six months of fiscal 2004 compared to the same period in 2003.

SEGMENT RESULTS FOR THE THREE MONTHS AND SIX MONTHS ENDED JUNE 30, 2004 AND 2003

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|--------------------------------|------------------|------------------------------|------------------|
| | 2004 | 2003 | 2004 | 2003 |
| | (In thousands) | | (In thousands) | |
| Revenues: | | | | |
| Immersion Computing, Entertainment and Industrial | \$ 3,161 | \$ 2,811 | \$ 6,564 | \$ 5,034 |
| Immersion Medical | 2,374 | 1,854 | 4,369 | 3,502 |
| Intersegment eliminations | (21) | (523) | (64) | (658) |
| Total | <u>\$ 5,514</u> | <u>\$ 4,142</u> | <u>\$ 10,869</u> | <u>\$ 7,878</u> |
| Net Loss: | | | | |
| Immersion Computing, Entertainment and Industrial | \$(3,901) | \$(3,741) | \$ (9,379) | \$(7,118) |
| Immersion Medical | (966) | (655) | (1,679) | (1,061) |
| Intersegment eliminations | 21 | (48) | 44 | 78 |
| Total | <u>\$(4,846)</u> | <u>\$(4,444)</u> | <u>\$(11,014)</u> | <u>\$(8,101)</u> |

Immersion Computing, Entertainment and Industrial segment. Revenues from the Immersion Computing, Entertainment and Industrial segment increased by \$350,000 or 12% in the second quarter of fiscal 2004 compared to the same period in 2003. Royalty and license revenues increased by \$650,000, mainly due to increased royalties from our licensees that sell console and PC gaming peripheral products; product sales decreased by \$231,000, mainly due to decreased intercompany sales to Immersion Medical partially offset by increased sales of our professional and industrial products such as our force feedback electronics for arcade gaming; and development contract revenues decreased by \$69,000, primarily due to reduced development work for Immersion Medical. Net loss for the three months ended June 30, 2004 increased by \$160,000 or 4% compared to the same period in 2003. Increased operating expenses of \$868,000 mainly due to increased litigation costs associated with our litigation against Sony Computer Entertainment and increased sales and marketing expenses, offset by increased gross margin of \$668,000 account for the increase in net loss for the three months ended June 30, 2004 compared to the same period in 2003.

Revenues for the first six months of fiscal 2004 increased by \$1.5 million or 30% as compared to the same period last year for the Immersion Computing, Entertainment and Industrial segment. The increase in revenue is primarily attributable to increased royalties from our licensees that sell console and PC gaming peripheral products and increased development contract revenues from new commercial industrial and mobility contracts. Net loss for the six months ended June 30, 2004 increased by \$2.3 million or 32% compared to the same period in 2003. The increased net loss is primarily due to increased operating expenses of \$3.6 million mainly due to increased litigation costs associated with our litigation against Sony Computer Entertainment and increased sales and marketing expenses, and increased accretion and dividend costs of \$598,000, offset by increased gross margin of \$1.9 million primarily due to increased revenues for the

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six months ended June 30, 2004 compared to the six months ended June 30, 2003.

Immersion Medical segment. Revenues from Immersion Medical increased by \$520,000 or 28% for the second quarter of fiscal 2004 compared to the same period in 2003. The increase is primarily due to an increase of \$446,000 in royalty and licensing revenue and an increase of \$234,000 in product sales revenue partially offset by a decrease of \$160,000 in development contract revenue. Royalty and license revenue increased due to revenues recognized on the Medtronic licensing agreement entered into during February 2003. Revenues on this agreement were deferred until certain refund provisions had lapsed which occurred during the fourth quarter of 2003. Net loss for the three months ended June 30, 2004 increased by \$311,000 or 47% compared to the same period in 2003. The increase is mainly due to increased operating expenses of \$795,000 primarily due to increased sales and marketing costs, offset by increased gross margin of \$465,000.

Revenues from Immersion Medical increased by \$867,000 or 25% for the first six months of fiscal 2004 as compared to the first six months of 2003 mainly due to an increase in royalty and license revenue recognized as a result of the aforementioned Medtronic licensing agreement. The net loss for the six months ended June 30, 2004 increased by \$618,000 or 58% compared to the six months ended June 30, 2003 and was primarily due to increased operating expenses of \$1.5 million mainly due to increased sales and marketing expenses, offset by increased gross margin of \$883,000 mostly due to increased royalty and license revenue.

LIQUIDITY AND CAPITAL RESOURCES

Our cash and cash equivalents consist primarily of money market funds. All of our cash and cash equivalents are classified as available-for-sale under the provisions of SFAS 115, "Accounting for Certain Investments in Debt and Equity Securities." The securities are stated at market value with unrealized gains and losses reported as a component of accumulated other comprehensive income (loss) within stockholders' equity.

At June 30, 2004 our cash and cash equivalents totaled \$18.2 million, down \$3.5 million from \$21.7 million at December 31, 2003.

During the year ended December 31, 2003, we entered into agreements with Microsoft providing for certain license rights under our patents, the settling of our lawsuit and providing for an investment in our new Series A Preferred Stock. As a result of these agreements, our cash position increased by \$26.0 million. Pursuant to the license agreement, we granted Microsoft a worldwide royalty-free, irrevocable license in exchange for approximately \$20.0 million. Under the terms of the Series A Redeemable Convertible Preferred Stock purchase agreement, Microsoft purchased 2,185,792 shares of Preferred Stock for \$2.745 per share, or an aggregate purchase price of \$6.0 million. The Preferred Stock accrued cumulative dividends at a rate of 7% per year, payable in cash or additional shares of Preferred Stock and could have been redeemed at the request of Microsoft for twice the original purchase price plus any dividends in the form of additional shares that remain unpaid and any accrued but unpaid cash dividends per share on or after July 25, 2006. On April 2, 2004, Microsoft Corporation elected to convert all 2,185,792 shares of Series A Preferred Stock into 2,185,792 shares of common stock. In addition, and at our discretion, we may require Microsoft to buy up to \$6.0 million of our 7% Senior Redeemable Convertible Debentures, at a rate of \$2.0 million per annum for the next three years. No debentures have been sold to date.

In the second quarter of 2004, we extended an existing prepayment arrangement with a licensee, resulting in our receipt of an additional \$5.0 million in cash in return for a discount on the future royalties due from this licensee pursuant to our existing license agreement.

Net cash used in operating activities during the first six months of fiscal 2004 was \$3.1 million, a decrease of \$2.2 million from \$5.3 million used during the comparable period in 2003. Cash used in operations during the six month period ended June 30, 2004 was comprised primarily of our \$11.0 million net loss offset by noncash charges and credits of \$1.9 million, which consist primarily of depreciation, amortization of intangibles, deferred stock compensation, and preferred stock accretion and dividend expense. Cash used in operating activities was also impacted by a increase of \$2.7 million due to a change in deferred revenue and customer advances, partially attributable to extending a prepayment arrangement with a licensee, an increase of \$2.2 million due to a change in accounts receivable due in part to \$1.0 million received from Medtronic, an increase of \$1.1 million due to a change in accounts payable due to the timing of payments to vendors, an increase of \$408,000 due to a change in prepaid expenses and other current assets, and a decrease of \$235,000 due to a change in accrued compensation and other current liabilities.

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Net cash used in investing activities during the first six months of fiscal 2004 was \$1.3 million. Capitalization of external patent filing and application costs accounted for \$1.0 million and purchases of capital equipment accounted for \$276,000 of cash used in investing activities during the six months ended June 30, 2004.

Net cash provided by financing activities during the first six months of fiscal 2004 was \$1.0 million due mainly to issuances of common stock and the exercise of stock options of \$1.2 million, offset by the payment of dividends on Series A Preferred Stock of \$212,000 as discussed in Note 6 to the condensed consolidated financial statements.

We believe that our cash and cash equivalents will be sufficient to meet our working capital needs and our continued litigation costs for the next twelve months. We have taken measures to control our costs and will continue to monitor these efforts. We do, however, expect our legal costs to increase during the remainder of 2004 as a result of our lawsuit against Sony Computer Entertainment. We anticipate costs for the capitalization of patents will approximate \$2.0 million for the year ended December 31, 2004 in connection with the maintenance and expansion of our patent portfolio. We anticipate that capital expenditures for the year ended December 31, 2004 will total approximately \$500,000 in connection with anticipated upgrades to operations and infrastructure. To the extent we raise additional capital through debt or equity financing, this could result in substantial dilution for our stockholders. If we acquire one or more businesses, patents, or products, our cash or capital requirements could increase substantially. In the event of such an acquisition, or should any unanticipated circumstances arise which significantly increase our capital requirements, we may elect to raise additional capital through debt or equity financing. Although we expect to be able to raise additional capital, there is no assurance that such additional capital will be available on terms acceptable to us, if at all.

SUMMARY DISCLOSURES ABOUT CONTRACTUAL OBLIGATIONS AND COMMERCIAL COMMITMENTS

The following table reflects a summary of our contractual cash obligations and other commercial commitments as of December 31, 2003 (in thousands) updated for the renegotiation of our San Jose facilities lease effective March 1, 2004:

| Contractual Obligations | Total | Less than 1 year | 1 - 3 years | 4 - 5 years | After 5 years |
|------------------------------------|----------------|-----------------------------|------------------------|------------------------|--------------------------|
| Long-Term Debt | \$ 26 | \$ 10 | \$ 16 | \$ — | \$ — |
| Capital Lease Obligations | 24 | 24 | — | — | — |
| Operating Leases | 5,047 | 988 | 1,615 | 1,585 | 859 |
| Total Contractual Cash Obligations | <u>\$5,097</u> | <u>\$1,022</u> | <u>\$1,631</u> | <u>\$1,585</u> | <u>\$859</u> |

The above table reflects the renegotiation of our San Jose facilities lease effective March 1, 2004, which reduced the lease rate and extended the term of the lease from June 2005 to June 2010.

In connection with our series of agreements with Microsoft executed in July 2003, we are obligated to pay Microsoft certain amounts based on a settlement of the Sony Computer Entertainment litigation (see Note 6 to the condensed consolidated financial statements).

On April 2, 2004, Microsoft Corporation elected to convert 2,185,792 shares of Series A Preferred Stock into 2,185,792 shares of common stock thereby eliminating its ability to redeem the Series A Preferred Stock for twice the original purchase price plus any dividends in the form of additional shares that remain unpaid and any accrued but unpaid cash dividends per share.

There were no other material changes to our contractual cash obligations and other commercial commitments during the quarter ended June 30, 2004.

RECENT ACCOUNTING PRONOUNCEMENTS

On March 31, 2004, the FASB issued its Exposure Draft, "Share-Based Payment," which is a proposed amendment to SFAS No. 123, "Accounting for Stock-Based Compensation." Generally, the approach in the Exposure Draft is similar to the approach described in SFAS No. 123. However, the Exposure Draft would require all share-based payments to

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employees, including grants of employee stock options, to be recognized in the income statement based on their fair values. The FASB expects to issue a final standard late in 2004 that would be effective for our 2005 fiscal year. The pro forma impact of the adoption of SFAS No. 123 on our historical financial statements is included in the footnotes to our condensed consolidated financial statements. We expect to continue to grant stock-based compensation to employees and the impact of the adoption of the new standard, when and if issued, may have a material impact on our future results of operations.

In March 2004, the EITF reached a final consensus on Issue No. 03-01, "The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments," to provide additional guidance in determining whether investment securities have an impairment that should be considered other-than-temporary. The adoption of this Issue will not have an effect on our operating results or financial condition.

FACTORS THAT MAY AFFECT FUTURE RESULTS

WE HAD AN ACCUMULATED DEFICIT OF \$104 MILLION AS OF JUNE 30, 2004, 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 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, including the costs of our litigation against Sony Computer Entertainment;
- continue to develop our technologies;
- attempt to expand the market for touch-enabled products;
- increase our sales 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 AGAINST SONY COMPUTER ENTERTAINMENT IS EXPENSIVE, DISRUPTIVE, AND TIME CONSUMING AND WILL CONTINUE TO BE, AND REGARDLESS OF WHETHER WE ARE ULTIMATELY SUCCESSFUL, COULD ADVERSELY AFFECT OUR BUSINESS.

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 are also seeking damages for attorneys' fees. On October 8, 2002, we filed an amended complaint, withdrawing the claim under the '672 patent and adding claims under a new patent, U.S. Patent No. 6,424,333.

On October 10, 2002, the Court entered an Amended Case Management Order that set, among other dates in the case, April 25, 2003 for a hearing to construe the claims of the asserted patents and April 5, 2004 for the start of trial. On October 28, 2002, Sony Computer Entertainment and Microsoft answered the amended complaint and alleged similar counterclaims for declaratory relief that the asserted patents are invalid, unenforceable, or not infringed. On March 21, 2003, Sony Computer Entertainment filed a motion for summary judgment of non-infringement. At Immersion's request, the Court ordered this motion stricken, without prejudice to its being refiled at a later date after the Court rules on claim construction. On April 25, 2003, the Court held the scheduled claim construction hearing. On July 9, 2003, the Court

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issued an Order Modifying Case Management Order that reset certain scheduled dates in the case, including setting April 12, 2004 as the start of trial. On October 2, 2003, the Court issued its Claim Construction Order construing certain terms of the patents asserted in the lawsuit. On January 16, 2004, Sony Computer Entertainment filed a motion for summary judgment of invalidity and that Sony Computer Entertainment Inc. should be dismissed as a party. We filed a motion for summary judgment seeking to dismiss Sony's defenses that the asserted patents are unenforceable. On February 27, 2004, the Court held a hearing on these motions. On March 2, 2004, the Court issued a written ruling on the summary judgment motions. The Court denied Sony's motion for summary judgment of invalidity. The Court granted all but one of Immersion's motions and dismissed several Sony defenses. On March 23, 2004 the Court rescheduled the trial from April 12, 2004 to April 19, 2004. On April 13, 2004, the Court held a pretrial conference to address various pretrial matters. Due to a scheduling conflict with another matter on the Court's calendar, the Court tentatively rescheduled the trial date to May 24, 2004, with a tentative backup date of August 16, 2004. On May 18, 2004, the Court rescheduled the trial date to August 16, 2004. This date continues to be subject to the Court's calendar. There are also several additional pretrial matters which are scheduled for hearing before the Court on August 13, 2004.

On July 28, 2003, we announced that we had settled our legal differences with Microsoft, and we and Microsoft agreed to dismiss all claims and counterclaims relating to this matter as well as assume financial responsibility for our respective legal costs with respect to the lawsuit between Immersion and Microsoft. We continue to pursue our claims of infringement against Sony Computer Entertainment. In the event we settle our lawsuit with Sony Computer Entertainment, we will be obligated to pay certain sums to Microsoft as described in Note 6 to our condensed consolidated financial statements. If Sony Computer Entertainment were successful in its counterclaims and our patents involved in this litigation were deemed invalid and/or unenforceable, the assets relating to the patents that were deemed invalid and/or unenforceable would be impaired, and we may be required to pay Sony Computer Entertainment's attorneys' fees.

Due to the inherent uncertainties of litigation, we cannot accurately predict the ultimate outcome of the litigation. 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.

THE MARKET FOR 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 our touch-enabling technologies and 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 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 Immersion's 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 technology in the future.

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.

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These factors include:

- the establishment or loss of licensing relationships;
- the timing of payments under fixed and/or up-front license agreements;
- the timing of our expenses, including costs related to litigation, acquisitions of technologies, or businesses;
- the timing of introductions of new products and product enhancements by us, our licensees, 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 licensees' products.

Accordingly, we believe that period-to-period comparisons of our operating results should not be relied upon as an indicator of our future performance. In addition, because a high percentage of our operating expenses are fixed, a shortfall of revenues can cause significant variations in operating results from period to period.

IF WE ARE UNABLE TO ENTER INTO NEW LICENSING ARRANGEMENTS WITH OUR EXISTING LICENSEES AND WITH ADDITIONAL THIRD-PARTY MANUFACTURERS FOR OUR TOUCH-ENABLING TECHNOLOGY, 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 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 consumer product manufacturers to work with us, to rely on us for critical technology, and to disclose to us proprietary product development and other strategies;
- if we are not successful in the litigation with Sony, not only might we have a difficult time signing up new gaming licensees, we also risk losing our existing licensees as well;
- difficulties in convincing car companies to sign a license agreement with us when they will need to purchase components from one of their vendors who may or may not yet be able to meet the car companies' stringent quality and parts availability standards;
- difficulties in persuading existing and potential licensees to bear the development costs necessary to incorporate our technologies into their products; and
- challenges in demonstrating the compelling value of our technologies in new applications like mobile phones and automobiles.

A majority of our current royalty revenue has been derived from the licensing of our portfolio of touch-enabling technologies for personal computer gaming peripherals, such as joysticks and steering wheels. The market for joysticks and steering wheels for use with personal computers is declining and is a substantially smaller market than the dedicated gaming console market and is characterized by declining average selling prices. If we are unable to gain market acceptance beyond the personal computer gaming peripherals market, we may not achieve royalty revenue growth.

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WE MAY ELECT TO OR NEED TO RAISE ADDITIONAL CAPITAL IN THE FUTURE, WHICH MAY RESULT IN SUBSTANTIAL DILUTION TO OUR STOCKHOLDERS.

Should any unanticipated circumstances arise which significantly increase our cash or capital requirements, we may elect to or need to raise additional capital in order to ensure a sufficient supply of cash for such events or future periods. Our plans to raise additional capital may include possible customer prepayments of certain royalty obligations in exchange for a royalty discount and/or other negotiated concessions, entering into new license agreements that require up-front license payments, and through debt or equity financing. We have taken measures to control our costs and will continue to monitor these efforts. We cannot be certain that additional financing will be available to us on favorable terms when required, or at all. Changes in equity markets over the past three years have adversely affected the ability of companies to raise equity financing and have adversely affected the markets for financing for companies with a history of losses such as ours. Additional financing may require us to issue additional shares of our common or preferred stock such that our existing stockholders may experience substantial dilution.

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 will 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. The license terms and restrictions in our agreements, including but not limited to field of use definitions, market sector and product category definitions, and sublicensing and exclusivity terms, shall collectively be referred to 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 to 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 entering into an agreement it is possible that markets and/or products, or legal and/or regulatory environments, will evolve in a manner that was not foreseen or was not foreseeable at the time the agreement was entered into. As a consequence, in the agreement we may have granted rights that will preclude or restrict our exploitation of potentially lucrative new opportunities that arise after the execution of the agreement.

AUTOMOTIVE ROYALTIES COULD BE REDUCED IF BMW WERE TO ABANDON ITS IDRIVE SYSTEM.

Our largest royalty stream from the auto industry is from BMW for its iDrive controller. Press reviews of this system have been largely negative and critical of the system's complexity. While this negative press primarily relates to a user interface that was not designed by us, it may mean limited sales of BMW's cars, and could ultimately lead to their abandoning the system, which could reduce or eliminate the related royalties.

BECAUSE WE HAVE A FIXED PAYMENT LICENSE WITH MICROSOFT, OUR ROYALTY REVENUE FROM LICENSING IN THE GAMING MARKET AND OTHER CONSUMER MARKETS MIGHT 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 Immersion's worldwide portfolio of patents. This license permits Microsoft to make, use, and sell hardware, software, and services, excluding specified products, covered by Immersion's patents. Immersion also granted to Microsoft a limited right, under Immersion's patents relating to touch technology, to sublicense specified rights, excluding rights to excluded products and peripheral devices, to third party customers of Microsoft's or Microsoft's subsidiaries' operating systems (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

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in a separate Sublicense Agreement, Microsoft paid Immersion 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 and PDAs. Microsoft has significantly greater financial, sales, and marketing resources, as well as greater name recognition and a larger customer base than 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.

OUR RELATIONSHIP WITH MEDTRONIC, A LEADING MEDICAL DEVICE COMPANY, MAY INTERFERE WITH OUR ABILITY TO ENTER INTO DEVELOPMENT AND LICENSING RELATIONSHIPS WITH MEDTRONIC'S COMPETITORS.

In February 2003, we entered into an agreement with Medtronic, a leading medical device company, in which Medtronic was granted a right of first negotiation. The right of first negotiation applies to any agreement, which we refer to as a "Proposed Agreement," under which we would grant a third party rights to use specified Immersion intellectual property in specified fields of use. Under the terms of the right of first negotiation, we must notify Medtronic if we have received a written offer from a third party to enter into a Proposed Agreement, or if we are seeking to find a third party to enter into a Proposed Agreement. Medtronic has the exclusive right, for a period of forty days, to negotiate with us regarding the material terms of the Proposed Agreement. If during such forty-day period, Medtronic and Immersion fail to reach agreement in principle upon the material terms of the Proposed Agreement, then we will have twelve months after the expiration of such forty day period to enter into an agreement with the applicable third party, provided that the terms of such agreement are in the aggregate more favorable to Immersion than the offer presented by Medtronic or the terms under which we initially sought to find a third party to enter into the Proposed Agreement. The right of first negotiation ceases to apply to any Proposed Agreement for which Medtronic and Immersion reach agreement in principle upon the material terms during the applicable forty-day period, but thereafter do not execute a definitive agreement within 145 days after the expiration of such forty-day period. In addition, Medtronic's right of first negotiation terminates upon the second anniversary of the completion of a development project to be undertaken by us for Medtronic. Although the right of first negotiation has not impeded our ability to interest other medical device companies in our technologies to date, this right of first negotiation or our relationship with Medtronic may impede, restrict, or delay our ability to enter into development or license agreements with large medical device companies that compete with Medtronic. Any restriction in our ability to enter into development or license agreements with other medical device companies would adversely affect our revenues.

MEDTRONIC ACCOUNTS FOR A LARGE PORTION OF OUR REVENUES AND A REDUCTION IN SALES TO MEDTRONIC, A REDUCTION IN DEVELOPMENT WORK, OR A DECISION NOT TO RENEW EXISTING LICENSES BY MEDTRONIC MAY REDUCE OUR TOTAL REVENUE.

For the three months ended June 30, 2004 and 2003, we derived 23% and 3%, respectively, of our total revenue from Medtronic. For the six months ended June 30, 2004 and 2003, Medtronic accounted for 20% and 3% of our total revenue. If our royalty and license revenue or product sales to Medtronic decline, and/or Medtronic reduces the development activities we perform, then our total revenue may decline. In addition, under our recent agreements with Medtronic, monies advanced by Medtronic are subject to refund provisions under certain circumstances. These circumstances have not arisen to date, but we cannot predict whether these circumstances will arise in the future.

MAD CATZ ACCOUNTS FOR A SIGNIFICANT PORTION OF OUR REVENUE AND THE FAILURE OF MAD CATZ TO ACHIEVE SALES VOLUMES FOR ITS GAMING PRODUCTS THAT INCORPORATE OUR TOUCH-ENABLING TECHNOLOGIES MAY REDUCE OUR TOTAL REVENUE.

Mad Catz accounts for a significant portion of our total revenue. For the three months ended June 30, 2004 and 2003, we derived 7% and 9%, respectively, of our total revenue from Mad Catz. For the six months ended June 30, 2004 and 2003, Mad Catz accounted for 6% and 10% of our total revenue. We expect that a significant portion of our total revenue will continue to be derived from Mad Catz. If Mad Catz fails to achieve anticipated sales volumes for its gaming peripheral products that incorporate our technologies, our total revenue may decline.

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.

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Logitech has in the past and may in the future account for a significant portion of our revenue. For the three months ended June 30, 2004 and 2003, we derived from Logitech 10% and 3%, respectively of our total revenue. For the six months ended June 30, 2004 and 2003, Logitech accounted for 9% and 2% of our total revenue. We expect that a significant portion of our total revenue will continue to be derived from Logitech. If Logitech fails to achieve anticipated sales volumes for its computer and console gaming peripheral products that incorporate our technologies, our total revenue may decline.

WE MAY BE UNABLE TO INCREASE SALES OF OUR MEDICAL SIMULATION DEVICES IF MEDICAL INSTITUTIONS DO NOT BUDGET ADEQUATELY FOR SUCH DEVICES.

Our medical simulation products, such as our Endoscopy AccuTouch® System, the Endovascular AccuTouch System and our Laparoscopy AccuTouch System, have only recently begun to be used by hospitals and medical schools to train healthcare professionals. As a result, many of these medical institutions do not budget for such simulation devices. To increase sales of our simulation devices, we must, in addition to convincing medical institution personnel of the utility 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 sales of medical simulators at a satisfactory rate. As a result of the terrorist attacks against the United States on September 11, 2001 and the continuing threat of terrorist acts, hospitals may have assigned priority in their capital expenditure budgets to equipment that will enable them to respond more effectively to catastrophic emergencies, and federal, state and local governments may have delayed certain funding for medical and educational institutions, in which case purchases of medical simulators may have been deferred. If we are unable to increase sales of our medical simulation products, our results of operations and financial condition may be adversely affected. We believe that medical device companies may also decrease their expenditures in corporate research and development budgets, and this may adversely affect our contract and development revenue generated by the medical segment.

WE DO NOT CONTROL OR INFLUENCE OUR LICENSEES' MANUFACTURING, PROMOTION, DISTRIBUTION, OR PRICING OF THEIR PRODUCTS INCORPORATING OUR TOUCH-ENABLING TECHNOLOGIES, UPON WHICH WE ARE DEPENDENT TO GENERATE ROYALTY REVENUE.

A key part of our business strategy is to license our intellectual property to companies that manufacture and sell products incorporating our touch-enabling technologies. Sales of those products generate royalty and license revenue for us. For the three months ended June 30, 2004 and 2003, 34% and 19%, respectively, of our total revenues were royalty and license revenues. For the six months ended June 30, 2004 and 2003, 34% and 21%, respectively, of our total revenues were royalty and license revenues. However, we do not control or influence the 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 technology in 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 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.

Peak demand for products that incorporate our technologies, especially in the computer and console gaming peripherals market, typically occurs in the third and fourth calendar quarters as a result of increased demand during the year-end holiday season. If our licensees do not ship products incorporating our touch-enabling technology 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.

REDUCED SPENDING BY CORPORATE RESEARCH AND DEVELOPMENT DEPARTMENTS MAY ADVERSELY AFFECT SALES OF OUR THREE-DIMENSIONAL AND PROFESSIONAL PRODUCTS.

We believe that the current economic downturn has led to a reduction in corporations' budgets for research and development in several sectors, including the automotive and aerospace sectors, which use our three-dimensional and

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professional products. Sales of our three-dimensional and professional products, including our CyberGlove® line of whole-hand sensing gloves and our MicroScribe G2 line of three-dimensional digitizers may be adversely affected by these cuts in corporate research and development budgets.

WE HAVE LIMITED DISTRIBUTION CHANNELS AND RESOURCES TO MARKET AND SELL OUR MEDICAL SIMULATION AND THREE-DIMENSIONAL SIMULATION 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 or three-dimensional simulation 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 and three-dimensional simulation products will depend upon our ability to retain and develop a qualified sales force and effective distributor channels. We may not be successful in attracting and retaining the personnel necessary to sell and market our simulation products. A number of our distributors represent small-specialized companies that may not have sufficient capital or human resources to support the complexities of selling and supporting simulation products. There is no assurance that our direct selling efforts will be effective, distributors will market our products successfully or, if our relationships with distributors terminate, we will be able to establish relationships with other distributors on satisfactory terms, if at all. Any disruption in the distribution, sales, or marketing network for our simulation products could have a material adverse effect on our product revenues.

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, could result in the expenditure of significant financial resources and the diversion of 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 technology, 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 technology 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 technology or license the infringed or similar technology 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 may influence our licensees' decisions whether to ship products incorporating our technologies. Although none of these matters has resulted in litigation to date, any of these notices, or additional notices that we could receive in the future from these or other companies, could lead to litigation.

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 technology 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

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existing license arrangements, or require us or our licensees to cease utilizing the technology unless we can enter into royalty or licensing agreements. Royalty or 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. We have recently received such a claim from one of our major licensees requesting indemnification from a patent infringement allegation. We have reviewed this demand and believe that it is without merit. This claim could result in litigation, however, which could be costly and time-consuming to defend. Further, our business could be adversely affected if we were unsuccessful in defending against the claim.

IF WE FAIL TO PROTECT AND ENFORCE OUR INTELLECTUAL PROPERTY RIGHTS, OUR ABILITY TO LICENSE OUR TECHNOLOGIES AND TO 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. 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 were to limit the scope of, declare unenforceable, or invalidate any of our patents, current licensees may refuse to make royalty payments or may themselves 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 our licensees do business.

We also rely on licenses, confidentiality 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 products and trademarks would be difficult, expensive, and time-consuming, particularly overseas.

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, 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 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.

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

Personal computer and console gaming peripherals 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 Logitech, Microsoft, ALPS Electric Co., Ltd., Samsung, and BMW have licensed our

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technology, the greater expense of products containing our touch-enabling technologies as compared to non-touch-enabled products may be a significant barrier to the widespread adoption and sale of touch-enabled products.

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.

COMPETITION IN THE MEDICAL MARKET MAY REDUCE OUR REVENUE.

If the medical simulation market develops as we anticipate, we believe we will have a greater number of competitors and may have competition in product lines where we have previously enjoyed sole supplier status. Increased competition may result in the reduction of our market share and/or cause us to reduce our selling prices which may result in a decline in our revenue.

COMPETITION IN THE MOBILITY MARKET MAY INCREASE OUR COSTS AND REDUCE OUR REVENUE.

If the mobility market develops as we anticipate, we believe we will face a greater number of competitors. These potential competitors may have significantly greater financial, technical, and marketing 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.

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 technology 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:

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- we fail to develop new technologies;
- the technologies we develop infringe on existing non-Immersion patents;
- our new technologies fail to gain market acceptance; or
- our current products become obsolete.

WE DEPEND ON A SINGLE SUPPLIER TO PRODUCE SOME OF OUR MEDICAL SIMULATORS AND MAY LOSE CUSTOMERS IF THIS SUPPLIER DOES NOT MEET OUR REQUIREMENTS.

We have one supplier for some of our custom medical simulators. Any disruption in the manufacturing process from our sole supplier could adversely affect our ability to deliver our products and ensure quality workmanship and could result in a reduction of our product sales. Additionally, the single supplier could increase prices and thereby erode our margins before we are able to find an alternative source.

MEDICAL LICENSING AND CERTIFICATION AUTHORITIES MAY NOT ENDORSE OR REQUIRE USE OF OUR TECHNOLOGIES FOR TRAINING 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, or ABIM, and the American College of Cardiology, or ACC, have great influence in endorsing particular medical methodologies, including medical training methodologies, for use by medical professionals. In the event that the ABIM and the ACC, as well as other, similar bodies, do not endorse our medical simulation training products as a training vehicle, market penetration for our products could be significantly and adversely affected.

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. Throughout the product development process, we face the risk that an automobile manufacturer or supplier may delay the incorporation of, or choose not to incorporate, our technologies into its automobiles, making it difficult for us to predict the per unit automotive royalties we may receive, if any. After the product launches, our royalties still depend on market acceptance of the vehicle, 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. 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 technology, and develop new technologies.

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

We 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.

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 technology for personal computer peripheral products that incorporate our touch-enabling technologies is currently compatible with Microsoft's Windows 98, Windows 2000, Windows Me and Windows XP operating systems, including DirectX, Microsoft's entertainment applications programming interface. If Microsoft modifies its operating system, including DirectX, we may need to modify our technologies 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.

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, including the Sarbanes-Oxley Act of 2002, and there may potentially be new accounting pronouncements or additional regulatory rulings which will have an impact on our future financial position and results of operations. These changes and other legal changes, as well as proposed legislative initiatives following the Enron bankruptcy, are likely to increase general and administrative costs. In addition, insurers are likely to increase premiums as a result of high claims rates over the past year, which we expect will increase our premiums for our various insurance policies. Further, proposed initiatives are expected to result in changes in certain accounting rules, including legislative and other proposals to account for employee stock options as a compensation expense. These and other potential changes could materially increase the expenses we report under generally accepted accounting principles, and adversely affect our operating results.

THE NEW REQUIREMENTS OF SECTION 404 OF THE SARBANES-OXLEY ACT WILL INCREASE OUR OPERATING EXPENSES.

Rules adopted by the Securities and Exchange Commission pursuant to Section 404 of the Sarbanes-Oxley Act of 2002 require annual review and evaluation of our internal control systems, and attestation of these systems by our independent auditors. We are currently undergoing a review of our internal control systems and procedures and considering improvements that will be necessary in order for us to comply with the requirements of Section 404 by the end of the fiscal year ended December 31, 2004. This evaluation process will require us to hire additional personnel and outside advisory services and will result in additional accounting and legal expenses, all of which will cause our operating expenses to increase. In addition, the evaluation and attestation processes required by Section 404 are new and untested, and we may encounter problems or delays in completing the implementation of improvements and receiving a favorable review and attestation by our independent auditors.

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. 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. In addition, a substantial portion of our research and development activities, manufacturing, our corporate headquarters, and other critical business operations are located near

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major earthquake faults in San Jose, California, an area with a history of seismic events. Any such loss at our facilities could disrupt our operations, delay production, shipments, and revenue, 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.

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 change may place significant strains on our managerial, financial, engineering, and other resources. Further economic weakness, in combination with our complex technologies, may demand an unusually high level of managerial effectiveness in anticipating, planning, coordinating, and meeting our operational needs as well as the needs of our licensees.

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 acquired, 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.

OUR CURRENT CLASS ACTION LAWSUIT COULD BE EXPENSIVE, DISRUPTIVE, AND TIME CONSUMING TO DEFEND AGAINST, AND IF WE ARE NOT SUCCESSFUL, COULD ADVERSELY AFFECT OUR BUSINESS.

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 the Company and three of its current or former officers or directors (the "Immersion Defendants"), and certain underwriters of the Company's November 12, 1999 initial public offering ("IPO"). Subsequently, two of the individual defendants stipulated to a dismissal without prejudice.

The operative amended complaint is brought on purported behalf of all persons who purchased the common stock of the Company from the date of the 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.

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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 the Company, as well as in all other cases (except for 10 cases). The motion was denied as to the claim under Section 10(b) as to the Company, on the basis that the complaint alleged that the Company had made acquisition(s) following the IPO. The motion was granted as to the claim under Section 10(b), but denied as to the claim under Section 20(a), as to the remaining individual defendant.

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.

IF WE FAIL TO COMPLY WITH NASDAQ'S MAINTENANCE CRITERIA FOR CONTINUED LISTING ON THE NASDAQ NATIONAL MARKET, OUR COMMON STOCK COULD BE DELISTED.

To maintain the listing of our common stock on the Nasdaq National 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 June 30, 2004, our most recent balance sheet date, we had \$1.5 million 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 National Market. If we are unable to comply with the applicable criteria and our common stock is delisted from the Nasdaq National Market, it would likely be more difficult to effect 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.

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; new products or new contracts; sales or the perception in the market of possible sales of large number of shares of Immersion common stock by insiders or others including Microsoft; 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 filed 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.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We have limited exposure to financial market risks, including changes in interest rates. The fair value of our portfolio or related income would not be significantly impacted by a 100 basis point increase or decrease in interest rates due mainly to the short-term nature of the major portion of our investment portfolio. An increase or decrease in interest rates would not significantly increase or decrease interest expense on debt obligations due to the fixed nature of our debt obligations. Our foreign operations are limited in scope and thus we are not materially exposed to foreign currency fluctuations.

ITEM 4. CONTROLS AND PROCEDURES

(a) Under the supervision and with the participation of our management, including our President, Chief Executive Officer and Chief Financial Officer, we evaluated the effectiveness of our disclosure controls and procedures, as such term is defined under Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended. Based on this evaluation, our President, Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective as of the end of the period covered by this quarterly report.

(b) There has been no change in our internal control over financial reporting during the period covered by this quarterly report that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

In re Immersion Corporation

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

The operative amended complaint is brought on purported behalf of all persons who purchased the common stock of the Company from the date of the 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 the Company, as well as in all other cases (except for 10 cases). The motion was denied as to the claim under Section 10(b) as to the Company, on the basis that the complaint alleged that the Company had made acquisition(s) following the IPO. The motion was granted as to the claim under Section 10(b), but denied as to the claim under Section 20(a), as to the remaining individual defendant.

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

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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.

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 are also seeking damages for attorneys' fees. On October 8, 2002, we filed an amended complaint, withdrawing the claim under the '672 patent and adding claims under a new patent, U.S. Patent No. 6,424,333.

On October 10, 2002, the Court entered an Amended Case Management Order that set, among other dates in the case, April 25, 2003 for a hearing to construe the claims of the asserted patents and April 5, 2004 for the start of trial. On October 28, 2002, Sony Computer Entertainment and Microsoft answered the amended complaint and alleged similar counterclaims for declaratory relief that the asserted patents are invalid, unenforceable, or not infringed. On March 21, 2003, Sony Computer Entertainment filed a motion for summary judgment of non-infringement. At our request, the Court ordered this motion stricken, without prejudice to its being refiled at a later date after the Court rules on claim construction. On April 25, 2003, the Court held the scheduled claim construction hearing. On July 9, 2003, the Court issued an Order Modifying Case Management Order that reset certain scheduled dates in the case, including setting April 12, 2004 as the start of trial. On October 2, 2003, the Court issued its Claim Construction Order construing certain terms of the patents asserted in the lawsuit. On January 16, 2004, Sony Computer Entertainment filed a motion for summary judgment of invalidity and that Sony Computer Entertainment Inc. should be dismissed as a party. We filed a motion for summary judgment seeking to dismiss Sony's defenses that the asserted patents are unenforceable. On February 27, 2004, the Court held a hearing on these motions. On March 2, 2004, the Court issued a written ruling on the summary judgment motions. The Court denied Sony's motion for summary judgment of invalidity. The Court granted all but one of Immersion's motions and dismissed several Sony defenses. On March 23, 2004 the Court rescheduled the trial from April 12, 2004 to April 19, 2004. On April 13, 2004, the Court held a pretrial conference to address various pretrial matters. Due to a scheduling conflict with another matter on the Court's calendar, the Court tentatively rescheduled the trial date to May 24, 2004, with a tentative backup date of August 16, 2004. On May 18, 2004, the Court rescheduled the trial date to August 16, 2004. This date continues to be subject to the Court's calendar. There are also several additional pretrial matters which are scheduled for hearing before the Court on August 13, 2004.

On July 28, 2003, we announced that we had settled our legal differences with Microsoft, and we and Microsoft agreed to dismiss all claims and counterclaims relating to this matter as well as assume financial responsibility for our respective legal costs with respect to the lawsuit between Immersion and Microsoft. We continue to pursue our claims of infringement against Sony Computer Entertainment. In the event we settle our lawsuit with Sony Computer Entertainment, we will be obligated to pay certain sums to Microsoft as described in Note 6 to our condensed consolidated financial statements. If Sony Computer Entertainment was successful in its counterclaims and our patents involved in this litigation were deemed invalid and/or unenforceable, the assets relating to the patents that were deemed invalid and/or unenforceable would be impaired. We currently believe it is unlikely that our patents will be deemed invalid and/or unenforceable in connection with the counterclaims of Sony Computer Entertainment. We cannot at this time estimate the amount of a possible loss associated with the possible impairment of these assets nor can we forecast the amount of any future revenue streams that may be affected. Sony Computer Entertainment has requested that it be awarded attorneys fees in the event it prevails. The court in exceptional cases may award reasonable attorney fees to the prevailing party. We currently believe it is remote that Sony Computer Entertainment would be awarded attorneys' fees.

Due to the inherent uncertainties of litigation, we cannot accurately predict the ultimate outcome of the litigation. 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.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

The Company held its annual meeting of stockholders (the “Annual Meeting”) on June 2, 2004, to consider and vote on the following proposals to: (i) elect two (2) members of the Board of Directors to serve for a three-year term as a Class II Directors (Proposal 1); and (ii) to ratify the appointment of Deloitte & Touche LLP as the Company’s independent public accountants for the fiscal year ending December 31, 2004 (Proposal 2).

Proposal 1: The stockholders elected the two (2) nominees for Class II directors to our Board of Directors. The votes were as follows:

| Nominees | Number of Votes For | Withheld Authority |
|---------------------|--------------------------------|-------------------------------|
| Jonathan Rubinstein | 18,551,077 | 329,011 |
| Robert Van Naarden | 18,637,998 | 242,090 |

Messrs, Rubenstein and Van Naarden’s term will expire at the 2007 annual meeting. The following directors’ terms of office continue until the annual meeting indicated: John Hodgman (Class III term expires at the 2005 annual meeting) and Steven Blank, Jack Saltich, and Victor Viegas (Class I term expires at the 2006 annual meeting).

Proposal 2: The ratification of Deloitte & Touche LLP as the Company’s independent public accountants for the fiscal year ending December 31, 2004:

| Number of Votes For | Number of Votes Against | Number of Votes Abstained |
|--------------------------------|------------------------------------|--------------------------------------|
| 18,511,715 | 342,106 | 26,267 |

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits.

The following exhibits are filed herewith:

| Exhibit Number | Description |
|---------------------------|---|
| 10.57 | Voluntary Severance Agreement and General Release dated April 16, 2004 by and between Richard Stacey and Immersion Corporation |
| 31.1 | Certification of Victor Viegas, President, Chief Executive Officer, Chief Financial Officer, and Director, pursuant to Section 302(a), the Sarbanes-Oxley Act of 2002 |
| 32.1 | Certification of Victor Viegas, President, Chief Executive Officer, Chief Financial Officer, and Director, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

(b) Reports on Form 8-K

(i) We filed a Current Report on Form 8-K on April 7, 2004, announcing the conversion of Immersion’s Series A Redeemable Convertible Preferred Stock by Microsoft Corporation.

(ii) We filed a Current Report on Form 8-K on April 19, 2004, announcing the rescheduling of the trial date for Immersion’s lawsuit against Sony Computer Entertainment, Inc. and Sony Computer Entertainment of America, Inc.

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(iii) We furnished a Current Report on Form 8-K on April 26, 2004, announcing the release of the Company's earnings for the first quarter of 2004.

(iv) We filed a Current Report on Form 8-K on May 20, 2004, announcing the rescheduling of the trial date for Immersion's lawsuit against Sony Computer Entertainment, Inc. and Sony Computer Entertainment of America, Inc.

SIGNATURES

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

IMMERSION CORPORATION
Registrant

Date: August 13, 2004

/s/ Victor Viegas

Victor Viegas
President, Chief Executive Officer,
Chief Financial Officer, and Director

EXHIBIT INDEX

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VOLUNTARY SEVERANCE AGREEMENT AND GENERAL RELEASE

This is an Agreement and General Release (Agreement) between Immersion Medical, ("the Company") and Richard Stacey (Employee), collectively referred to herein as the "Parties". In order to forever resolve and settle any and all disputes regarding Employee's employment with the Company or any other disputes with the Company the Employee may have, the Parties agree as follows:

1. The Parties agree that, as of April 13, 2004, Employee's employment with the Company ended.

2. Employee agrees that he/she will submit any business expense reports to the Company within thirty (30) days after receipt of this Agreement, and the Company agrees to pay all such properly submitted expense reports subject to Company policy in accordance with its customary procedures.

3. Employee agrees that he/she shall immediately return to the Company all Company property, including but not limited to all computer equipment, keys, passwords, tangible proprietary information, documents, books, records, report, contract, customer and contact lists, computer files and data (and any copies thereof), which exist in any medium, which were prepared or obtained by Employee in the course of or incident to his/her employment.

4. The Company agrees that it will continue to pay Employee's salary equal to 12 months of base salary which will include all lawful deductions. Employee recognizes that for purposes of the continuation coverage requirement of group health plans under the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA), as amended, and the group health provisions of the Maryland Annotated Code, a "qualifying event: and "applicable change in status" occurs as of April 13, 2004. The Company also agrees to subsidize the employee's entire COBRA premium for a 12 month period beginning May 2004. The Company agrees to give Employee all notices and information required under such laws.

5. Employee agrees that he/she will not disparage or make any derogatory or negative statements related to the Company and/or its officers, directors or employees.

6. Employee agrees that in consideration of the promises set forth in paragraph 4 he/she will, and hereby does, forever and irrevocably release and discharge the Company, its officers, directors, employees, agents, parents, affiliates, predecessors, successors, purchasers, assigns, and representatives, of any and all grievances, claims, demands, debts, defenses, actions or causes of action, obligations, damages, and liabilities whatsoever which he/she now has, has had, or may have, whether the same be at law, in equity, or mixed, in any way arising from or relating to any act, occurrence, or transaction before the date of this Agreement. This is a General Release. Employee expressly acknowledges that this General Release includes, but is not limited to, Employee's intent to release the Company from any claim under contract, tort, defamation, misrepresentation, and wage and hour, as well as any claim of age, race, sex, religion, national origin or any other claim of employment discrimination under the Age Discrimination of

Employment Act (29 U.S.C. ss.621 et seq.), Title VII of Civil Rights Act of 1964 (42 U.S.C. ss.2000e et seq.), the Employee Retirement Income Security Act (29 U.S.C. ss.1001 et seq.), Article 49B of the Maryland Annotated Code, and any other law prohibiting employment discrimination.

7. Employee and the Company understand and agree that the General Release includes not only claims presently known to Employee, but also includes all unknown or unanticipated claims, rights, demands, actions, obligations, liabilities, and causes of action of every kinds and character that would otherwise come within the scope of the General Release as described in paragraph 6. Employee understands that he/she may hereafter discover facts different from what he/she now believes to be true, which if known, could have materially affected this Agreement, but he/she nevertheless waives any claims or rights based on different or additional facts. Employee knowingly and voluntarily waives any and all rights or benefits that he/she may now have, or in the future may have, under terms of Section 1542 of the California Civil Code (or other similar law or regulation or another jurisdiction), which provides as follows: "A general release does not extend to claims which the creditor does not know or suspect to exist in his favor at the time of executing the release, which if known by him/her must have materially affected his settlement with the debtor."

8. Employee agrees not to sue the Company or to join in any lawsuit against the company, or any other person or entity specified in paragraph 6, concerning any matter, which arose on or before the date of this Agreement. The Parties agree that to the extent, if any, Employee may have a right to file or participate in a claim or charge against the Company, which cannot be waived, the Agreement shall not be intended to waive such a right. However, even if Employee has a right to file or participate in a claim or charge against the Company, he/she agrees that he/she shall not obtain, and hereby waives his/her right to, any relief (legal, equitable, or other) from such a claim or charge.

9. The Parties agree that the terms of the Agreement are strictly confidential and expressly covenants not to display, publish, disseminate, or disclose any terms of this Agreement to any person or entity. Employee agrees that any judicially determined breach of the promise contained in this paragraph by him/her shall be considered to be a material breach of the terms of this Agreement and, in addition to any other remedies the Company may have. The Company shall be entitled to recover all of the monies paid to him/her under the terms of the Agreement.

10. Employee agrees that he/she shall not be regarded as the prevailing party for any purpose, including, but not limited to, determining responsibility for or entitlement to attorneys' fees, under any statute or otherwise.

11. Employee understands that he/she has forty five (45) days from his/her receipt of the Agreement to consider his/her decision to sign it. By signing this Agreement, Employee expressly acknowledges that his/her decision to sign the Agreement was of his/her own free will.

12. Employee understands that he/she may revoke this Agreement for up to and including seven (7) days after his/her execution of the Agreement, and that the Agreement shall not become effective until the expiration of eight days from its execution.

13. Employee has been advised by the Company to consult an attorney regarding the terms of this Agreement before signing.

14. Employee expressly acknowledges and understands that this Agreement is not an admission of liability under any statute or otherwise by the Company, and does not admit any

violation of Employee's legal rights, but is solely entered into as an exchange for the terms described above.

15. The Parties agree that this Agreement shall be binding upon and inure to the benefit of the assigns, heirs, executors, and administrators of Employee and the officers, directors, employees, agents, parents, affiliates, predecessors, successors, purchasers, assigns, and representatives of the Company. Except for the non-competition and confidentiality agreement previously executed by the parties, the Agreement contains the entire agreement and understanding of the parties, that there are no additional promises or terms among the parties other than those contained herein, and that this Agreement shall not be modified except in writing signed by each of the parties. The parties hereto expressly reaffirm their respective duties and obligations under the aforesaid non-competition and confidentiality agreement.

16. This Agreement shall in all respects be interpreted, enforced, and governed under the laws of the State of Maryland. The language of all parts of this Agreement shall in all cases be construed as a whole, according to its fair meaning, and not strictly for or against any of the parties.

17. Employee represents that he/she has read this Agreement, that he/she understand all of its terms, and that he/she enters into this Agreement voluntarily and with knowledge of its effect.

4/16/2004

Date

/s/ Richard Stacey

Employee (Richard Stacey)

Immersion Medical

By: /s/ Mary Brown

Mary Brown

CERTIFICATIONS

I, Victor Viegas, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Immersion Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonable likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
 - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 13, 2004

/s/ Victor Viegas

Victor Viegas
President, Chief Executive Officer,
Chief Financial Officer, and Director

CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of Immersion Corporation (the "Company") on Form 10-Q for the period ending June 30, 2004 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Victor Viegas, President, Chief Executive Officer, Chief Financial Officer and Director of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that based on my knowledge:

(1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d)); and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

/s/ Victor Viegas

Victor Viegas
President, Chief Executive Officer,
Chief Financial Officer, and Director

August 13, 2004