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

FORM 10-Q

(MARK ONE)

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

For the quarterly period ended June 30, 2003

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 [X] No [ ]

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

Yes [ ] No [X]

Number of shares of Common Stock outstanding at August 7, 2003: 20,409,642

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PART I
FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

IMMERSION CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except share and per share amounts)
(Unaudited)

	June 30, 2003	December 31, 2002
ASSETS		
Current assets:		
Cash and cash equivalents	$ 3,048	$ 8,717
Accounts receivable, (net of allowances for doubtful accounts of: 2003, $221; and 2002, $334)	2,950	3,645
Inventories	2,315	2,128
Prepaid expenses and other current assets	590	1,151
Total current assets	8,903	15,641
Property and equipment, net	1,639	2,044
Intangibles and other assets, net	6,528	6,616
Other investments	1,000	1,000
Total assets	$ 18,070	$ 25,301
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 1,126	$ 1,160
Accrued compensation	998	671
Other current liabilities	1,416	1,311
Deferred revenue and customer advances	3,708	3,515
Current portion of long-term debt and warrant liability	10	64
Current portion of capital lease obligation	17	22
Total current liabilities	7,275	6,743
Long-term debt, less current portion	21	26
Capital lease obligation, less current portion	18	25
Long-term deferred revenue, less current portion	4,400	4,559
Total liabilities	11,714	11,353
Contingencies (Note 9)		
Stockholders' equity:		
Common stock — $0.001 par value; 100,000,000 shares authorized; shares issued and outstanding: 2003, 20,197,984 and 2002, 20,137,040	89,033	89,061
Warrants	1,974	1,974
Deferred stock compensation	(550)	(1,046)
Accumulated other comprehensive income (loss)	24	(16)
Accumulated deficit	(84,125)	(76,025)
Total stockholders' equity	6,356	13,948
Total liabilities and stockholders' equity	$ 18,070	$ 25,301

See accompanying Notes to Condensed Consolidated Financial Statements.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2002	2003	2002
Revenues:				
Royalty and license	$ 804	$ 1,633	$ 1,637	$ 2,867
Product sales	2,465	2,821	4,613	5,219
Development contracts and other	873	1,007	1,628	2,180
Total revenues	4,142	5,461	7,878	10,266
Costs and expenses:				
Cost of product sales (exclusive of amortization of intangibles shown separately below)	1,462	1,479	2,568	2,764
Sales and marketing	1,885	1,817	3,676	3,926
Research and development	1,739	1,588	3,428	3,291
General and administrative	2,860	1,813	5,016	3,791
Amortization of intangibles and deferred stock compensation*	611	712	1,260	1,626
Other charges	—	—	—	397
Total costs and expenses	8,557	7,409	15,948	15,795
Operating loss	(4,415)	(1,948)	(8,070)	(5,529)
Interest and other income	2	100	13	235
Interest and other expense	(31)	(223)	(44)	(431)
Net loss	$ (4,444)	$ (2,071)	$ (8,101)	$ (5,725)
Basic and diluted net loss per share	$ (0.22)	$ (0.10)	$ (0.40)	$ (0.29)
Shares used in calculating basic and diluted net loss per share	20,179	20,002	20,162	19,679
* Amortization of intangibles and deferred stock compensation				
Amortization of intangibles	$ 398	$ 384	$ 817	$ 961
Deferred stock compensation — sales and marketing	—	3	3	6
Deferred stock compensation — research and development	212	323	437	644
Deferred stock compensation — general and administrative	1	2	3	15
Total	$ 611	$ 712	$ 1,260	$ 1,626

See accompanying Notes to Condensed Consolidated Financial Statements.

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

	Six Months Ended June 30, 2003	Six Months Ended June 30, 2002
Cash flows from operating activities:		
Net loss	$(8,101)	$ (5,725)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	563	644
Amortization of intangibles	817	961
Amortization of deferred stock compensation	443	665
Amortization of discounts on notes payable	1	226
Fair value adjustment for warrant liability	(2)	(116)
Loss on disposal of equipment	1	6
Noncash compensation expense	—	14
Noncash interest expense	16	166
Changes in operating assets and liabilities:		
Accounts receivable	718	(109)
Inventories	(187)	(69)
Prepaid expenses and other current assets	561	922
Accounts payable	(614)	528
Accrued compensation and other current liabilities	421	(78)
Deferred revenue and customer advances	35	4,577
Net cash provided by (used in) operating activities	(5,328)	2,612
Cash flows from investing activities:		
Purchases of short-term investments	—	(5)
Sales and maturities of short-term investments	—	2,550
Other assets	(729)	(192)
Purchases of property and equipment	(148)	(237)
Net cash provided by (used in) investing activities	(877)	2,116
Cash flows from financing activities:		
Issuance of common stock	11	68
Exercise of stock options	14	209
Exercise of warrants	—	50
Payments on notes payable and capital leases	(85)	(64)
Net cash provided by (used in) financing activities	(60)	263
Effect of exchange rates on cash and cash equivalents	596	6
Net increase (decrease) in cash and cash equivalents	(5,669)	4,997
Cash and cash equivalents:		
Beginning of the period	8,717	10,381
End of the period	$ 3,048	$15,378
Supplemental disclosure of cash flow information :		
Cash paid for taxes	$ —	$ 2
Cash paid for interest	$ 43	$ 44

See accompanying Notes to Condensed Consolidated Financial Statements.

IMMERSION CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2003
(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 enable users to interact with computing and other devices using their sense of touch.

Principles of Consolidation and Basis of Presentation — The 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, 2002.

The results of operations for the interim period ended June 30, 2003 are not necessarily indicative of the results to be expected for the full year.

Reclassifications — Certain prior period amounts have been reclassified to conform to the current period presentation. These reclassifications had no material effect on net loss or stockholder’s equity.

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”) Issue No. 96-18. Pro forma disclosures required under Statement of Financial Accounting Standards (“SFAS’) No. 123, “Accounting for Stock-Based Compensation,” as amended, 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,	
	2003	2002	2003	2002
Net loss — as reported	$(4,444)	$(2,071)	$(8,101)	$(5,725)
Add: Stock-based employee compensation included in reported net loss	213	328	443	665
Less: Stock-based compensation expense determined using fair value method	(1,084)	(2,040)	(2,115)	(3,753)
Net loss — pro forma	$(5,315)	$(3,783)	$(9,773)	$(8,813)
Basic and diluted loss per common share — as reported	$ (0.22)	$ (0.10)	$ (0.40)	$ (0.29)
Basic and diluted loss per common share — pro forma	$ (0.26)	$ (0.19)	$ (0.48)	$ (0.45)

Other charges — During the quarter ended March 31, 2002, we incurred $397,000 of severance related costs associated with terminated employees. Severance costs of $137,000 were paid out in the same quarter and $260,000 in the quarter ended June 30, 2002.

Recent Accounting Pronouncements — In June 2002, the Financial Accounting Standards Board ("FASB") issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities," which addresses accounting for restructuring and similar costs. SFAS No. 146 supersedes previous accounting guidance, principally EITF Issue No. 94-3. The Company has adopted the provisions of SFAS No. 146 for restructuring activities initiated after December 31, 2002. SFAS No. 146 requires that the liability for costs associated with an exit or disposal activity be recognized when the liability is incurred. Under EITF Issue No. 94-3, a liability for an exit cost would be recognized at the date of the Company's commitment to an exit plan. SFAS No. 146 also establishes that the liability should be measured and recorded at fair value. Accordingly, SFAS No. 146 may affect the timing of recognizing future restructuring costs as well as the amounts recognized. The adoption of SFAS No. 146 did not have an impact on the Company's financial position, results of operations or cash flows.

In November 2002, the EITF reached a consensus on Issue No. 00-21 "Accounting for Revenue Arrangements with Multiple Deliverables". The EITF concluded that revenue arrangements with multiple elements should be divided into separate units of accounting if the deliverables in the arrangement have value to the customer on a standalone basis, if there is objective and reliable evidence of fair value of the undelivered elements, and as long as there are no rights of return or additional performance guarantees by the Company. The provisions of EITF Issue No. 00-21 are applicable to agreements entered into in fiscal periods beginning after June 15, 2003. The Company is currently determining what effect, if any, the provisions of EITF Issue No. 00-21 will have on its operating results or financial condition.

In December 2002, the FASB issued SFAS No. 148, "Accounting for Stock-Based Compensation — Transition and Disclosure." The statement amends SFAS No. 123, "Accounting for Stock-Based Compensation", to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, this statement amends the disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. The Company adopted the disclosure provisions of SFAS No. 148 at December 31, 2002.

In April 2003, the FASB issued SFAS No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities." SFAS No. 149 amends and clarifies the accounting for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities under SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities." SFAS No. 149 is generally effective for contracts entered into or modified after June 30, 2003 and for hedging relationships designated after June 30, 2003. The Company is currently determining what effect, if any, the provisions of SFAS No. 149 will have on its operating results or financial condition.

In May 2003, the FASB issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity." SFAS No. 150 requires that certain financial instruments, which under previous guidance were accounted for as equity, must now be accounted for as liabilities. The financial instruments affected include mandatorily redeemable stock, certain financial instruments that require or may require the issuer to buy back some of its shares in exchange for cash or other assets and certain obligations that can be settled with shares of stock. SFAS No. 150 is effective for interim periods beginning after June 15, 2003. The Company is currently determining what effect, if any, the provisions of SFAS No. 150 will have on its operating results or financial condition.

2. INVENTORIES

	June 30, 2003	December 31, 2002
	(In thousands)	
Raw materials and subassemblies	$1,684	$1,587
Work in process	258	183
Finished goods	373	358
Total	$2,315	$2,128

3. PROPERTY AND EQUIPMENT

	June 30, 2003	December 31, 2002
	(In thousands)	
Computer equipment and purchased software	$ 2,078	$ 2,002
Machinery and equipment	1,888	1,810
Furniture and fixtures	1,342	1,325
Leasehold improvements	692	692
Total	6,000	5,829
Less accumulated depreciation	(4,361)	(3,785)
Property and equipment, net	$ 1,639	$ 2,044

4. INTANGIBLES AND OTHER ASSETS

	June 30, 2003	December 31, 2002
	(In thousands)	
Patents and technology	$ 7,691	$ 6,962
Other intangibles	5,748	5,748
Other assets	83	83
Gross intangibles and other assets	13,522	12,793
Accumulated amortization of patents and technology	(2,881)	(2,545)
Accumulated amortization of other intangibles	(4,113)	(3,632)
Net intangibles and other assets	$ 6,528	$ 6,616

The estimated annual amortization expense for intangible assets as of December 31, 2002 is $1.5 million in 2003, $1.3 million in 2004, $1.0 million in 2005, $579,000 in 2006, $498,000 in 2007, and $80,000 in 2008.

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

	June 30, 2003	December 31, 2002
	(In thousands)	
Accrued legal	$ 863	$ 523
Other current liabilities	553	788
Total other current liabilities	$1,416	$1,311
Deferred revenue	$3,669	$ 976
Customer advances	39	2,539
Total current deferred revenue and customer advances	$3,708	$3,515

At December 31, 2002, customer advances included a $2.5 million prepayment from one licensee. Subsequent to December 2002, $500,000 of this prepayment was returned to the licensee as a result of the final agreement reached between the Company and the licensee regarding the terms of the prepayment and the Company reclassified $2.0 million to deferred revenue which is being amortized to revenue based on royalty reports received from the licensee. During the three months ended June 30, 2003, the Company reclassified $1.0 million from long-term deferred revenue to current deferred revenue due to the expectation that this revenue will be earned within the next twelve months.

6. 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,	
	2003	2002	2003	2002
Numerator:				
Net loss	$ (4,444)	$ (2,071)	$ (8,101)	$ (5,725)
Denominator:				
Shares used in computation, basic and diluted (weighted average common shares outstanding)	20,179	20,002	20,162	19,679
Net loss per share, basic and diluted	$ (0.22)	$ (0.10)	$ (0.40)	$ (0.29)

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,	
	2003	2002
Convertible note payable	—	226,450
Outstanding stock options	7,604,928	7,030,253
Warrants	480,943	511,999

7. COMPREHENSIVE LOSS

The following table sets forth the components of comprehensive loss:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2002	2003	2002
	(in thousands)		(in thousands)	
Net loss	$(4,444)	$(2,071)	$(8,101)	$(5,725)
Foreign currency adjustment	23	14	40	12
Total comprehensive loss	$(4,421)	$(2,057)	$(8,061)	$(5,713)

8. 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, personal computing, medical and other professional computing applications. The Company has two operating and reportable segments. 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 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,	
	2003	2002	2003	2002
	(In thousands)		(In thousands)	
Revenues:				
Immersion Computing, Entertainment and Industrial	$ 2,811	$ 3,329	$ 5,034	$ 6,697
Immersion Medical	1,854	2,189	3,502	3,632
Intersegment eliminations	(523)	(57)	(658)	(63)
Total	$ 4,142	$ 5,461	$ 7,878	$10,266
Net Loss:				
Immersion Computing, Entertainment and Industrial	$(3,741)	$(1,931)	$(7,118)	$ (4,199)
Immersion Medical	(655)	(114)	(1,061)	(1,499)
Intersegment eliminations	(48)	(26)	78	(27)
Total	$(4,444)	$(2,071)	$(8,101)	$ (5,725)

	June 30, 2003	December 31, 2002
	(In thousands)	
Total Assets:		
Immersion Computing, Entertainment and Industrial	$ 29,031	$ 36,389
Immersion Medical	3,362	2,919
Intersegment eliminations	(14,323)	(14,007)
Total	$ 18,070	$ 25,301

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.

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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,	
	2003	2002	2003	2002
	(In thousands)		(In thousands)	
Revenues:				
Consumer, Computing and Entertainment	$ 718	$1,168	$1,378	$ 2,348
3D and Professional Products	1,188	1,634	2,217	3,236
Automotive	202	253	409	694
Other	180	217	372	356
Subtotal Immersion Computing, Entertainment and Industrial	2,288	3,272	4,376	6,634
Immersion Medical	1,854	2,189	3,502	3,632
Total	$4,142	$5,461	$7,878	$10,266

REVENUE BY REGION

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2002	2003	2002
North America	68%	68%	70%	63%
Europe	18%	15%	18%	17%
Far East	13%	13%	11%	17%
Rest of the world	1%	4%	1%	3%
Total	100%	100%	100%	100%

The Company derived 68% and 67% of its total revenues from the United States for the three months ended June 30, 2003 and 2002 respectively. The Company derived 68% and 63% of its total revenues from the United States for the six months ended June 30, 2003 and 2002 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, 2003 and December 31, 2002.

SIGNIFICANT CUSTOMERS

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2002	2003	2002
Customer A	*	*	10%	*
Customer B	*	14%	*	12%
Total	0%	14%	10%	12%

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

As of June 30, 2003, no customer accounted for more than 10% of the Company's accounts receivable for the periods presented.

9. 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 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 has decided to accept a settlement proposal presented to all issuer defendants. In this settlement, plaintiffs will dismiss and release 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. The process of discovery and exchanging information and documents on infringement, invalidity, and damages, is ongoing. 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. It is anticipated that the Court will issue a written claim construction decision, though the timing of when the Court issues its ruling is within the Court's discretion. 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 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 have certain obligations to pay certain sums to Microsoft. See Note 10 for further details. If Sony Computer Entertainment were successful in its counterclaims and the Company's patents were deemed invalid and unenforceable, the assets relating to the patents that were deemed invalid would be impaired. For Sony Computer Entertainment to be awarded damages for attorneys' fees the court would have to rule that the Company acted with willful disregard and did not perform a proper investigation. The Company currently believes it is remote that a loss may be or has been incurred related to the counterclaims of Sony Computer Entertainment.

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.

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.

10. SUBSEQUENT EVENT

On July 28, 2003 the Company issued a press release announcing it had entered into agreements with Microsoft regarding certain license rights under the Company's patents, the settlement of the Company's lawsuit against Microsoft and certain investments by Microsoft in the Company's Series A Redeemable Convertible Preferred Stock and 7% Senior Redeemable Convertible Debentures.

Pursuant to the license agreement, the Company granted Microsoft a world-wide royalty-free, irrevocable license in exchange for $20 million. Under the terms of the Series A Redeemable Convertible Preferred Stock purchase agreement, Microsoft agreed to purchase 2,185,792 shares of Preferred Stock for $2.745, an aggregate purchase price of $6 million. Preferred Stock accrues cumulative dividends at a rate of 7% per year, payable in cash or additional shares of Preferred Stock. Under the terms of the Senior Redeemable Convertible Debentures agreement, Microsoft may purchase up to $9 million debentures accruing interest at 7% per year. No debentures have been purchased to date. The Company is currently evaluating the impact of these agreements on its results of operations and financial condition. Certain provisions of these agreements may preclude revenue recognition in the near term. In the event the Company settles its lawsuit with Sony Computer Entertainment, the Company will have certain repayment obligations including paying Microsoft up to 2.5 times the original purchase price of the Series A Redeemable Convertible Preferred Stock and up to 125% of the amount of any debentures drawn down by the Company as of the settlement date.

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 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.

OVERVIEW

We develop, manufacture, license and support a wide range of hardware and software technologies that enable users to interact with a multitude of computing and other devices using their sense of touch. We manage our business under two operating and reportable segments: Immersion Computing, Entertainment and Industrial, and Immersion Medical. We focus on four application areas — consumer, computing and entertainment, medical simulation, industrial and automotive, and three-dimensional and professional. In high volume market areas such as consumer computer peripherals and automotive interfaces, we primarily license our touch-enabling technologies to third party manufacturers. We have licensed our intellectual property to numerous manufacturers of mice, joysticks, knobs, wheels and gamepads targeted at consumers. For lower-volume markets like medical simulation systems and three-dimensional and professional products, our primary strategy is to manufacture and sell products through direct sales, distributors and value added resellers. We sell medical simulation devices used to train and allow health care providers to practice and enhance their skills in a variety of procedures. These devices simulate such procedures as intravenous catheterization, endovascular interventions, and laparoscopic and endoscopic surgical procedures. We also sell three-dimensional and professional products. Our three-dimensional products include the MicroScribe G2 desktop digitizer product line and associated software and accessories, specialized whole-hand sensing gloves, armatures and software, including the CyberGlove, CyberGrasp, CyberForce, CyberTouch and VirtualHand software products that permit simulated interaction with three-dimensional environments. In all market areas, we also engage in development projects for third parties and government agencies from time to time.

We have entered into numerous contracts with government agencies and corporations since 1993. Government contracts help fund advanced research and development, are typically less than two years in duration, are usually for a fixed price or for our costs plus a fixed fee, and allow the government agency to license the resulting technology for government applications, specifically excluding any commercial activity. Corporate contracts are typically for product development, are for a fixed fee and are also less than two years in duration.

Since inception, we have completed a number of acquisitions of patents and technology. We capitalize the cost of patents and technology and license agreements, except for amounts relating to acquired in-process research and development for which there is no alternative future use. As of June 30, 2003, we had capitalized patents and technology of $4.8 million, net of accumulated amortization of $2.9 million. We are amortizing these patents and technology over the estimated useful life of the technology of nine years.

We currently derive royalty revenue from sales of our licensees' consumer computer peripheral devices, such as touch-enabled mice and joysticks. We also derive royalty revenue from the inclusion of touch-enabled controls incorporating our technology in automobiles and medical simulators. Our basic licensing model typically includes an up-front license fee and/or a royalty paid by the peripheral or automobile manufacturer that is a percentage of the wholesale selling price of the touch-enabled product. We derive product revenue from a number of sources including sales of our medical simulation hardware devices and from the licensing of the software modules that are used in conjunction with such devices. Other sources of product revenue include sales of our three-dimensional digitizing products, such as the MicroScribe G2 products and sales of hardware and software for our whole-hand sensing gloves, such as the CyberGlove. With respect to development projects, most such projects involve assisting our licensees in the development of their touch-enabled products for which we receive fixed payments for product-related deliverables.

RESULTS OF OPERATIONS FOR THE THREE MONTHS AND SIX MONTHS ENDED JUNE 30, 2003 AND 2002

	June 30,		Change
REVENUES	**2003**	**2002**	
	($ In thousands)		
Three months ended:			
Royalty and license	$ 804	$ 1,633	(51)%
Product sales	2,465	2,821	(13)%
Development contracts and other	873	1,007	(13)%
Total Revenue	$4,142	$ 5,461	(24)%
Six months ended:			
Royalty and license	$1,637	$ 2,867	(43)%
Product sales	4,613	5,219	(12)%
Development contracts and other	1,628	2,180	(25)%
Total Revenue	$7,878	$10,266	(23)%

Total Revenue. Our total revenue for the second quarter of fiscal 2003 decreased by $1.3 million or 24% from the second quarter of fiscal 2002. Royalty and license revenue for the three months ended June 30, 2003 decreased by $829,000 or 51% from the three months ended June 30, 2002. Royalty and license revenue is comprised of royalties earned on sales by our TouchSense licensees and license fees charged for our intellectual property portfolio. This decrease is mainly due to weakness in the gaming market and the decline in sales of general computing and PC gaming peripheral devices. In addition, one of our licensees filed for bankruptcy protection under Chapter 11 and we derived no royalty revenue from this licensee during the quarter ended June 30, 2003. We derived $166,000 of royalty revenue from this licensee during the three months ended June 30, 2002 and $447,000 for the full year 2002. In the short-term it may be difficult to replace this revenue source. Product sales for the three months ended June 30, 2003 decreased by $356,000 or 13% as compared to the three months ended June 30, 2002. The decrease in product sales was mainly due to a reduction in medical product sales of $381,000, and a reduction of $53,000 in our professional products offset by an increase of $62,000 in our consumer, computing and entertainment products. Some of our products areas have not achieved commercial success beyond research centric customers and during this environment of economic decline and fixed budgets for research we have experienced reduced demand for such products. Development contract and other revenue is comprised of revenue on commercial and government contracts, which decreased by $134,000 during the three months ended June 30, 2003, as compared to the same period for fiscal 2002. The decrease is attributable to a reduction in automotive commercial contracts entered into during fiscal 2003 compared to fiscal 2002.

Our total revenue for the first six months of fiscal 2003 decreased by $2.4 million or 23% from the first six months of fiscal 2002. The decrease in royalty and license revenue of $1.2 million or 43% is attributable to the weakness in the gaming market and the decline in sales of general computing and PC gaming peripheral devices. In addition, due to the Chapter 11 bankruptcy protection filing of one of our licensees, royalty revenue from that licensee declined $382,000 for the six months ended June 30, 2003. Product sales decreased by $606,000 or 12% for the six-month period ended June 30, 2003 as compared to the six-month period ended June 30, 2002. The decrease in product sales is mainly due to a decrease in medical product sales of $539,000 and professional products of $140,000. Many of our customers rely on grant monies to purchase our medical simulation devices. During this economic downturn, our customers have had difficulties in securing these funding sources and hence our product sales have declined. Development contract revenue decreased by $552,000 or 25% for the six months ended June 30, 2003 as compared to the six months ended June 30, 2002. The decrease is attributable to a decrease in commercial contracts in the medical and automotive sectors in the amount of $1.1 million offset by an increase of $520,000 in government contracts. While the commercial sector has experienced decreased development contract spending due to declining research and development budgets the government has increased spending related to military and security needs. Additionally medical commercial contract revenue is down, in part, due to the revenue deferral of one contract until we achieve certain milestones in the project.

We categorize our geographic information into four major regions: North America, Europe, Far East and Rest of the World. For the second quarter of fiscal 2003, revenue generated in North America, Europe, Far East and Rest of the World represented 68%, 18%, 13% and 1% respectively compared to 68%, 15%, 13% and 4% respectively, for the second quarter of fiscal 2002. The shift in revenues among regions is mainly due to an increase in 3D products sales to customers in Europe.

In the first six months of fiscal 2003, revenue generated in North America, Europe, Far East and Rest of the World represented 70%, 18%, 11% and 1% respectively compared to 63%, 17%, 17% and 3% respectively, for the first six months of fiscal 2002. The shift in revenues among regions is mainly due to an increase in medical product sales to customers in North America and an increase in 3D products sales to customers in Europe offset by a decrease in automotive development contracts and royalties on computer peripherals from customers in the Far East.

	June 30,		Change
COST OF PRODUCT SALES	**2003**	**2002**	
	($ In thousands)		
Three months ended:			
Cost of product sales	$1,462	$1,479	(1)%
% of total product revenue	59%	52%	
Six months ended:			
Cost of product sales	$2,568	$2,764	(7)%
% of total product revenue	56%	53%	

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 does not include amortization of intangible assets, we cannot reasonably allocate the amortization expense between cost of sales and operating expenses since the benefit from the patents and technology relates to all classes of revenue as well as internal on-going research and development projects. Cost of product sales decreased by $17,000 or 1% for the three months ended June 30, 2003 as compared to the three months ended June 30, 2002. The decrease is attributable to decreased royalty cost of $120,000 due in part to the settlement agreement reached with MicroScribe LLC in 2002, which eliminated royalty payments on our MicroScribe G2 product line, and a decrease in price and production variances of $53,000 offset by an increase of inventory write offs for excess and obsolete inventory in the amount of $145,000 due to revisions made to certain products to improve product quality. Cost of product sales as a percentage of total product revenue increased to 59% for the three months ended June 30, 2003 from 52% for the three months ended June 30, 2002 in part due to a shift in product mix as a result of reduced sales of higher margin medical products.

Cost of product sales decreased by $196,000 or 7% for the first six months ended June 30, 2003 compared to the first six months ended June 30, 2002. The decrease is a combination of decreased product sales volume of 12%, decreased royalty expense of $197,000, decreased price and production variances of $61,000 offset by increased inventory write offs of $108,000 and increased overhead costs of $133,000.

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OPERATING EXPENSES AND OTHER	June 30, 2003	June 30, 2002	Change
	($ In thousands)		
Three months ended:			
Sales and marketing	$ 1,885	$ 1,817	4%
% of total revenue	46%	33%	
Research and development	$ 1,739	$ 1,588	10%
% of total revenue	42%	29%	
General and administrative	$ 2,860	$ 1,813	58%
% of total revenue	69%	33%	
Amortization of intangibles and deferred stock compensation	$ 611	$ 712	(14)%
% of total revenue	15%	13%	
Six months ended:			
Sales and marketing	$ 3,676	$ 3,926	(6)%
% of total revenue	47%	38%	
Research and development	$ 3,428	$ 3,291	4%
% of total revenue	44%	32%	
General and administrative	$ 5,016	$ 3,791	32%
% of total revenue	64%	37%	
Amortization of intangibles and deferred stock compensation	$ 1,260	$ 1,626	(23)%
% of total revenue	16%	16%	
Other charges	$ —	$ 397	(100)%
% of total revenue	0%	4%	

Sales and Marketing. Our sales and marketing expenses are comprised primarily of employee headcount and related compensation and benefits, advertising, trade shows, brochures, market development funds, travel and an allocation of facilities costs. Sales and marketing expenses increased by $68,000 or 4% in the second quarter of fiscal 2003 compared to the comparable period in 2002. The increase was mainly due to increased headcount and related compensation, benefits and overhead costs of $23,000, increased professional and consulting fees of $33,000, an increase in bad debt expenses of $41,000 and an increase in travel expenses of $42,000 offset by reduced advertising and marketing expenses of $57,000 mainly for collateral reproduction and advertising.

Sales and Marketing expenses decreased by $250,000 or 6% in the first six months of fiscal 2003 compared to the same period last year. The decrease was mainly the result of decreased compensation, benefits and overhead of $33,000, reduced expenses in market development funds, application development, collateral reproduction and advertising of $164,000, reduced bad debt expense of $113,000, reduced professional fees of $29,000, offset by increased travel expenses of $95,000.

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 $151,000 or 10% in the second quarter of fiscal 2003 compared to the same period in 2002. The increase was mainly due to an increase in compensation, benefits and overhead costs of $81,000, an increase in supplies of $55,000 and an increase in outside professional consulting and licensing fees of $20,000.

Research and development expenses increased by $137,000 or 4% in the first six months of fiscal 2003 compared to the same period last year. The increase was mainly due to an increase in compensation, benefits and overhead of $128,000, an increase in supplies of $38,000, an increase of travel of $8,000 and a decrease in outside professional consulting and licensing fees of $49,000.

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 $1.0 million or 58% in the second quarter of fiscal 2003 compared to the same period in 2002. The increase is mainly due to an increase in legal and professional fees of $1.1 million due to the litigation against both Sony Computer Entertainment and Microsoft, offset by decreased public company expenses of $40,000 due to decreased proxy expenses. We expect that the dollar amount of general and administrative expenses will increase in the future as we incur additional costs related to our litigation against Sony Computer Entertainment, as well as additional public company compliance costs.

General and administrative expenses increased $1.2 million or 32% in the first six months of fiscal 2003 as compared to the same period last year. The increase is due to increased legal and professional fees of $1.5 million due to our litigation against Sony Computer Entertainment and Microsoft, offset by decreased compensation, benefits and overhead of $141,000, decreased public company expenses of $73,000 due to decreased investor relations costs, decreased office supplies of $26,000, and decreased travel costs of $16,000.

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 $101,000 or 14% in the second quarter of fiscal 2003 compared to the same period in 2002. The reduction is mainly attributable to a decrease of $115,000 for the amortization of deferred stock compensation over the comparable second quarter in 2002, due to the expiration of vesting periods, offset by an increase in intangible amortization of $14,000.

Amortization of intangibles and deferred stock compensation decreased by $366,000 or 23% in the first six months of fiscal 2003 compared to the same period last year. Intangible amortization decreased by $144,000, as some of those intangibles reached full amortization, and deferred stock compensation decreased by $222,000 due to the expiration of vesting periods, for the six month period ended June 30, 2003 as compared to the six month period ended in June 30, 2002.

Other Charges. During the six months ended June 30, 2003 other charges decreased by $397,000 or 100% compared to the comparable period during fiscal year 2002. During the period ended June 30, 2002 we incurred $397,000 related to severance costs due to the reduction in force of eight employees during the first quarter of 2002. Employees from manufacturing, sales and marketing, research and development and general and administrative were included in the reduction in force. We did not incur any additional charges related to the aforementioned reduction in force.

Interest and Other Income. Interest and other income consist primarily of interest income, dividend income and capital gains from cash and cash equivalents and short-term investments. Interest and other income declined by $98,000 in the second quarter of fiscal 2003 compared to the same period in 2002 as a result of reduced cash, cash equivalents and short-term investments invested for the period due to cash used in operating activities, as well as reduced yields on investments due to lower interest rates.

Interest and other income declined by $222,000 in the first six months of fiscal 2003 compared to the same period last year as a result of reduced cash, cash equivalents and short-term investments invested for the period due to cash used in operating activities as well as reduced yields on investments due to lower interest rates.

Interest and Other Expense. Interest and other expense consist primarily of interest expense on our notes payable and capital leases. Interest and other expense decreased by $192,000 for the three months ended June 30, 2003 compared to the three months ended June 30, 2002. The reduction of interest and other expense was mainly attributable to reduced interest expense associated with outstanding debt obligations that were paid during fiscal year 2002. Interest and other expensed decreased by $387,000 in the first six months of fiscal 2003 compared to the same period last year.

SEGMENT RESULTS FOR THE THREE MONTHS AND SIX MONTHS ENDED JUNE 30, 2003 AND 2002

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2002	2003	2002
	(In thousands)		(In thousands)	
Revenues:				
Immersion Computing, Entertainment and Industrial	$ 2,811	$ 3,329	$ 5,034	$ 6,697
Immersion Medical	1,854	2,189	3,502	3,632
Intersegment eliminations	(523)	(57)	(658)	(63)
Total	$ 4,142	$ 5,461	$ 7,878	$10,266
Net Loss:				
Immersion Computing, Entertainment and Industrial	$(3,741)	$(1,931)	$(7,118)	$ (4,199)
Immersion Medical	(655)	(114)	(1,061)	(1,499)
Intersegment eliminations	(48)	(26)	78	(27)
Total	$(4,444)	$(2,071)	$(8,101)	$ (5,725)

Immersion Computing, Entertainment and Industrial segment. Revenues from the Immersion Computing, Entertainment and Industrial segment decreased by $518,000 or 16% in the second quarter of fiscal 2003 compared to the same period in 2002. All revenue categories experienced decline during the three months ended June 30, 2003 versus the three months ended June 30, 2002. The decrease is mainly due to a reduction in royalty and license revenue associated with a decline in the gaming market for the second quarter 2003 and a decline in product sales due to longer sales cycles and the general economic downturn. Net loss for the quarter ended June 30, 2003 increased by $1.8 million or 94% compared to the same period in 2002. Reduced revenues of $518,000 as well as increased litigation costs of $1.2 million associated with our continued litigation against Sony Computer Entertainment and Microsoft offset by decreased amortization of intangibles and deferred stock compensation of $97,000 account for the increase in net loss for the quarter ended June 30, 2003 compared to the same period in 2002.

Revenues for the first six months of fiscal 2003 decreased by $1.7 million or 25% as compared to the same period last year for the Immersion Computing, Entertainment and Industrial segment. The decrease in revenue is primarily attributable to a decrease in royalty and licensing revenue and 3D and professional product sales compared to the six months ended 2002. Net loss for the six months ended June 30, 2003 increased by $2.9 million or 70% compared to the same period in 2002. The increased net loss is due to the decrease in revenue and the increase of litigation costs of $1.8 million offset by decreased amortization of intangibles and deferred stock compensation of $359,000.

Immersion Medical segment. Revenues from Immersion Medical decreased by $335,000 or 15% for the three months ended June 30, 2003 compared to the three months ended June 30, 2002. The decrease is primarily due to a decrease of $140,000 in product sales and a decrease of $213,000 in royalty and licensing revenue offset by an increase of $18,000 in development contract revenue. Net loss for the three months period ended June 30, 2003 increased by $541,000 compared to the same period in 2002. The increase in net loss is due primarily to a decrease in royalty and license revenue and product sales as well as an increase in research and development costs.

Revenues from Immersion Medical decreased by $130,000 or 4% for the first six months of fiscal 2003 as compared to the first six months of 2002 mainly due to a decrease in royalty and license revenue. The net loss for the six months ended June 30, 2003 declined by $438,000 compared to the six months ended June 30, 2002 and was primarily due to a reduction in general and administrative expenses of $519,000, a reduction in severance costs of $317,000 and a reduction in other income and expenses of $272,000 offset by decreased revenue of $130,000, increased cost of product sales of $330,000 and increased research and development costs of $181,000.

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, 2003 our cash and cash equivalents totaled $3 million, down $5.7 million from $8.7 million at December 31, 2002.

Net cash used in operating activities during the six months of fiscal 2003 was $5.3 million, an increase of $7.9 million from $2.6 million provided during the comparable period in 2002. Cash used in operations during the six months period ended June 30, 2003 comprised primarily of our $8.1 million net loss offset by noncash charges and credits of $1.8 million which consists primarily of amortization of intangibles and deferred stock compensation, a decrease in accounts receivable of $718,000, a decrease of prepaid expenses of $561,000, a decrease in accrued compensation and other current liabilities of $421,000, partially offset by an increase in inventory of $187,000 and an increase in accounts payables of $614,000 due to increased legal fees associated with our litigation against Sony Computer Entertainment and Microsoft. Net cash provided by operating activities during the first six months of fiscal 2002 was $2.6 million, an increase from the $7.9 million of net cash used in operating activities during the comparable period in the prior year. Cash provided by operations during the six-month period ended June 30, 2002 comprised primarily of our $5.7 million net loss offset by noncash charges and credits of $2.6 million, including amortization of intangibles and deferred compensation of $1.6 million, an increase of $922,000 due to a change in prepaid expenses and other assets, and an increase of $528,000 due to a change in accounts payable, and an increase of $4.6 million in deferred revenue. The increase in deferred revenue was due to a license agreement entered into during the six months ended June 30, 2002, with one licensee, which required a $5.0 million up-front payment. The $5.0 million up-front payment consisted of $2.0 million of prepaid per unit royalties and $3.0 million of license fees for license rights under our intellectual property portfolio. The term of the contract is for 10 years over which the $3.0 million license fee is being amortized. The $2.0 million of prepaid per unit royalties are being amortized to revenue based on monthly royalty reports received from the licensee.

Net cash used in investing activities during the six months of fiscal 2003 was $877,000. Capitalization of external patent filing and application costs accounted for $729,000 and purchases of capital equipment accounted for $148,000 of cash used in investing activities during the six months ended June 30, 2003. For the comparable period in fiscal 2002, net cash provided by investing activities was $2.1 million, which was primarily the result of a sale of short-term securities offset by purchases of capital equipment of $237,000 and capitalized patent costs of $192,000.

Net cash used by financing activities during the first six months of fiscal 2003 was $60,000 due mainly to payments on debt obligations as opposed to the net cash provided of $263,000 during the first six months of fiscal year 2002. Net cash used by financing included notes payable payments of $85,000 offset by the increase in exercise of stock options and issuance of common stock of $25,000.

On July 28, 2003 we issued a press release announcing that we had entered into agreements with Microsoft regarding certain license rights under our patents, the settlement of our lawsuit against Microsoft and certain investments by Microsoft in our new Series A Redeemable Convertible Preferred Stock; as a result, our cash position was increased by $26 million. Pursuant to the license agreement, we granted Microsoft a world-wide royalty-free, irrevocable license in exchange for $20 million. Under the terms of the Series A Redeemable Convertible Preferred Stock purchase agreement, Microsoft agreed to purchase 2,185,792 shares of Preferred Stock for $2.745, an aggregate purchase price of $6 million. The Preferred Stock accrues cumulative dividends at a rate of 7% per year, payable in cash or additional shares of Preferred Stock. In addition, and at our discretion we may require Microsoft to buy up to $9 million in our new 7% Senior Redeemable Convertible Debentures, $5 million in the first year plus $2 million per annum for the next two years. No debentures have been purchased to date.

We believe that our cash and cash equivalents, including the amounts received in July from Microsoft, 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 anticipate that capital expenditures for the year ended December 31, 2003 will total approximately $500,000 in connection with anticipated upgrades to operations and infrastructure. 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, 2002 (in thousands):

Contractual Obligations	Total	Less than 1 year	1 - 3 years	4 - 5 years	After 5 years
Long-Term Debt	$ 87	$ 61	$ 20	$ 6	$ —
Capital Lease Obligations	53	30	23	—	—
Operating Leases	4,417	1,214	2,065	653	485
Total Contractual Cash Obligations	$4,557	$1,305	$2,108	$659	$485

There were no material changes to our contractual cash obligations and other commercial commitments during the quarter ended June 30, 2003.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States (“GAAP”). The preparation of these consolidated financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, expenses, and related disclosure of contingent assets and liabilities. On an ongoing basis, we evaluate our estimates, 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 consolidated financial statements:

We recognize revenues in accordance with applicable accounting standards including Staff Accounting Bulletin (“SAB”) No. 101, “Revenue Recognition in Financials Statements” and the American Institute of Certified Public Accountants’ (the “AICPA”) Statement of Position 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 principle sources: royalties 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	Based on straight-line amortization of an annual minimum/up-front payments recognized over contract period or annual minimum period. No

License revenue model	Revenue recognition
contracted	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 technology — no modification necessary	Up-front revenue recognition based on SOP 97-2 criteria

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 to SAB No. 101 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 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 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 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. 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, in addition, changes could affect the amount of future period amortization expense that we will incur.

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 consolidated financial statements included elsewhere in this quarterly report on From 10-Q which contains accounting policies and other disclosures required by GAAP.

RECENT ACCOUNTING PRONOUNCEMENTS

In June 2002, the FASB issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities," which addresses accounting for restructuring and similar costs. SFAS No. 146 supersedes previous accounting guidance, principally Emerging Issues Task Force Issue No. 94-3. The Company has adopted the provisions of SFAS No. 146 for restructuring activities initiated after December 31, 2002. SFAS No. 146 requires that the liability for costs associated with an exit or disposal activity be recognized when the liability is incurred. Under EITF Issue 94-3, a liability for an exit cost would be recognized at the date of the Company's commitment to an exit plan. SFAS No. 146 also establishes that the liability should be measured and recorded at fair value. Accordingly, SFAS No. 146 may affect the timing of recognizing future restructuring costs as well as the amounts recognized. The adoption of SFAS No. 146 did not impact our financial position, results of operations or cash flows.

In November 2002, the EITF reached a consensus on Issue No. 00-21 “Accounting for Revenue Arrangements with Multiple Deliverables”. The EITF concluded that revenue arrangements with multiple elements should be divided into separate units of accounting if the deliverables in the arrangement have value to the customer on a standalone basis, if there is objective and reliable evidence of fair value of the undelivered elements, and as long as there are no rights of return or additional performance guarantees by the Company. The provisions of EITF Issue No. 00-21 are applicable to agreements entered into in fiscal periods beginning after June 15, 2003. We are currently determining what effect, if any, the provisions of EITF Issue No. 00-21 will have on our operating results or financial condition.

In December 2002, the FASB issued SFAS No. 148, “Accounting for Stock-Based Compensation — Transition and Disclosure.” The statement amends SFAS No. 123, “Accounting for Stock-Based Compensation”, to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, this statement amends the disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. We adopted the disclosure provisions of SFAS No. 148 at December 31, 2002.

In April 2003, the FASB issued SFAS No. 149, “Amendment of Statement 133 on Derivative Instruments and Hedging Activities.” SFAS No. 149 amends and clarifies the accounting for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities under SFAS No. 133, “Accounting for Derivative Instruments and Hedging Activities.” SFAS No. 149 is generally effective for contracts entered into or modified after June 30, 2003 and for hedging relationships designated after June 30, 2003. We are currently determining the effect, if any, the provisions of SFAS No. 149 will have on our operating results or financial condition.

In May 2003, the FASB issued SFAS No. 150, “Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity.” SFAS No. 150 requires that certain financial instruments, which under previous guidance were accounted for as equity, must now be accounted for as liabilities. The financial instruments affected include mandatorily redeemable stock, certain financial instruments that require or may require the issuer to buy back some of its shares in exchange for cash or other assets and certain obligations that can be settled with shares of stock. SFAS No. 150 is effective for interim periods beginning after June 15, 2003. We are currently determining what effect, if any, the provisions of SFAS No. 150 will have on our operating results or financial condition.

FACTORS THAT MAY AFFECT FUTURE RESULTS

WE HAD AN ACCUMULATED DEFICIT OF $84 MILLION AS OF JUNE 30, 2003, 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 IF WE ARE NOT 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. The process of discovery and exchanging information and documents on infringement, invalidity, and damages, is ongoing. 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. It is anticipated that the Court will issue a written claim construction decision, though the timing of when the Court issues its ruling is within the Court's discretion. 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 July 28, 2003, we announced that we had settled our legal differences with Microsoft and we and Microsoft have 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 have certain obligations to pay certain sums to Microsoft. If Sony Computer Entertainment were successful in its counterclaims and our patents were deemed invalid and unenforceable, the assets relating to the patents that were deemed invalid would be impaired and we may be required to pay 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. We are currently working to increase the demand for these technologies and products in the following five principal application areas:

- touch-enabled medical simulators that can be used for training and skills assessment for procedures such as catheterization, bronchoscopy, colonoscopy, sigmoidoscopy and laparoscopic procedures;
- touch-enabled peripherals for gaming on personal computers and dedicated gaming consoles;
- touch-enabled automotive interfaces;
- touch-enabled, whole-hand sensing gloves, such as our CyberForce product;
- cursor control peripherals, such as touch-enabled mice and trackballs, for use with personal computers; and
- touch-enabled personal electronics, such as cell phones and PDAs.

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.

OUR QUARTERLY REVENUES AND OPERATING RESULTS ARE VOLATILE, AND IF OUR FUTURE RESULTS ARE BELOW THE EXPECTATIONS OF PUBLIC MARKET ANALYSTS OR INVESTORS, THE PRICE OF OUR COMMON STOCK IS LIKELY TO DECLINE.

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

These factors include:

- the establishment or loss of licensing relationships;
- the timing 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;
- 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 cell phones and automobiles.

A substantial 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 a substantially smaller market than either the mouse market or 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.

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 world-wide portfolio of patents. This license permits Microsoft to make, use and sell hardware, software and services (excluding certain products ("Excluded Products")) covered by Immersion's patents. Immersion also granted to Microsoft a limited right, under Immersion's patents relating to touch technology, to sublicense certain rights (excluding rights to Excluded Products and peripheral devices) to third party customers of Microsoft's or Microsoft's subsidiary's operating systems (other than Sony Corporation, Sony Computer Entertainment, Inc., Sony Computer Entertainment of America, Inc., and their subsidiaries (the "Sony Entities")). In exchange, for these rights and the rights included in a separate Sublicense Agreement, Microsoft paid Immersion a one-time payment of $20 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 gaming computer peripherals and is pursuing other consumer markets such as cell 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 ("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, 2003 and 2002 we derived 3% and 14%, respectively, of our net revenues from Medtronic. For the six months ended June 30, 2003 and 2002, Medtronic accounted for 3% and 12% of our net revenues. If our product sales to Medtronic decline, and/or Medtronic reduces the development activities we perform then our total revenues 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.

MADCATZ ACCOUNTS FOR A LARGE PORTION OF OUR ROYALTY REVENUE AND THE FAILURE OF MADCATZ TO ACHIEVE SALES VOLUMES FOR ITS GAMING PRODUCTS THAT INCORPORATE OUR TOUCH-ENABLING TECHNOLOGIES MAY REDUCE OUR ROYALTY REVENUE.

MadCatz accounts for a large portion of our royalty revenue. For the quarter ended June 30, 2003 our royalty revenues from MadCatz significantly increased as compared to the same period during 2002. For the three months ended June 30, 2003 we derived 9% of our net revenues and 46% of our royalty and license revenue from MadCatz, and for the three months ended June 30, 2002, we derived 8% of our net revenue and 19% of our royalty and license revenue from MadCatz. For the six months ended June 30, 2003, we derived 10% of our total revenues and 50% of our royalty and license revenue from MadCatz as compared to the six months ended June 30, 2002, MadCatz accounted for 8% of our total revenues and 22% of our royalty and license revenue. We expect that a significant portion of our total revenues will continue to be derived from MadCatz. If MadCatz fails to achieve anticipated sales volumes for its computer peripheral products that incorporate our technologies, our royalty revenue would be reduced.

LOGITECH ACCOUNTS FOR A LARGE PORTION OF OUR ROYALTY REVENUE AND THE FAILURE OF LOGITECH TO ACHIEVE SALES VOLUMES FOR ITS GAMING AND CURSOR CONTROL PERIPHERAL PRODUCTS THAT INCORPORATE OUR TOUCH-ENABLING TECHNOLOGIES MAY REDUCE OUR ROYALTY REVENUE.

Logitech has in the past and may in the future account for a large portion of our royalty revenue. For the quarter ended June 30, 2003 our revenues from Logitech significantly declined as compared to the same period during 2002. For the three months ended June 30, 2003 we derived 3% of our net revenues and 14% of our royalty and license revenue from Logitech, and for the three months ended June 30, 2002, we derived 7% of our net revenue and 22% of our royalty and license revenue from Logitech. For the six months ended June 30, 2003, we derived 2% of our total revenues and 8% of our royalty and license revenue from Logitech as compared to the six months ended June 30, 2002, Logitech accounted for 8% of our total revenues and 28% of our royalty and license revenue. We expect that a significant portion of our total revenues will continue to be derived from Logitech. If Logitech fails to achieve anticipated sales volumes for its computer peripheral products that incorporate our technologies, our royalty revenue would be reduced.

WE MAY ELECT 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 raise additional capital to have a 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 two 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 RECENT SLOWDOWN IN PERSONAL COMPUTER SALES MAY LEAD TO A REDUCTION IN SALES OF OUR LICENSEES' TOUCH-ENABLED PERIPHERAL PRODUCTS, SUCH AS TOUCH-ENABLED MICE AND JOYSTICKS, WHICH MAY ADVERSELY AFFECT OUR ROYALTY REVENUE.

Over the past year, large personal computer manufacturers have announced slower than anticipated sales of personal computers. This slowdown in personal computer sales may adversely affect sales of our licensees' royalty bearing, touch-enabled peripheral products, such as touch-enabled mice and joysticks, that are used with personal computers. The slowdown affecting personal computer companies may also make it more difficult to persuade such manufacturers to incorporate more costly touch-enabled mice products into their product lines. The impact of this downturn on our royalty revenue may be more pronounced if a significant cause of this trend is a reduction in the amount that individuals and companies have budgeted for personal computer-related devices, such as touch-enabled mice, rather than saturation of the market for personal computers generally. As a result, our results of operations and financial condition may be adversely affected.

WE MAY BE UNABLE TO INCREASE SALES OF OUR MEDICAL SIMULATION DEVICES IF, AS A RESULT OF THE CURRENT ECONOMIC SLOWDOWN OR OTHER FACTORS, MEDICAL INSTITUTIONS DO NOT BUDGET FOR SUCH DEVICES.

Our medical simulation products, such as our AccuTouch Endoscopy Simulator, the AccuTouch Endovascular Simulator and our Laparoscopic Surgical Workstation, 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 the economic slowdown, 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 quarters ended June 30, 2003 and 2002, 19% and 30% of our total revenues were royalty and license revenues. For the six months ended June 30, 2003 and 2002, 21% and 28% 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 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 licensed products 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 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 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 could also result in claims from our licensees under the indemnification provisions of their agreements with us.

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 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. Also it is 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.

Claims that our products or our licensees' products have flaws or other defects that lead to personal or other injury are common in the computer peripherals industry and medical fields. 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 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, such as computer mice and 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 gaming peripherals, computer mice and automotive controls incorporating our touch-enabling technologies are more expensive than similar competitive products that are not touch-enabled. Although major manufacturers, such as Logitech, Microsoft, ALPS Electric Co., Ltd. and BMW, have licensed our 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, 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.

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 we:

- fail to develop new technologies;
- 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 the Company’s ability to deliver our products, ensure quality workmanship and could result in a reduction of the Company’s product sales.

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 (“ABIM”) and the American College of Cardiology (“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. 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.

VICTOR VIEGAS, OUR PRESIDENT, CHIEF EXECUTIVE OFFICER, CHIEF FINANCIAL OFFICER AND DIRECTOR, RECENTLY BECAME THE CHIEF EXECUTIVE OFFICER AND DIRECTOR OF THE COMPANY AND IF THERE ARE DIFFICULTIES WITH THIS LEADERSHIP TRANSITION IT COULD IMPEDE THE EXECUTION OF OUR BUSINESS STRATEGY

Victor Viegas, our President, Chief Executive Officer, Chief Financial Officer and Director, took over the duties of Chief Executive Officer and Director in October 2002. Our success will depend to a significant extent on his ability to implement a successful strategy, to successfully lead and motivate our employees, and to work effectively with our executive staff and board of directors. If this leadership transition is not successful, our ability to execute our business strategy would be impeded.

WE MIGHT BE UNABLE TO RETAIN OR RECRUIT NECESSARY PERSONNEL, WHICH COULD SLOW THE DEVELOPMENT AND DEPLOYMENT OF OUR TECHNOLOGIES.

Our ability to develop and deploy our technologies and to sustain our revenue growth depends upon the continued service of our executive officers and other key personnel and upon hiring additional key personnel. A number of employees of our subsidiaries, including several members of these subsidiaries senior management, have departed since the acquisitions were completed. It may not be possible to retain enough key employees of our subsidiaries to operate these businesses effectively.

We may hire additional sales, support, marketing and research and development personnel. We may not be able to attract, assimilate or retain additional highly qualified personnel in the future. Our executive officers and key employees hold stock options with exercise prices considerably above the current market price of our common stock. In addition, merit increases were suspended for fiscal 2002. 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.

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.

Certain stockholders hold a substantial amount of our outstanding common 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 software, 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 be increased 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. The Sarbanes-Oxley Act of 2002 and other rule 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.

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 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 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.

WE COULD LOSE SOME OR ALL OF THE INVESTMENT THAT WE HAVE MADE IN AN EARLY STAGE TECHNOLOGY COMPANY IF THAT COMPANY IS NOT SUCCESSFUL IN DEVELOPING ITS TECHNOLOGIES OR UNABLE TO OBTAIN ADDITIONAL FINANCING IF AND WHEN NEEDED.

From time to time we have made strategic investments in early stage technology companies that are developing technologies that we believe could complement or enhance our own technologies, if successful. We have made these investments to provide funding for the development of these companies technologies primarily because of the anticipated benefits to Immersion of the availability of these technologies. The prospect of realizing a substantial return on these investments was a secondary, though important, consideration. We wrote down $1.2 million of these investments in the third quarter of 2002, and in the third quarter of 2001 we wrote down $4.3 million of these investments and approximately $239,000 of interest receivable from these companies, and do not expect to realize any return on these amounts. The remaining company in which we have invested may not succeed in developing its technology, might be unsuccessful in marketing its technology or products based on its technology or might fail for any number of other reasons, including an inability to obtain additional capital if required to fund operations, including the completion of the development of its technology. In the event that this company in which we have invested fails or does not achieve a level of success that permits us to realize the value of this investment, we could experience a complete or partial loss on some or all of this investment. If we experience additional losses and related write-downs on the carrying value of our remaining investment, it would decrease our assets and increase our losses.

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 the 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 have decided to accept a settlement proposal presented to all issuer defendants. In this settlement, plaintiffs will dismiss and release 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.

OUR STOCK MAY BE VOLATILE.

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; 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.

We have equity investments in several privately-held companies. We intend to hold our equity investments for the long term and will monitor whether there has been other-than-temporary declines in their values based on management's estimates of their net realizable value taking into account the companies respective financial condition and ability to raise third-party financing. If the decline in fair value is determined to be other-than-temporary, an impairment loss is recorded and the individual security is written down to a new cost basis. As a result of our review, of the fair value of these investments, we recorded an impairment loss of $1.2 million related to our investment in Geometrix Inc., in the third quarter of 2002. This impairment was based on Geometrix's continued decline in financial condition and uncertain future revenue streams, as well as Geometrix's inability to raise third party financing. Also, Geometrix plans to raise third party financing during the quarter ended September 30, 2002 would have required us to convert our note into equity thereby eliminating our creditor status, which in turn would have subordinated our rights to their net assets upon a liquidation to the new investors. Based on these prospects and Geometrix's depletion of substantially all of its remaining cash resources, we concluded the remaining investment was impaired. The remaining cost basis of these investments on our Consolidated Balance Sheet is $1.0 million. We will monitor the remaining value of these investments, and may determine that there could be other impairment losses in the future. As of June 30, 2003 management has determined that the carrying value of these investments at $1.0 million is appropriate.

ITEM 4. CONTROLS AND PROCEDURES

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 in 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 were effective as of the end of the period covered by this quarterly report.

PART II
OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

In re Immersion Corporation

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We have decided to accept a settlement proposal presented to all issuer defendants. In this settlement, plaintiffs will dismiss and release 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.

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. The process of discovery and exchanging information and documents on infringement, invalidity, and damages, is ongoing. 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. It is anticipated that the Court will issue a written claim construction decision, though the timing of when the Court issues its ruling is within the Court's discretion. 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 July 28, 2003, we announced that we had settled our legal differences with Microsoft and we and Microsoft have 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 have certain obligations to pay certain sums to Microsoft. If Sony Computer Entertainment was successful in its counterclaims and our patents were deemed invalid and unenforceable, the assets relating to the patents that were deemed invalid would be impaired. For Sony Computer Entertainment to be awarded damages for attorneys' fees the court would have to rule that we acted with willful disregard and did not perform a proper investigation. We currently believe it is remote that a loss may be or has been incurred related to the counterclaims of Sony Computer Entertainment.

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 3, 2003, to consider and vote on the following proposals to: (i) elect three (3) members of the Board of Directors to serve for a three-year term as a Class I Directors (Proposal 1); (ii) to ratify the appointment of Deloitte & Touche LLP as the Company's independent public accountants for the fiscal year ending December 31, 2003 (Proposal 2); and (iii) to approve an amendment to the 1997 stock option plan (Proposal 3).

Proposal 1: The stockholders elected the three (3) nominees for Class I directors to our Board of Directors. The votes were as follows:

Nominees	Number of Votes For	Withheld Authority
Steven Blank	17,472,351	174,670
Jack Saltich	17,482,673	164,348
Victor Viegas	17,482,873	164,148

Messrs, Blank, Saltich and Viegas' term will expire at the 2006 annual meeting. The following directors' terms of office continue until the annual meeting indicated: Jonathan Rubinstein and Robert Van Naarden (Class II term expires at the 2004 annual meeting) and John Hodgman (Class III term expires at the 2005 annual meeting).

Proposal 2: The ratification of Deloitte & Touche LLP as the Company's independent public accountants for the fiscal year ending December 31, 2003:

Number of Votes For	Number of Votes Against	Number of Votes Abstained
16,616,722	1,013,245	17,054

Proposal 3: Approval of an Amendment to the 1997 Stock Option Plan:

Number of Votes For	Number of Votes Against	Number of Votes Abstained
8,989,742	261,072	32,289

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits.

The following exhibits are filed herewith:

Exhibit Number	Description
31.1	Certification of Victor Viegas, President, Chief Executive Officer, Chief Financial Officer and Director, pursuant to Section 302(a)of 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 28, 2003, announcing the release of the Company's earnings for the first quarter of 2003.

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SIGNATURES

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

IMMERSION CORPORATION
Registrant

Date: August 14, 2003

/s/ Victor Viegas

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

EXHIBIT INDEX

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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

Exhibit 31.1

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 14, 2003

/s/ Victor Viegas

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

Exhibit 32.1

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, 2003 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. § 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 14, 2003

A signed original of this written statement required by Section 906, or other document authenticating, acknowledging, or otherwise adopting the signature that appears in typed form within the electronic version of this written statement required by Section 906, has been provided to the Registrant and will be retained by the Registrant and furnished to the Securities and Exchange Commission or its staff upon request.