SYNAPTICS INC
Form 10-K
September 06, 2007

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SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-K
ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
For the Fiscal Year Ended June 30, 2007
Commission File Number 000-49602
SYNAPTICS INCORPORATED
(Exact name of registrant as specified in its charter)

Delaware	77-0118518
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
3120 Scott Blvd., Ste 130 Santa Clara, California	95054
(Address of principal executive offices)	(Zip Code)

(408) 454-5100

Registrant s telephone number, including area code
Securities registered pursuant to section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock, par value $.001 per share	The Nasdaq Global Select Market
Preferred Stock Purchase Rights	The Nasdaq Global Select Market

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

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

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

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

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

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

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

The aggregate market value of Common Stock held by nonaffiliates of the registrant (24,894,527 shares) based on the closing price of the registrant s Common Stock as reported on the Nasdaq Global Select Market on December 29, 2006 of $29.69, was $739,118,507. For purposes of this computation, all officers, directors, and 10% beneficial owners of the registrant are deemed to be affiliates. Such determination should not be deemed to be an admission that such officers, directors, or 10% beneficial owners are, in fact, affiliates of the registrant.

As of August 1, 2007, there were outstanding 26,238,166 shares of the registrant s Common Stock, par value $.001 per share.

Documents Incorporated by Reference

Portions of the registrant s definitive Proxy Statement for the 2007 Annual Meeting of Stockholders are incorporated by reference into Part III of this Form 10-K.

SYNAPTICS INCORPORATED
ANNUAL REPORT ON FORM 10-K
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Statement Regarding Forward-Looking Statements

The statements contained in this report on Form 10-K that are not purely historical are forward-looking statements within the meaning of applicable securities laws. Forward-looking statements include statements regarding our expectations, anticipation, intentions, beliefs, or strategies regarding the future, whether or not those words are used. Forward-looking statements also include statements regarding revenue, margins, expenses, and earnings analysis for fiscal 2008 and thereafter; technological innovations; products or product development, including their performance, market position, and potential; our product development strategies; potential *acquisitions or strategic alliances; the success of particular product or marketing programs; the amounts of revenue generated as a result of sales to significant customers; and liquidity and anticipated cash needs and availability. All forward-looking statements included in this report are based on information available to us as of the filing date of this report, and we assume no obligation to update any such forward-looking statements. Our actual results could differ materially from the forward-looking statements. Among the factors that could cause actual results to differ materially are the factors discussed in Item 1A. Risk Factors.*

PART I

ITEM 1. BUSINESS

Overview

We are a leading worldwide developer and supplier of custom-designed user interface solutions that enable people to interact more easily and intuitively with a wide variety of mobile computing, communications, entertainment, and other electronic devices. We currently target the personal computer, or PC, market and the market for digital lifestyle products, including portable digital music and video players, mobile phones, and other select electronic device markets with our customized user interface solutions.

We are the global market leader in providing user interface solutions for notebook computers. Our original equipment manufacturer, or OEM, customers include tier one PC OEMs. We generally supply custom designed user interface solutions to our OEM customers through their contract manufacturers, which take delivery of our products and pay us directly for them. Through our new OneTouch offering, we now offer not only our custom module solutions but also access to our technologies to enable customers to develop their own user interface designs for capacitive buttons and scrolling applications for products such as mobile phones, portable digital music and video players, and notebook peripherals.

Our website is www.synaptics.com. Through our website, we make available free of charge all of our Securities and Exchange Commission filings, including our annual reports on Form 10-K, our proxy statements, our quarterly reports on Form 10-Q, and our current reports on Form 8-K as well as Form 3, Form 4, and Form 5 Reports for our directors, officers, and principal stockholders, together with amendments to those reports filed or furnished pursuant to Section 13(a), 15(d), or 16 under the Securities Exchange Act. These reports are available immediately after their electronic filing with the Securities and Exchange Commission. The website also includes corporate governance information, including our Code of Conduct, our Code of Ethics for the CEO and Senior Financial Officers, and our Board Committee Charters.

PC Market

We provide custom user interface solutions for navigation, cursor control, and multimedia controls for many of the world s premier PC OEMs. In addition to notebooks, other PC applications for our technology include peripherals, such as keyboards, mice, and monitors, as well as desktop and PC remote control applications. Our solutions for the PC market include the TouchPad , a touch-sensitive pad that senses the position and movement of a person s finger on its surface; the TouchStyk , a self contained, easily integrated pointing stick module; and dual pointing solutions, which combine both a TouchPad and a pointing stick into a single notebook computer, enabling users to use the interface of their choice. Additional products offered for the PC markets include LuxPad , Dual Mode TouchPad, QuickStroke®, RoundPad , TouchRing , ScrollStrip , LightTouch , SmartTouch, MobileTouch , ClearPad , NavPoint , an OneTouch**.**

The latest industry projections for notebook unit growth for the period 2007-2011 show a compound annual growth rate of 15% compared with 3% for desktop computers, reflecting the continued migration of desktops to notebooks fueled by users desire for mobile computing and on-the-go access to applications, information, and digital content, which is expanding on a daily basis. Based on the strength of our technology and engineering know-how, we believe we are well positioned to take advantage of the growth opportunity in the notebook market and to provide innovative, value-added user interface solutions for each of the key end-user preferences. We estimate that in our fiscal 2007 approximately 83% of all notebook computers sold used solely a touch pad interface; 2% used solely a pointing stick interface; and 15% used a dual pointing interface, which consists of both a touch pad and a pointing stick. Our notebook product lines of touch pads and pointing sticks allow us to address 100% of the notebook market.

Digital Lifestyle Product Markets

We believe our extensive intellectual property portfolio, our experience in providing user interface solutions to major OEMs of electronic devices, and our proven track record of growth in our expanding core notebook computer interface business position us to be a key technological enabler for multiple consumer electronic devices targeted to meet the growing digital lifestyle trend. Based on these strengths, we are addressing the

opportunities created by the growth of mobile computing, communications, and entertainment devices within the digital lifestyle products markets. Digital lifestyle products include portable digital music and video players, mobile phones, remote controls, GPS devices, as well as a variety of mobile, handheld, wireless, and entertainment devices. We believe our existing technologies, our range of product solutions, and our emphasis on ease of use, small size, low power consumption, advanced functionality, durability, and reliability will enable us to serve multiple aspects of the markets for digital lifestyle products and other electronic devices.

Our array of user interface solutions for digital lifestyle products includes the ScrollStrip and TouchRing, which are scrolling solutions allowing users to navigate efficiently through menus and content; LightTouch capacitive buttons, which provide illuminated button functionality; and MobileTouch, NavPoint, and our ClearPad.

Industry projections for the portable digital music player market for the period 2007-2010 suggest a compound annual growth rate of 8% for the overall market and a compound annual growth rate of 32% for video capable MP3 players, reflecting the trend towards portable digital entertainment devices with advanced capabilities, such as built-in video playback capabilities. These products require a simple, durable, and intuitive user interface solution to enable the user to navigate efficiently through menus and scroll through extensive play lists, songs, and videos contained in the host device. We believe we are well positioned to take advantage of this growing market based on our technology, engineering know-how, and the acceptance of our user interface solutions by OEMs in this market.

Industry projections for the mobile phone market for the period 2007-2010 show a compound annual growth rate of 6% for the overall market and a compound annual growth rate of 55% for the smartphone market, reflecting the trend towards increased interest among non-business consumers and the trend towards greater functionality in smartphone products to meet and address the expanded needs and expectations of the consumer oriented market.

Our Strategy

Our objective is to continue to enhance our position as a leading supplier of user interface solutions for the notebook computer market and to become a leading supplier of user interface solutions for digital lifestyle products. Key aspects of our strategy to achieve this objective include those set forth below.

Extend Our Technological Leadership

We plan to utilize our extensive intellectual property portfolio and technological expertise to extend the functionality of our product solutions and offer innovative product solutions to customers across multiple markets. We intend to continue utilizing our technological expertise to reduce the overall size, weight, cost, and power consumption of our user interface solutions while increasing their applications, capabilities, and performance. We plan to continue enhancing the ease of use and functionality of our solutions. We also plan to expand our research and development efforts through increased investment in our engineering activities, the hiring of additional engineering personnel, and strategic acquisitions and alliances. We believe that these efforts will enable us to meet customer expectations and to achieve our goal of supplying on a timely and cost-effective basis the most advanced, easy-to-use, functional user interface solutions to our target markets.

Enhance Our Position in the Notebook Computer and Portable Digital Music Player Markets

We intend to continue introducing market-leading user interface solutions in terms of performance, functionality, size, and ease of use. We plan to continue enhancing our customer s industrial design alternatives and device functionality through innovative product development based on our existing capabilities and technological advances.

Capitalize on Growth of New Markets

We intend to capitalize on the growth of new markets, including the digital lifestyle products markets, brought about by the convergence of computing, communications, and entertainment devices. We plan to offer innovative, intuitive user interface solutions that address the evolving portability, connectivity, and functionality requirements of these new markets. We plan to offer these solutions to existing and potential OEM customers to enable increased functionality, reduced size, lower cost, and enhanced industrial design features and to enhance the

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user experience of their products. We plan to utilize our existing technologies as well as aggressively pursue new technologies as new markets evolve that demand new solutions.

Emphasize and Expand Customer Relationships

We plan to emphasize and expand our strong and long-lasting customer relationships and to establish successful relationships with new customers. In each market we serve, we plan to provide the most advanced user interface solutions for our customers products. We believe that our user interface solutions enable our customers to deliver a positive user experience and to differentiate their products from those of their competitors. We continually attempt to enhance the competitive position of our customers by providing them with innovative, distinctive, and high-quality user interface solutions on a timely and cost-effective basis. To do so, we work continually to improve our productivity, to reduce costs, and to speed the delivery of our user interface solutions. We endeavor to streamline the entire design and delivery process through our ongoing design, engineering, and production improvement efforts. We also focus on providing timely support to our customers after the purchase of our user interface solutions.

We plan to increase our business with existing customers and attract new customers by offering design tools, documentation, a family of capacitive sensing ASICs, and technical support to enable them to develop their own user interface designs for capacitive buttons and scrolling applications in products such as mobile phones, portable digital music and video players, and notebook peripherals. As a result, customers will have a choice of determining the most optimal way to meet their emerging and growing needs: our traditional custom module solutions or OneTouch, which offers a flexible alternative when design integration or quick turns are important.

Pursue Strategic Relationships and Acquisitions

We intend to develop and expand strategic relationships to enhance our ability to offer value-added user interface solutions to our customers, penetrate new markets, and strengthen the technological leadership of our product solutions. We also consider the potential acquisition of companies in order to expand our technological expertise and to establish or strengthen our presence in selected target markets.

Continue Virtual Manufacturing

We plan to expand and diversify our production capacity through third-party relationships, thereby strengthening our virtual manufacturing platform. This strategy results in a scalable business model; enables us to concentrate on our core competencies of research and development, technological advances, and product design; and reduces our capital expenditures. Our virtual manufacturing strategy allows us to maintain a variable cost model, in which we do not incur most of our manufacturing costs until our product solutions have been shipped and billed to our customers.

Product Solutions

We develop and enhance interface technologies that enrich the user s experience in interacting with the user s mobile computing, communications, and entertainment devices. Our innovative and intuitive user interfaces can be engineered to accommodate many diverse platforms, and our expertise in human factors and usability can be utilized to improve the features and functionality of our solutions. Our extensive array of technologies includes ASICs, firmware, software, mechanical and electrical designs, and pattern recognition and touch sensing technologies.

Our custom-designed user interface solutions are custom engineered, total solutions for our customers and include sensor design, module layout, ASICs, firmware, and software features for which we provide manufacturing and design support and device testing. This allows us to be a one-stop supplier for complete user interface design from the early design stage, to manufacturing, to testing and support. Our OneTouch offering includes design tools, documentation, a family of capacitive sensing ASICs, and technical support to enable customers to develop their own user interface designs for capacitive buttons and scrolling applications. Through our technologies and expertise, we seek to provide our customers with solutions that address their individual design issues and result in high-performance, feature-rich, and reliable interface solutions. We believe our interface solutions offer the following characteristics:

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Ease of Use. Our interface solutions offer the ease of use and intuitive interaction that users demand.

Small Size. The small, thin size of our interface solutions enables our customers to reduce the overall size and weight of their products in order to satisfy consumer demand for portability.

Low Power Consumption. The low power consumption of our interface solutions enables our customers to offer products with longer battery life or smaller battery size.

Advanced Functionality. Our interface solutions offer advanced features, such as virtual scrolling, customizable tap zones, edge motion, and tapping and dragging icons, to enhance user experience.

Reliability. The reliability of our interface solutions satisfies consumer requirements for dependability, which is a major component of consumer satisfaction.

Durability. Our interface solutions withstand repeated use, harsh physical treatment, and temperature fluctuations while providing a superior level of performance.

We believe these characteristics will enable us to maintain our leadership position in the notebook computer market and to enhance our position as a technological enabler within the markets for digital lifestyle products and other electronic devices.

Our user interface solutions are intended to satisfy our customer s specification needs, including features and functionality, industrial design, mechanical, and electrical requirements. Our products also offer unique integration options, including allowing our capacitive sensors to be placed underneath the plastic of the device, which allows for streamlined and stylized designs, incorporating LEDs to indicate status or enhance industrial design, and incorporating tactile indicators, including ridges, Braille bumps, and textures designed to provide the user with additional feedback.

Our emphasis on technological leadership and design capabilities positions us to provide unique user interface solutions that address specific customer requirements. Our long-term working relationships with large, global OEMs provide us with experience in satisfying their demanding design specifications and other requirements. Our custom product solutions provide OEMs with numerous benefits, including the following:

modular integration;

reduced product development costs;

shorter product time to market;

compact and efficient platforms;

improved product functionality and utility; and

product differentiation.

We work with our customers in order to meet their technical and functional specifications, their industrial design requirements, and their desire to differentiate their products from those of their competitors. This collaborative effort reduces the duplication and overlap of investment and resources, enabling our OEM customers to devote more time and resources to the market development of their products.

We utilize capacitive technology rather than resistive or mechanical technology in our product solutions. Unlike resistive and mechanical technology, our solid state capacitive technology have no moving parts or activation force, thereby offering a durable, more reliable solution that can be integrated into both curved and flat surfaces. Capacitive technologies also allow for much thinner sensors than resistive or mechanical technology, providing for slimmer, more compact and unique industrial designs.

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Products

Our family of product solutions allows our customers to solve their interface needs and differentiate their products from those of their competitors.

TouchPad

Our TouchPad, which takes the place and exceeds the functionality of a mouse, is a small, touch-sensitive pad that senses the position of a person s finger on its surface through the measurement of capacitance. Our TouchPad provides an accurate, comfortable, and reliable method for screen navigation and cursor movement and provides a platform for interactive input. Our TouchPad solutions allow our customers to provide stylish, simple, user-friendly, and intuitive user interface solutions for both the consumer and corporate markets. Our TouchPad solutions offer various advanced features, including the following:

Virtual scrolling. This feature enables the user to scroll through any document by swiping a finger along the side or bottom of the TouchPad.

Customizable tap zones. These zones permit designated portions of the TouchPad to be used to simulate mouse clicks, launch applications, and perform other selected functions.

PalmCheck™. PalmCheck eliminates false activation when a person s palm accidentally rests on the TouchPad.

EdgeMotion™. This feature permits cursor movement to continue when a user s finger reaches the edge of the TouchPad.

Tapping and dragging of icons. This feature allows the user to simply tap and hold on an icon in order to drag it, rather than being forced to hold a button down in order to drag an icon.

Multi-finger gestures. This feature allows the user to designate specific actions when more than one finger is used on the TouchPad.

Our TouchPad solutions are available in a variety of sizes, electrical interfaces, and thicknesses. Our TouchPad solutions are designed to meet the electrical and mechanical specifications of our customers. Customized firmware and driver software ensure the availability of specialized features. As a result of their solid state characteristics, our TouchPad solutions have no moving parts that wear out, resulting in a robust and reliable input solution that also allows for unique industrial designs.

TouchStyk

Our TouchStyk is a proprietary pointing stick interface solution. TouchStyk is a self-contained, easily integrated module that uses capacitive technology similar to that of our TouchPad. TouchStyk is enabled with press-to-select and tap-to-click capabilities and can be easily integrated into multiple computing and communications devices. In addition, our design greatly reduces susceptibility to electromagnetic interference, thereby providing greater pointing accuracy and preventing the pointer from drifting when not in use.

We are currently shipping our TouchStyk in notebooks, portable multimedia players, and ultra mobile personal computers. Our modular approach allows OEMs to include our TouchPad, our TouchStyk, or a combination of both interfaces in their products.

Dual Pointing Solutions

Our dual pointing solutions offer a TouchPad with a pointing stick in a single notebook computer, enabling users to select their interface of choice. Our dual pointing solution also provides the end user the ability to use both interfaces interchangeably. Our dual pointing solution provides the following advantages:

cost-effective and simplified OEM integration;

simplified OEM product line because one device contains both solutions;

single-source supplier, which eliminates compatibility issues; and

end user flexibility because one notebook can address both user preferences.

We have developed two solutions for use in the dual pointing market. Our first solution integrates all the electronics for controlling a third-party resistive strain gauge pointing stick onto our TouchPad PCB. This solution simplifies OEM integration by eliminating the need to procure the pointing stick electronics from another party and physically integrate them into the notebook. Our second dual pointing solution uses our TouchStyk rather than a third-party pointing stick and offers the same simplified OEM integration. The second solution is a completely modular design, allowing OEMs to offer TouchPad-only, TouchStyk-only, or dual pointing solutions on a build-to-order basis.

LuxPad

LuxPad is an innovative illuminated TouchPad. The LuxPad is designed to allow our customers to differentiate their products. The LuxPad can either light up the entire touchpad, light up a logo in the center of the TouchPad, or light up designated virtual buttons on the TouchPad, depending on the preference of the notebook designer.

Dual Mode TouchPad

Dual Mode TouchPad is designed to transform the TouchPad from a cursor control device to a launch and control center with the touch of a button. In default mode, the Dual Mode provides the same cursor control for on screen navigation as a standard TouchPad. When the user taps on a launch icon located on the TouchPad surface, icons illuminate on the TouchPad surface.

The Dual Mode offers a variety of customization options to the OEM, including tap zones for launching applications and multimedia controls, scrolling zones to adjust volume, and programmable buttons so end users can choose which application they would like to launch through our Dual Mode driver. To regain cursor control, the user simply taps the mode switch button and the illuminated icons disappear, allowing the user to control the cursor for on-screen navigation.

QuickStroke

QuickStroke provides a fast, easy, and accurate way to input Chinese characters. Using our recognition technology that combines our patented software with our TouchPad, QuickStroke can recognize handwritten, partially finished Chinese characters, thereby saving considerable time and effort. Our QuickStroke, which operates with our touch pad products, can be integrated into notebook computers, keyboards, and a host of stand-alone interface devices that use either a pen or a finger.

Our patented Incremental Recognition Technology allows users to simply enter the first few strokes of a Chinese character, and QuickStroke accurately interprets the intended character. Since the typical Chinese character consists of an average of 13 strokes, QuickStroke technology saves considerable time and effort. We can port different alphabets or characters to our underlying pattern recognition engine, allowing us to offer support for different languages.

TouchRing

Our TouchRing is an integrated, solid state scrolling wheel utilizing our capacitive touch sensing technology that enables the user to navigate through menus and scroll through lists. Our TouchRing is utilized in MP3 players, personal media players, and remote controls, enabling the user to navigate efficiently through menus and scroll through extensive play lists and songs.

ScrollStrip

ScrollStrip is a one-dimensional TouchPad that provides a simple and intuitive way for users to scroll through menus, navigate through content, and adjust controls. A ScrollStrip can be used in a wide variety of applications that require a thin, robust, accurate, and easy-to-use input and navigation device, including PC peripherals, such as keyboards and mice, and digital lifestyle products. ScrollStrip is thin, lightweight, and flexible and can be mounted on curved surfaces to meet the industrial design needs of our OEM customers. Currently, the ScrollStrip is incorporated into a number of devices, including MP3 players, PC keyboards, and computer mice.

LightTouch

LightTouch is a simple, easy to use, stylish interface solution that replaces mechanical buttons with an illuminated sensor programmed to perform functions, such as multimedia controls, including pause, play, fast-forward, and rewind. LightTouch is designed for integration under the plastic face of a device, allowing for a sealed, thin design that is both stylish and durable. Currently, a number of custom LightTouch solutions are available in the market, including multimedia controls for notebook PCs, a multimedia keyboard, and as button controls for MP3 players.

MobileTouch

MobileTouch is a new product solution specifically designed for the mobile phone environment that combines our expertise in ease of use with our technology capabilities. The result is custom-designed modules that can combine our scrolling, selection, and navigation capabilities into a simple, easy to use interface solution that improves access to mobile phone content and applications. MobileTouch can be mounted beneath the plastic of the phone, making it well suited to the mobile phone environment where slim design and durability are essential.

SmartTouch

SmartTouch is a software-configurable auxiliary interface for notebook computers that enables notebook computer OEMs to offer their customers the advanced functionality and customizability of our software-configured LightTouch control bar with on-screen display. Our SmartTouch solution replaces conventional multimedia buttons with virtual contextual controls that automatically adapt to the software application that is being used at the time to present customized browser, media player, DVD player, or systems controls and enables users to personalize touch control behavior, including audio feedback, touch sensibility, illumination, control functions, and control placement.

ClearPad

ClearPad consists of a clear, thin capacitive sensor that can be placed over any viewable surface, including display devices, such as LCDs. Similar to our traditional TouchPad, our ClearPad has various distinct advantages, including light weight; low profile form factor; high reliability, durability, and accuracy; and low power consumption. ClearPad, can be mounted on or under curved surfaces, providing for unique and sleek industrial designs.

NavPoint

The NavPoint solution offers users improved functionality and versatility in accessing and managing content in handheld devices through unique navigation controls, including short- and long-distance scrolling features, tapping, and mouse-like cursor navigation.

OneTouch

OneTouch is a configurable solution based on our capacitive sensing technology, which includes a capacitive sensing ASIC, easy-to-use design tools, documentation, and technical support, that enables customers to develop their own custom interface designs in-house for capacitive buttons and scrolling applications in various products, including mobile phones, portable digital media players, and PC peripherals, such as monitors, keyboards, mice, and remote controls. OneTouch increases our reach from a customer standpoint by offering them an alternative and flexible way to leverage our technology and know-how whether through our traditional custom module solution or through the new OneTouch capability that allows them to implement capacitive sensing in-house when design integration or quick design turns are important.

Technologies

We have developed and own an extensive array of technologies, encompassing ASICs, firmware, software, pattern recognition, and touch sensing technologies. With 89 U.S. patents in force and 55 U.S. patents pending, as well as many non-U.S. counterparts, we continue to develop technology in these areas. We believe these technologies and the related intellectual property create barriers for competitors and allow us to provide user interface solutions in a variety of high-growth market segments.

Our broad line of user interface solutions currently is based upon the following key technologies:

capacitive position sensing technology;

capacitive force sensing technology;

transparent capacitive position sensing technology;

pattern recognition technology;

mixed signal, very large scale integrated circuit, or VLSI, technology; and

proprietary microcontroller technology.

In addition to these technologies, we develop firmware and driver software that we incorporate into our products, which provide unique features, such as virtual scrolling, customizable tap zones, PalmCheck, EdgeMotion, and tapping and dragging of icons. In addition, our ability to integrate all of our products to interface with major operating systems, including Windows 98, Windows 2000, Windows NT, Windows CE, Windows XP, Windows ME, Windows Vista, Mac OS, Pocket PC, Palm OS, Symbian, UNIX, and LINUX, provides us with a competitive advantage.

Capacitive Position Sensing Technology. This technology provides a method for sensing the presence, position, and contact area of one or more fingers or a conductive stylus on a flat or curved surface, such as our TouchPad, TouchRing, and ScrollStrip. Our technology works with very light touch and provides highly responsive cursor navigation, scrolling, and selection. It uses no moving parts, can be implemented under plastic, and is extremely durable.

Capacitive Force Sensing Technology. This technology senses the direction and magnitude of a force applied to an object. The object can either move when force is applied, like a typical joystick used for gaming applications, or it can be isometric, with no perceptible motion during use, like our TouchStyk. The primary competition for this technology is resistive strain gauge technology. Resistive strain gauge technology requires electronics that can sense very small changes in resistance, presenting challenges to the design of that circuitry, including sensitivity to electrical noise and interference. Our electronic circuitry determines the magnitude and direction of an applied force, permits very accurate sensing of tiny changes in capacitance, and minimizes electrical interference from other sources.

Transparent Capacitive Position Sensing Technology. This technology allows us to build transparent sensors for use with our capacitive position sensing technology, such as in our ClearPad. It has all the advantages of our capacitive position sensing technology and allows for visual feedback when incorporated with a display device, such as an LCD. Our technology does not require calibration, does not produce undesirable internal reflections, and has reduced power requirements, allowing for longer battery life.

Pattern Recognition Technology. This technology is a set of software algorithms and techniques for converting real-world data, such as handwriting, into a digital form that can be recognized and manipulated within a computer, such as our QuickStroke product and gesture decoding for our TouchPad products. Our technology provides reliable handwriting recognition and can be used in other applications such as signature verification.

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Mixed Signal VLSI Technology. This hybrid analog-digital integrated circuit technology combines the power of digital computation with the ability to interface with non-digital, real-world signals, such as the position of a finger or stylus on a surface. Our patented design techniques permit us to utilize this technology to optimize our core ASIC engine for all our products.

Proprietary Microcontroller Technology. This technology consists of a proprietary 16-bit microcontroller core embedded in the digital portion of our mixed signal ASIC, which allows us to optimize our ASIC for position sensing tasks. Our embedded microcontroller provides great flexibility in customizing our product solutions utilizing firmware, which eliminates the need to design new circuitry for each new application.

Competing Technology

Many user interface solutions currently utilize resistive sensing technology. Resistive sensing technology consists of a flexible membrane above a flat, rigid, electrically conductive surface. When finger or stylus pressure is applied to the membrane, it deforms until it makes contact with the rigid layer below, at which point attached electronics can determine the position of the finger or stylus. Since the flexible membrane is a moving part, it is susceptible to mechanical wear and will eventually suffer degraded performance. Due to the way that resistive position sensors work, it is not possible for them to detect more than a single finger or stylus at any given time. The positional accuracy of a resistive sensor is limited by the uniformity of the resistive coating as well as by the mechanics of the flexible membrane. Finally, implementations of resistive technology over display devices, such as an LCD, result in reduced transmissivity, or the amount of light that can pass through the display, requiring the use of backlighting and thereby reducing the battery life of the device.

Research and Development

We conduct ongoing research and development programs that focus on advancing our technologies, developing new products, improving design and manufacturing processes, and enhancing the quality and performance of our product solutions. Our goal is to provide our customers with innovative solutions that address their needs and improve their competitive positions. Our research and development is focused on advancing our existing interface technologies, improving our current product solutions, and expanding our technologies to serve new markets. Our vision is to offer user interface solutions, such as touch, handwriting, vision, and voice capabilities, that can be readily incorporated into varied electronic devices.

Our research and development programs focus on the development of accurate, easy to use, reliable, and intuitive user interfaces for electronic devices. We believe our innovative interface technologies can be applied to many diverse products. We believe the interface is a key factor in the differentiation of these products. We believe that our interface technologies enable us to provide customers with product solutions that have significant advantages over alternative technologies in terms of functionality, size, power consumption, durability, and reliability. We also intend to pursue strategic relationships and acquisitions to enhance our research and development capabilities, leverage our technology, and shorten our time to market with new technological applications.

Our research, design, and engineering teams frequently work directly with our customers to design custom solutions for specific applications. We focus on enabling our customers to overcome technical barriers and enhance the performance of their products. We believe our engineering know-how and electronic systems expertise provide significant benefits to our customers by enabling them to concentrate on their core competencies of production and marketing.

As of June 30, 2007, we employed 161 people in our technology, engineering, and product design functions in the United States, Hong Kong, and Taiwan. Our research and development expenses were approximately $25.0 million, $35.4 million, and $39.4 million in fiscal 2005, 2006, and 2007, respectively.

Intellectual Property Rights

Our success and ability to compete depend in part on our ability to maintain the proprietary aspects of our technologies and products. We rely on a combination of patents, copyrights, trade secrets, trademarks, confidentiality agreements, and other contractual provisions to protect our intellectual property, but these measures may provide only limited protection. Our research, design, and engineering teams frequently work directly with our OEM customers to design custom solutions for specific applications.

We hold 89 U.S. patents in force and have 55 U.S. patents pending, as well as many non-U.S. counterparts to the U.S. patents and U.S. patents pending. Collectively, these patents and patents pending cover various aspects of our key technologies, including touch sensing, pen sensing, handwriting recognition, customizable tap zones, edge motion, and virtual scrolling technologies. Our proprietary software is protected by copyright laws. The source code for our proprietary software is also protected under applicable trade secret laws.

Our extensive array of technologies includes ASICs, firmware, software, and pattern recognition and position sensing technologies. Our products rely on a combination of these technologies, making it difficult to use any single technology as the basis for replicating our products. Furthermore, the length and customization of the customer design cycle serve to protect our intellectual property rights.

Patent applications that we have filed or may file in the future may not result in a patent being issued. Our issued patents may be challenged, invalidated, or circumvented, and claims of our patents may not be of sufficient scope or strength, or issued in the proper geographic regions, to provide meaningful protection or any commercial advantage. We have not applied for, and do not have, any copyright registration on our technologies or products. We have applied to register certain of our trademarks in the United States and other countries. There can be no assurance that we will obtain registrations of trademarks in key markets. Failure to obtain registrations could compromise our ability to protect fully our trademarks and brands and could increase the risk of challenge from third parties to our use of our trademarks and brands. In addition, our failure to enforce and protect our intellectual property rights or obtain from third parties the right to use necessary technology could have a material adverse effect on our business, financial condition, and results of operations.

We do not consistently rely on written agreements with our customers, suppliers, manufacturers, and other recipients of our technologies and products, and therefore some trade secret protection may be lost and our ability to enforce our intellectual property rights may be limited. Furthermore, our customers, suppliers, manufacturers, and other recipients of our technologies and products may seek to use our technologies and products without appropriate limitations. In the past, we did not consistently require our employees and consultants to enter into confidentiality agreements, employment agreements, or proprietary information and invention agreements. Therefore, our former employees and consultants may try to claim some ownership interest in our technologies and products and may use our technologies and products competitively and without appropriate limitations.

Other companies, including our competitors, may develop technologies that are similar or superior to our technologies, duplicate our technologies, or design around our patents and may have or obtain patents or other proprietary rights that would prevent, limit, or interfere with our ability to make, use, or sell our products. Effective intellectual property protection may be unavailable or limited in some foreign countries in which we operate, such as China and Taiwan. Unauthorized parties may attempt to copy or otherwise use aspects of our technologies and products that we regard as proprietary. There can be no assurance that our means of protecting our proprietary rights in the United States or abroad will be adequate or that competitors will not independently develop similar technologies. If our intellectual property protection is insufficient to protect our intellectual property rights, we could face increased competition in the market for our technologies and products.

We may receive notices from third parties that claim our products infringe their rights. From time to time, we receive notice from third parties of the intellectual property rights such parties have obtained. We cannot be certain that our technologies and products do not and will not infringe issued patents or other proprietary rights of third parties. Any infringement claims, with or without merit, could result in significant litigation costs and diversion of resources, including the payment of damages, which could have a material adverse effect on our business, financial condition, and results of operations.

Customers

Our customers include many of the world s largest PC OEMs, based on unit shipments, as well as a variety of consumer electronics manufacturers. Our demonstrated track record of technological leadership, design innovation, product performance, cost effectiveness, and on-time delivery have resulted in our leadership position in providing user interface solutions to the notebook market. We believe our strong relationship with our OEM

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customers, many of which are currently developing digital lifestyle products, will position us as a source of supply for their product offerings.

Our industry leading OEM customers in fiscal 2007 included the following:

Acer

Asustek

Dell

Fujitsu

Gateway

Hewlett-Packard

IBM

Lenovo

LG Electronics

NEC

Samsung

Toshiba

We generally supply custom-designed products to our OEM customers through their contract manufacturers. We sell our custom-designed products directly to these contract manufacturers, which include Compal, Hon Hai, Inventec, Kangzhun Electronical, Lenovo, Shanghai Yi Hsin, Wistron, and Zhan Yun Shanghai Electronics. Sales to Compal and Wistron in the aggregate accounted for approximately 26% of our net revenue for fiscal 2007, and sales to Inventec and Wistron in the aggregate accounted for approximately 24% of our net revenue for fiscal 2006. No other customer accounted for more than 10% of our net revenue for either fiscal 2006 or 2007. We supply our OneTouch solution directly to our OEM customers.

We consider both the OEMs and their contract manufacturers to be our customers. Both the OEMs and their contract manufacturers may determine the design and pricing requirements and make the overall decision regarding the use of our user interface solutions in their products. The contract manufacturers place orders with us for the purchase of our products, take title to the products purchased upon shipment by us, and pay us directly for those purchases. These customers have no return privileges except for warranty provisions.

Strategic Relationships

We have used strategic relationships to enhance our ability to offer value-added customer solutions in the past and we intend to enter into additional strategic relationships with companies that may help us serve our target markets.

Sales and Marketing

We sell our product solutions for incorporation into the products of our OEM customers. We generate sales through direct sales employees as well as outside sales representatives and distributors. Our sales personnel receive substantial technical assistance and support from our internal engineering resources because of the highly technical nature of our product solutions. Sales frequently result from multi-level sales efforts that involve senior management, design engineers, and our sales personnel interacting with our customers decision makers throughout the product development and order process.

We currently employ 79 sales and marketing professionals. We maintain eight customer support offices domestically and internationally, which are located in the United States, Taiwan, China, Korea, Japan, Hong Kong, and Switzerland. In addition, we utilize sales representatives in Korea, Singapore, and Malaysia and sales distributors in Japan and Taiwan.

International sales constituted approximately 98%, 98%, and 99% of our revenue for fiscal 2005, 2006, and 2007, respectively. Over 90% of our sales were made to companies located in China and Taiwan that provide design and manufacturing services for major notebook computer and digital lifestyle product OEMs. All of our sales were denominated in U.S. dollars.

Manufacturing

We employ a virtual manufacturing platform through third-party relationships. We currently utilize two semiconductor wafer manufacturers to supply us with silicon wafers integrating our proprietary design specifications. The completed silicon wafers are forwarded to third-party package and test processors for further processing into die and packaged ASICs, as applicable, which are then utilized in our custom interface products.

After processing and testing, the die and ASICs are consigned to various contract manufacturers for assembly or, in the case of OneTouch ASICs are shipped directly to our customers. During the assembly process, our die or ASIC is combined with other components to complete the module for our custom user interface solution. The finished assembled product is subsequently shipped by our contract manufacturers directly to our customers for integration into their products.

We believe our virtual manufacturing strategy provides a scalable business model; enables us to concentrate on our core competencies of research and development, technological advances, and product design; and reduces our capital expenditures. In addition, this strategy significantly reduces our working capital requirements for inventory because we do not incur most of our manufacturing costs until we have actually shipped our interface products to our customers and billed those customers for those products.

Our third-party contract manufacturers are Asian-based organizations. We provide our contract manufacturers with six-month rolling forecasts of our production requirements. We do not, however, have long-term agreements with any of our contract manufacturers that guarantee production capacity, prices, lead times, or delivery schedules. The strategy of relying on those parties exposes us to vulnerability owing to our dependence on few sources of supply. We believe, however, that other sources of supply are available. In addition, we may establish relationships with other contract manufacturers in order to reduce our dependence on any one source of supply.

Periodically, we purchase inventory from our contract manufacturers when a customer s delivery schedule is delayed or a customer s order is cancelled. In those circumstances in which our customer has cancelled its order and we purchase inventory from our contract manufacturers, we consider a write-down to reduce the carrying value of the inventory purchased to its net realizable value. Write-downs to reduce the carrying value of obsolete, slow moving, and non-usable inventory to net realizable value are charged to cost of revenue.

Backlog

As of June 30, 2007, we had a backlog of orders of approximately $46.9 million, an increase of $18.2 million compared with our backlog of orders as of June 30, 2006 of approximately $28.7 million. The increase in backlog is primarily related to the increase in demand for our products. Our backlog consists of product orders for which purchase orders have been received and which are generally scheduled for shipment within three months. Most orders are subject to rescheduling or cancellation with limited penalties. Because of the possibility of customer changes in product shipments, our backlog as of a particular date may not be indicative of net sales for any succeeding period.

Competition

Our principal competitor in the sale of notebook touch pads is Alps Electric, a Japanese conglomerate. Our principal competitors in the sale of notebook pointing sticks are Alps Electric, NMB, and CTS. In the markets for digital lifestyle products and other electronic devices, our competitors include Alps Electric, Cypress, Quantum Technology Management, and various other companies involved in user interface solutions. In certain cases, large OEMs may develop alternative user interface solutions for their own products or provide key components for use in designing user interface solutions.

In the notebook user interface market, we plan to continue to compete primarily on the basis of our technological expertise, design innovation, customer service, and the long track record of performance of our user interface solutions, including their ease of use, reliability, and cost-effectiveness as well as their timely design, production, and delivery schedules. Our pointing stick solutions, including our proprietary TouchStyk, enable us to address the approximate 2% of the notebook computer market that uses solely a pointing stick rather than a touch pad as the user interface as well as the approximate 15% of the notebook market that uses dual pointing interfaces. Our ability to supply OEMs with TouchPads, TouchStyks, and dual pointing alternatives enhances our market position as we can provide OEMs with the following advantages:

single source supplier to eliminate compatibility issues;

cost-effective and simplified integration;

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simplified product line to address both interface preferences;

end user flexibility because one notebook can address both user preferences; and

modular approach allowing OEMs to utilize our TouchPad, our TouchStyk, or a combination of both interfaces.

In the user interface markets for digital lifestyle products and other electronic devices, we compete primarily based on the advantages of our systems knowledge of capacitive sensing and neural pattern recognition technologies. We believe our solutions based engineering expertise coupled with our technologies offer benefits in terms of size, power consumption, durability, light transmissivity, resolution, ease of use, and reliability when compared to our competitors and other technologies. While these markets continue to evolve and we do not know what the competitive factors will ultimately be, we believe we are positioned to compete aggressively for this business based on our proven track record, our marquee global customer base, and our reputation for design innovation. However, some of our competitors have greater market recognition, larger customer bases, and substantially greater financial, technical, marketing, distribution, and other resources than we possess that afford them potential competitive advantages. As a result, they may be able to introduce new product solutions and respond to customer requirements more quickly than we can. In addition, new competitors, alliances among competitors, or alliances among competitors and OEMs may emerge and allow competitors to rapidly acquire significant market share.

Furthermore, our competitors or our customers may develop technologies in the future that more effectively address the user interface needs of the notebook market and other markets. Our sales, profitability, and success depend on our ability to compete with other suppliers of user interface solutions and components used in user interface solutions. Our competitive position could be adversely affected if one or more of our current OEMs reduce their orders or if we are unable to develop new customers for our user interface solutions.

Employees

As of June 30, 2007, we employed a total of 312 persons, including 72 in finance, administration, and operations; 79 in sales and marketing; and 161 in research and development. Of these employees, 205 were located in North America, 106 in Asia/Pacific, and one in Europe. We consider our relationship with our employees to be good, and none of our employees are represented by a union in collective bargaining with us.

Competition for qualified personnel in our industry is extremely intense, particularly for engineering and other technical personnel. Our success depends on our continued ability to attract, hire, and retain qualified personnel.

Executive Officers

The following table sets forth certain information regarding our executive officers:

Name	Age	Position
Francis F. Lee	55	President, Chief Executive Officer, and Director
Thomas J. Tiernan	44	Executive Vice President and General Manager
Russell J. Knittel	57	Executive Vice President, Chief Financial Officer, Chief Administrative Officer, Secretary, and Treasurer
Shawn P. Day, Ph.D.	41	Vice President and Chief Technical Officer
Alex Wong	51	Vice President of World Wide Operations

Francis F. Lee has served as a director and the President and Chief Executive Officer of our company since January 1999. He was a consultant from August 1998 to November 1998. From May 1995 until July 1998, Mr. Lee served as General Manager of NSM, a Hong Kong-based joint venture between National Semiconductor Corporation and S. Megga. Mr. Lee held a variety of executive positions for National Semiconductor from 1988 until August 1995. These positions included Vice President of Communication and Computing Group, Vice President of Quality and Reliability, Director of Standard Logic Business Unit, and various other operations and engineering management positions. Mr. Lee is a director of Foveon, Inc., a privately held company in which we have an ownership interest. Mr. Lee holds a Bachelor of Science degree, with honors, in electrical engineering from the University of California at Davis.

Thomas J. Tiernan has been Executive Vice President and General Manager of our company since July 2007. Mr. Tiernan served as Senior Vice President of our company from March 2006 until July 2007. Prior to joining our company, Mr. Tiernan served as Vice President and General Manager of Symbol Technologies Mobile Computing Division. From 1985 to 2004, Mr. Tiernan held various management and executive positions at Hewlett-Packard, including running the Network Storage business in the Americas, the Enterprise Systems business in Asia Pacific, and the PC business in Japan. Mr. Tiernan holds a Bachelor s Degree in Electrical Engineering from California State Polytechnic University and a Masters of Science in Computer Engineering from Santa Clara University.

Russell J. Knittel has been Executive Vice President, Chief Financial Officer, of our company since July 2007 and Chief Financial Officer, Chief Administrative Officer, Secretary, and Treasurer of our company since November 2001. Mr. Knittel served as Senior Vice President of our company from April 2000 until July 2007. He served as the Vice President of Administration and Finance, Chief Financial Officer, and Secretary of our company from April 2000 through October 2001. Mr. Knittel served as Vice President and Chief Financial Officer of Probe Technology Corporation from May 1999 to March 2000. He was a consultant from January 1999 until April 1999. Mr. Knittel was Vice President and Chief Financial Officer at Starlight Networks from November 1994 to December 1998. Mr. Knittel holds a Bachelor of Arts degree in accounting from California State University at Fullerton and a Masters of Business Administration from San Jose State University.

Shawn P. Day, Ph.D. has been Vice President and Chief Technical Officer of our company since July 2007. He served as our Vice President of Research and Development of our company from June 1998 through July 2007; as the Director of Software Development of our company from November 1996 until May 1998; and as principal software engineer of our company from August 1995 until October 1996. Mr. Day holds a Bachelor of Science degree and a Doctorate, both in electrical engineering, from the University of British Columbia in Vancouver, Canada.

Alex Wong has been the Vice President of World Wide Operations of our company since September 2006. From 2003 to 2006, Mr. Wong served our company as Managing Director of Hong Kong and Director of Operations. Prior to joining Synaptics, Mr. Wong held various management positions with National Semiconductor, including General Manager for National Joint Ventures in China and Hong Kong as well as the Director of Corporate Business Development. Mr. Wong holds a Bachelor of Science degree in Computer Science from California State University at Northridge and a Masters in Business Administration from the University of East Asia, Macau.

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ITEM 1A. RISK FACTORS

You should carefully consider the following factors, together with all the other information included in this report, in evaluating our company and our business.

We currently depend on our TouchPad and TouchStyk products, and the notebook computer market, for a significant portion of our revenue, and a downturn in these products or market could have a disproportionate impact on our revenue.

Historically, we have derived a substantial portion of our revenue from the sale of our TouchPad and TouchStyk products for notebook computers. While our long-term objective is to derive revenue from multiple user interface solutions for both the notebook computer market and the markets for digital lifestyle products and other electronic devices, we anticipate that sales of our TouchPads and TouchStyks for notebooks will continue to represent a significant portion of our revenue. The PC market as a whole has experienced a slowdown in the rate of growth. A continued or accelerated softening in the demand in the notebook portion of the PC market or the level of our participation in that market would cause our business, financial condition, and results of operations to suffer more than they would have if we offered a more diversified line of products.

Net revenue from our user interface solutions for digital lifestyle products have been volatile in the past, and our net revenue from our user interface solutions for digital lifestyle products may not increase or be less volatile in the future.

Net revenue from our user interface solutions for digital lifestyle products, particularly portable digital music players, have been volatile in the past, and sales for other digital lifestyle products, such as mobile phones, have not been significant to date. Our net revenue from our user interface solutions for digital lifestyle products may not increase or be less volatile in the future. Net revenue from our user interface solutions for digital lifestyle products were $27.0 million, or 15% of our net revenue, in fiscal 2006 and $40.6 million, or 15% of our net revenue, in fiscal 2007. Further, our interface business for digital lifestyle products faces many uncertainties, particularly portable digital music players, including our success in penetrating new markets dominated by a limited number of OEMs. Our inability to address these uncertainties successfully and to become a leading supplier of user interfaces for digital lifestyle products would result in a slower growth rate than we currently anticipate. We do not know whether our user interface solutions for the digital lifestyle product market will gain market acceptance or will ever result in a substantial portion of our revenue on a consistent basis. The failure to succeed in these other markets would result in no return on the substantial investments we have made to date and plan to make in the future to penetrate these markets.

We cannot assure you that our user interface business for digital lifestyle products will be successful or that we will be able to generate significant revenue from the markets for digital lifestyle products.

Various target markets for our interfaces, such as those for smart phones, GPS devices, smart handheld devices, and interactive games and toys, are uncertain, may develop slower than anticipated, or could utilize competing technologies. The market for certain of these products depends in part upon the development and deployment of wireless and other technologies, which may or may not address the needs of users of these new products.

Our ability to generate significant revenue from the markets for certain digital lifestyle products and other electronic devices will depend on various factors, including the following:

- the development and growth of these markets;
- the ability of our technologies and product solutions to address the needs of these markets, the requirements of OEMs, and the preferences of end users; and
- our ability to provide OEMs with user interface solutions that provide advantages in terms of size, power consumption, reliability, durability, performance, and value-added features compared with alternative solutions.

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Many manufacturers of these products have well-established relationships with competitive suppliers. Penetrating these markets will require us to offer better performance alternatives to existing solutions at competitive costs. We generally do not have a significant backlog of orders for our user interface solutions to be incorporated in products in these markets. The failure of any of these target markets to develop as we expect, or our failure to penetrate these markets to a significant extent, will impede our anticipated sales growth and could result in substantially reduced earnings from those we anticipate. We cannot predict the size or growth rate of these markets or the market share we will achieve in these markets in the future.

Our historical financial performance is based primarily on net revenue generated from our user interface solutions to the notebook computer market and may not be indicative of our future performance in other markets.

Our historical financial performance primarily reflects net revenue generated from our user interface solutions for notebook computers. While we expect sales of our user interface solutions for notebook computers to continue to generate a substantial percentage of our revenue, we expect to derive an increasing portion of our revenue from sales of our product solutions for digital lifestyle products, including portable digital music players, mobile phones, and other electronic devices. We have a limited operating history in these markets, especially for mobile phones, upon which you can evaluate our prospects, which may make it difficult to predict our actual results in future periods. Actual results of our future operations may differ materially from our anticipated results.

Market acceptance of our customers existing or new products that utilize our user interface solution may decline or may not develop and, as a result, our sales may decline or may not increase.

We do not sell any products to end users. Instead, we design various user interface solutions that our OEM customers incorporate into their products. As a result, our success depends almost entirely upon the widespread market acceptance of our OEM customers products. We do not control or influence the manufacture, promotion, distribution, or pricing of the products that incorporate our user interface solutions. Instead, we depend on our customers to manufacture and distribute products incorporating our user interface solutions and to generate consumer demand through marketing and promotional activities. Even if our technologies successfully meet our customers price and performance goals, our sales would decline or fail to develop if our customers do not achieve commercial success in selling their products that incorporate our user interface solutions.

Competitive advances by OEMs in the PC or digital lifestyle product markets, which do not utilize our user interface solutions broadly in their product offerings, at the expense of our other OEM customers could result in lost sales opportunities. Within the digital lifestyle product market, the portable digital music player market also has become an important factor in our operating results. Any significant slowdown in the use of our user interface solutions by our customers in this market, the reduced demand for our customers products, or a slowdown in this market would adversely affect our sales.

If we fail to maintain and build relationships with our customers and do not continue to satisfy our customers, we may lose future sales and our revenue may stagnate or decline.

Because our success depends on the widespread market acceptance of our customers products, we must continue to maintain our relationships with the leading notebook computer and portable digital music player OEMs and expand our relationships with mobile phone OEMs. In addition, we must identify areas of significant growth potential in other markets, establish relationships with OEMs in those markets, and assist those OEMs in developing products that use our interface technologies. Our failure to identify potential growth opportunities, particularly in new markets, or establish and maintain relationships with OEMs in those markets, would prevent our business from growing in those markets.

Our ability to meet the expectations of our customers requires us to provide innovative user interface solutions for customers on a timely and cost-effective basis and to maintain customer satisfaction with our user interface solutions. We must match our design and production capacity with customer demand, maintain satisfactory delivery schedules, and meet performance goals. If we are unable to achieve these goals for any reason, our customers could reduce their purchases from us and our sales would decline or fail to develop.

Our customer relationships also can be affected by factors affecting our customers that are unrelated to our performance. These factors can include a myriad of situations, including business reversals of customers,

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determinations by customers to change their product mix or abandon business segments, or mergers, consolidations, or acquisitions involving our customers, such as the combination of Compaq and Hewlett-Packard or the acquisition of IBM s PC business unit by Lenovo.

Two customers accounted for an aggregate of 26% of our net revenue in fiscal 2007, and the loss of revenue from these customers could harm our business, financial condition, and results of operations.

Sales to two customers that provide contract manufacturing services to major OEMs accounted for an aggregate of 26% of our net revenue for the fiscal ended June 30, 2007, and two customers accounted for an aggregate of 24% of our net revenue for the fiscal ended June 30, 2006. These customers were Compal and Wistron in fiscal 2007 and Inventec and Wistron in fiscal 2006. Additionally, receivables from each of Compal and Zhan Yun Shanghai Electronics exceeded 10% of accounts receivable and in the aggregate represented 29% of accounts receivable at June 30, 2007.

Compal, Inventec, Wistron, and Zhan Yun Shanghai Electronics are contract manufacturers that serve our OEM customers. Any material delay, cancellation, or reduction of orders from any one or more of these contract manufacturers or the OEMs they serve could harm our business, financial condition, and results of operations. The adverse effect would be more substantial if our other customers in the notebook computer industry do not increase their orders or if we are unsuccessful in generating orders for user interface solutions in the markets for digital lifestyle products and other electronic devices, from existing or new customers. Many of these contract manufacturers sell to the same OEMs, and therefore our concentration with certain OEMs may be higher than with any individual contract manufacturer. Concentration in our customer base may make fluctuations in revenue and earnings more severe and make business planning more difficult.

We rely on others for our production and any interruptions of these arrangements could disrupt our ability to fill our customers orders.

We utilize contract manufacturers for all of our production requirements. The majority of our manufacturing is conducted in China, Hong Kong, Singapore, Taiwan, and Thailand by contract manufacturers that also perform services for numerous other companies. We do not have a guaranteed level of production capacity with any of our contract manufacturers. Qualifying new contract manufacturers, and specifically semiconductor foundries, is time consuming and might result in unforeseen manufacturing and operations problems. The loss of our relationships with our contract manufacturers or assemblers or their inability to conduct their manufacturing and assembly services for us as anticipated in terms of cost, quality, and timeliness could adversely affect our ability to fill customer orders in accordance with required delivery, quality, and performance requirements. If this were to occur, the resulting decline in revenue would harm our business.

We depend on third parties to maintain satisfactory manufacturing yields and delivery schedules, and their inability to do so could increase our costs, disrupt our supply chain, and result in our inability to deliver our products, which would adversely affect our results of operations.

We depend on our contract manufacturers to maintain high levels of productivity and satisfactory delivery schedules at manufacturing and assembly facilities located primarily in China, Hong Kong, Singapore, Taiwan, and Thailand. We provide our contract manufacturers with six-month rolling forecasts of our production requirements. We do not, however, have long-term agreements with any of our contract manufacturers that guarantee production capacity, prices, lead times, or delivery schedules. Our contract manufacturers serve other customers, a number of which have greater production requirements than we do. As a result, our contract manufacturers could determine to prioritize production capacity for other customers or reduce or eliminate deliveries to us on short notice. At times, we have experienced lower than anticipated manufacturing yields and lengthening of delivery schedules. Lower than expected manufacturing yields could increase our costs or disrupt our supplies. We may encounter lower manufacturing yields and longer delivery schedules in commencing volume production of our new products. Any of these problems could result in our inability to deliver our product solutions in a timely manner and adversely affect our operating results.

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Shortages of components and materials may delay or reduce our sales and increase our costs, thereby harming our results of operations.

The inability to obtain sufficient quantities of components and other materials necessary for the production of our products could result in reduced or delayed sales or lost orders. Any delay in or loss of sales could adversely impact our operating results. Many of the materials used in the production of our products are available only from a limited number of foreign suppliers, particularly suppliers located in Asia. In most cases, neither we nor our contract manufacturers have long-term supply contracts with these suppliers. As a result, we are subject to economic instability in these Asian countries as well as to increased costs, supply interruptions, and difficulties in obtaining materials. Our customers also may encounter difficulties or increased costs in obtaining the materials necessary to produce their products into which our product solutions are incorporated.

From time to time, materials and components used in our product solutions or in other aspects of our customers products have been subject to allocation because of shortages of these materials and components. Shortages in the future could cause delayed shipments, customer dissatisfaction, and lower revenue.

We are subject to lengthy development periods and product acceptance cycles, which can result in development and engineering costs without any future revenue.

We provide user interface solutions that are incorporated by OEMs into the products they sell. OEMs make the determination during their product development programs whether to incorporate our user interface solutions or pursue other alternatives. This process requires us to make significant investments of time and resources in the design of user interface solutions well before our customers introduce their products incorporating these interfaces and before we can be sure that we will generate any significant sales to our customers or even recover our investment. During a customer s entire product development process, we face the risk that our interfaces will fail to meet our customer s technical, performance, or cost requirements or that our products will be replaced by competitive products or alternative technological solutions. Even if we complete our design process in a manner satisfactory to our customer, the customer may delay or terminate its product development efforts. The occurrence of any of these events could cause sales to not materialize, to be deferred, or to be cancelled, which would adversely affect our operating results.

We do not have long-term purchase commitments from our customers, and their ability to cancel, reduce, or delay orders could reduce our revenue and increase our costs.

Our customers do not provide us with firm, long-term volume purchase commitments, but instead issue purchase orders. As a result, customers can cancel purchase orders or reduce or delay orders at any time. The cancellation, delay, or reduction of customer purchase orders could result in reduced revenue, excess inventory, and unabsorbed overhead. We have an established presence in the notebook computer market and have only recently established a presence in the digital lifestyle products markets. Our success in the digital lifestyle product market will require us to establish the value added by our products to OEMs that have traditionally used other solutions. All of the markets we serve are subject to severe competitive pressures, rapid technological change, and product obsolescence, which increase our inventory and overhead risks, resulting in increased costs.

We face intense competition that could result in our losing or failing to gain market share and suffering reduced revenue.

We serve intensely competitive markets that are characterized by price erosion, rapid technological change, and competition from major domestic and international companies. This intense competition could result in pricing pressures, lower sales, reduced margins, and lower market share. Any movement away from high-quality, custom designed, feature-rich user interface solutions to lower priced alternatives would adversely affect our business. Some of our competitors, particularly in the markets for digital lifestyle products and other electronic devices, have greater market recognition, larger customer bases, and substantially greater financial, technical, marketing, distribution, and other resources than we possess and that afford them competitive advantages. As a result, they may be able to devote greater resources to the promotion and sale of products, to negotiate lower prices for raw materials and components, to deliver competitive products at lower prices, and to introduce new product solutions and respond to customer requirements more quickly than we can. Our competitive position could suffer if one or more of our customers determine not to utilize our custom engineered, total solutions approach and instead decide to design and manufacture their own interfaces, to contract with our competitors, or to use alternative technologies.

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Our ability to compete successfully depends on a number of factors, both within and outside our control. These factors include the following:

- our success in designing and introducing new user interface solutions, including those implementing new technologies;
- our ability to predict the evolving needs of our customers and to assist them in incorporating our technologies into their new products;
- our ability to meet our customer s requirements for low power consumption, ease of use, reliability, durability, and small form factor;
- the quality of our customer services;
- the rate at which customers incorporate our user interface solutions into their own products;
- product or technology introductions by our competitors; and
- foreign currency fluctuations, which may cause a foreign competitor s products to be priced significantly lower than our product solutions.

If we do not keep pace with technological innovations, our products may not be competitive and our revenue and operating results may suffer.

We operate in rapidly changing markets. Technological advances, the introduction of new products, and new design techniques could adversely affect our business unless we are able to adapt to the changing conditions. Technological advances could render our solutions obsolete, and we may not be able to respond effectively to the technological requirements of evolving markets. As a result, we will be required to expend substantial funds for and commit significant resources to

- continue research and development activities on existing and potential user interface solutions,
- hire additional engineering and other technical personnel, and
- purchase advanced design tools and test equipment.

Our business could be harmed if we are unable to develop and utilize new technologies that address the needs of our customers, or our competitors or customers do so more effectively than we do.

Our efforts to develop new technologies may not result in commercial success, which could cause a decline in our revenue and could harm our business.

Our research and development efforts with respect to new technologies may not result in customer or market acceptance. Some or all of those technologies may not successfully make the transition from the research and development lab to cost-effective production as a result of technology problems, competitive cost issues, yield problems, and other factors. Even when we successfully complete a research and development effort with respect to a particular technology, our customers may decide not to introduce or may terminate products utilizing the technology for a variety of reasons, including the following:

- difficulties with other suppliers of components for the products,
- superior technologies developed by our competitors and unfavorable comparisons of our solutions with these technologies,
- price considerations, and
- lack of anticipated or actual market demand for the products.

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The nature of our business requires us to make continuing investments for new technologies. Significant expenses relating to one or more new technologies that ultimately prove to be unsuccessful for any reason could have a material adverse effect on us. In addition, any investments or acquisitions made to enhance our technologies may prove to be unsuccessful. If our efforts are unsuccessful, our business could be harmed.

We may not be able to enhance our existing product solutions and develop new product solutions in a timely manner.

Our future operating results will depend to a significant extent on our ability to continue to provide new user interface solutions that compare favorably with alternative solutions on the basis of time to introduction, cost, performance, and end user preferences. Our success in maintaining existing and attracting new customers and developing new business depends on various factors, including the following:

- innovative development of new solutions for customer products,
- utilization of advances in technology,
- maintenance of quality standards,
- efficient and cost-effective solutions, and
- timely completion of the design and introduction of new user interface solutions.

We recently introduced our OneTouch product offering to enable our customers to access our technologies to develop their own user interface designs for capacitive buttons and scrolling applications for products such as mobile phones, portable digital music and video players, and notebook peripherals. OneTouch may not enable us to achieve our goal of increasing our business with existing customers or attracting new customers. In addition, OneTouch could reduce demand for our custom-designed user interface solutions.

Our inability to enhance our existing product solutions and develop new product solutions on a timely basis could harm our operating results and impede our growth.

A technologically new user interface solution that achieves significant market share could harm our business.

Our user interface solutions are designed to integrate touch, handwriting, and vision capabilities. New computing and communications devices could be developed that call for a different interface solution. Existing devices also could be modified to allow for a different interface solution. Our business could be harmed if our products become noncompetitive as a result of a technological breakthrough that allows a new interface solution to displace our solutions and achieve significant market acceptance.

International sales and manufacturing risks could adversely affect our operating results.

Our manufacturing and assembly operations are primarily conducted in China, Hong Kong, Singapore, Taiwan, and Thailand by manufacturing contractors. We have sales and logistics operations in Hong Kong, and sales support operations in China, Japan, Korea, Switzerland, and Taiwan. These international operations expose us to various economic, political, and other risks that could adversely affect our operations and operating results, including the following:

- difficulties and costs of staffing and managing a multi-national organization,
- unexpected changes in regulatory requirements,
- differing labor regulations,
- potentially adverse tax consequences,
- tariffs and duties and other trade barrier restrictions,

possible employee turnover or labor unrest,

greater difficulty in collecting accounts receivable,

the burdens and costs of compliance with a variety of foreign laws,

potentially reduced protection for intellectual property rights, and

political or economic instability in certain parts of the world.

The risks associated with international operations could negatively affect our operating results.

Our business may suffer if international trade is hindered, disrupted, or economically disadvantaged.

Political and economic conditions abroad may adversely affect the foreign production and sale of our products. Protectionist trade legislation in either the United States or foreign countries, such as a change in the current tariff structures, export or import compliance laws, or other trade policies, could adversely affect our ability to sell user interface solutions in foreign markets and to obtain materials or equipment from foreign suppliers.

Changes in policies by the U.S. or foreign governments resulting in, among other things, higher taxation, currency conversion limitations, restrictions on the transfer of funds, or the expropriation of private enterprises also could have a material adverse effect on us. Any actions by countries in which we conduct business to reverse policies that encourage foreign investment or foreign trade also could adversely affect our operating results. In addition, U.S. trade policies, such as most favored nation status and trade preferences for certain Asian nations, could affect the attractiveness of our services to our U.S. customers and adversely impact our operating results.

Our operating results could be adversely affected by fluctuations in the value of the U.S. dollar against foreign currencies.

We transact business predominantly in U.S. dollars and bill and collect our sales in U.S. dollars. A weakening of the dollar could cause our overseas vendors to require renegotiation of either the prices or currency we pay for their goods and services. In the future, customers may negotiate pricing and make payments in non-U.S. currencies. For fiscal 2007, approximately 5% of our costs were denominated in non-U.S. currencies, including Hong Kong dollars, British pounds, Taiwan dollars, Japanese yen, Korean won, Chinese yuan, and Swiss francs.

If our overseas vendors or customers require us to transact business in non-U.S. currencies, fluctuations in foreign currency exchange rates could affect our cost of goods, operating expenses, and operating margins and could result in exchange losses. In addition, currency devaluation can result in a loss to us if we hold deposits of that currency. Hedging foreign currencies can be difficult, especially if the currency is not freely traded. We cannot predict the impact of future exchange rate fluctuations on our operating results. We currently do not hedge any foreign currencies, accordingly, we have no foreign currency hedge contracts outstanding as of the end of our fiscal year.

A majority of our contract manufacturers are located in China, Hong Kong, Singapore, Taiwan, and Thailand increasing the risk that a natural disaster, labor strike, war, or political unrest in those countries would disrupt our operations.

A majority of our contract manufacturers are located in China, Hong Kong, Singapore, Taiwan, and Thailand. Events out of our control, such as earthquakes, fires, floods, or other natural disasters, or political unrest, war, labor strikes, or work stoppages in these countries would disrupt their operations, which would impact our operations. The risk of earthquakes in Taiwan is significant because of its proximity to major earthquake fault lines. An earthquake, such as the one that occurred in Taiwan in September 1999, could cause significant delays in shipments of our product solutions until we are able to shift our outsourced operations. In addition, there is political tension between China and Taiwan that could lead to hostilities. If any of these events occur, we may not be able to obtain alternative capacity. Failure to secure alternative capacity could cause a delay in the shipment of our product solutions, which would cause our revenue to fluctuate or decline.

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Variability of customer requirements resulting in cancellations, reductions, or delays may adversely affect our operating results.

We must provide increasingly rapid product turnaround and respond to ever-shorter lead times. A variety of conditions, both specific to individual customers and generally affecting the demand for OEMs products, may cause customers to cancel, reduce, or delay orders. Cancellations, reductions, or delays by a significant customer or by a group of customers may adversely affect our revenue; and could require us to repurchase inventory from our contract manufacturers, which could adversely affect our costs. On occasion, customers require rapid increases in production, which can strain our resources and reduce our margins. Although we have been able to obtain increased production capacity from our third-party manufacturers, we may be unable to do so at any given time to meet our customers demands if their demands exceed anticipated levels.

Our operating results may experience significant fluctuations that could result in a decline in the price of our stock.

In addition to the variability resulting from the short-term nature of our customers commitments, other factors contribute to significant periodic and seasonal quarterly fluctuations in our results of operations. These factors include the following:

- the cyclicality of the markets we serve;
- the timing and size of orders;
- the volume of orders relative to our capacity;
- product introductions and market acceptance of new products or new generations of products;
- evolution in the life cycles of our customers products;
- timing of expenses in anticipation of future orders;
- changes in product mix, including the percentage of dual pointing and single pointing products shipped;
- availability of manufacturing and assembly services;
- changes in cost and availability of labor and components;
- the expanded use of high-cost third-party components in the products we sell;
- timely delivery of product solutions to customers;
- pricing and availability of competitive products;
- introduction of new technologies into the markets we serve;
- emergence of new competitors;
- pressures on reducing selling prices;
- the absolute and relative levels of corporate enterprise and consumer notebook purchases;
- our success in serving new markets, and

changes in economic conditions.

Accordingly, you should not rely on period-to-period comparisons as an indicator of our future performance. Negative or unanticipated fluctuations in our operating results may result in a decline in the price of our stock.

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If we fail to manage our growth effectively, our infrastructure, management, and resources could be strained, our ability to effectively manage our business could be diminished, and our operating results could suffer.

The failure to manage our growth effectively could strain our resources, which would impede our ability to increase revenue. We have increased the number of our user interface solutions and plan to expand further the number and diversity of our solutions and their use in the future. Our ability to manage our planned diversification and growth effectively will require us to

successfully hire, train, retain, and motivate additional employees, including employees outside the United States;

enhance our global operational, financial, and management systems; and

expand our production capacity.

In connection with the expansion and diversification of our product and customer base, we are increasing our personnel and making other expenditures to meet the increased demand we anticipate for our expanding product offerings, including offerings in the notebook computer and digital lifestyle markets. Increases in the demand for our products will require further expansion of our traditional notebook computer business as well as an increasing presence in the digital lifestyle product market, including portable digital music and video players and mobile phones. To date, our sales in the portable digital music and video player market has varied significantly from quarter to quarter and our mobile phone business is in its formative stage. Risks are further increased because customers do not commit to firm production schedules for more than a short time in advance. Any increase in expenses in anticipation of future orders that do not materialize would adversely affect our profitability. Our customers also may require rapid increases in design and production services that place an excessive short-term burden on our resources and the resources of our third-party manufacturers. If we cannot manage our growth effectively, our business and results of operations could suffer.

We depend on key personnel who would be difficult to replace, and our business will likely be harmed if we lose their services or cannot hire additional qualified personnel.

Our success depends substantially on the efforts and abilities of our senior management and other key personnel. The competition for qualified management and key personnel, especially engineers, is intense. Although we maintain noncompetition and nondisclosure covenants with most of our key personnel, we do not have employment agreements with most of them. The loss of services of one or more of our key employees or the inability to hire, train, and retain key personnel, especially engineers and technical support personnel, and capable sales and customer-support employees outside the United States, could delay the development and sale of our products, disrupt our business, and interfere with our ability to execute our business plan.

Our inability to protect our intellectual property could impair our competitive advantage, reduce our revenue, and increase our costs.

Our success and ability to compete depend in part on our ability to maintain the proprietary aspects of our technologies and products. We rely on a combination of patents, copyrights, trade secrets, trademarks, confidentiality agreements, and other contractual provisions to protect our intellectual property, but these measures may provide only limited protection. We license from third parties certain technology used in and for our products. These third-party licenses are granted with restrictions, and there can be no assurances that such third-party technology will remain available to us on terms beneficial to us. Our failure to enforce and protect our intellectual property rights or obtain from third parties the right to use necessary technology could have a material adverse effect on our business, financial condition, and results of operations. In addition, the laws of some foreign countries do not protect proprietary rights as fully as do the laws of the United States.

Patents may not issue from the patent applications that we have filed or may file in the future. Our issued patents may be challenged, invalidated, or circumvented, and claims of our patents may not be of sufficient scope or strength, or issued in the proper geographic regions, to provide meaningful protection or any commercial advantage. We have not applied for, and do not have, any copyright registration on our technologies or products. We have applied to register certain of our trademarks in the United States and other countries. There can be no assurance that we will obtain registrations of principle or other trademarks in key markets. Failure to obtain registrations could compromise our ability to protect fully our trademarks and brands and could increase the risk of challenge from third parties to our use of our trademarks and brands.

We do not consistently rely on written agreements with our customers, suppliers, manufacturers, and other recipients of our technologies and products, and therefore some trade secret protection may be lost and our ability to enforce our intellectual property rights may be limited. Additionally, our customers, suppliers, manufacturers, and other recipients of our technologies and products may seek to use our technologies and products without appropriate limitations. In the past, we did not consistently require our employees and consultants to enter into confidentiality agreements, employment agreements, or proprietary information and invention assignment agreements. Therefore, our former employees and consultants may try to claim some ownership interest in our technologies and products and may use our technologies and products competitively and without appropriate limitations.

We may be required to incur substantial expenses and divert management attention and resources in defending intellectual property litigation against us.

We may receive notices from third parties that claim our products infringe their rights. From time to time, we receive notice from third parties of the intellectual property rights such parties have obtained. We cannot be certain that our technologies and products do not and will not infringe issued patents or other proprietary rights of others. While we are not currently subject to any infringement claim, any future claim, with or without merit, could result in significant litigation costs and diversion of resources, including the attention of management, and could require us to enter into royalty and licensing agreements, any of which could have a material adverse effect on our business. There can be no assurance that such licenses could be obtained on commercially reasonable terms, if at all, or that the terms of any offered licenses would be acceptable to us. If forced to cease using such technology, there can be no assurance that we would be able to develop or obtain alternate technology. Accordingly, an adverse determination in a judicial or administrative proceeding or failure to obtain necessary licenses could prevent us from manufacturing, using, or selling certain of our products, which could have a material adverse effect on our business, financial condition, and results of operations.

Furthermore, parties making such claims could secure a judgment awarding substantial damages, as well as injunctive or other equitable relief that could effectively block our ability to make, use, or sell our products in the United States or abroad. Such a judgment could have a material adverse effect on our business, financial condition, and results of operations. In addition, we are obligated under certain agreements to indemnify the other party in connection with infringement by us of the proprietary rights of third parties. In the event we are required to indemnify parties under these agreements, it could have a material adverse effect on our business, financial condition, and results of operations.

We may incur substantial expenses and divert management resources in prosecuting others for their unauthorized use of our intellectual property rights.

The markets in which we compete are characterized by frequent litigation regarding patents and other intellectual property rights. Other companies, including our competitors, may develop technologies that are similar or superior to our technologies, duplicate our technologies, or design around our patents and may have or obtain patents or other proprietary rights that would prevent, limit, or interfere with our ability to make, use, or sell our products. Effective intellectual property protection may be unavailable or limited in some foreign countries in which we operate, such as China and Taiwan. Unauthorized parties may attempt to copy or otherwise use aspects of our technologies and products that we regard as proprietary. There can be no assurance that our means of protecting our proprietary rights in the United States or abroad will be adequate or that competitors will not independently develop similar technologies. If our intellectual property protection is insufficient to protect our intellectual property rights, we could face increased competition in the market for our technologies and products.

Should any of our competitors file patent applications or obtain patents that claim inventions also claimed by us, we may choose to participate in an interference proceeding to determine the right to a patent for these inventions because our business would be harmed if we fail to enforce and protect our intellectual property rights. Even if the outcome is favorable, this proceeding could result in substantial cost to us and disrupt our business.

In the future, we also may need to file lawsuits to enforce our intellectual property rights, to protect our trade secrets, or to determine the validity and scope of the proprietary rights of others. This litigation, whether

successful or unsuccessful, could result in substantial costs and diversion of resources, which could have a material adverse effect on our business, financial condition, and results of operations.

If we become subject to product returns and product liability claims resulting from defects in our products, we may fail to achieve market acceptance of our products and our business could be harmed.

We develop complex products in an evolving marketplace and generally warrant our products for a period of 12 months or more from the date of sale. Despite testing by us and our customers, defects may be found in existing or new products. In fiscal 2001, a manufacturing error of one of our contract manufacturers was discovered. Although the error was promptly discovered without significant interruption of supply and the contract manufacturer rectified the problem at its own cost, any such manufacturing errors or product defects could result in a delay in recognition or loss of revenue, loss of market share, or failure to achieve market acceptance. Additionally, these defects could result in financial or other damages to our customers; cause us to incur significant warranty, support, and repair costs; and divert the attention of our engineering personnel from our product development efforts. In such circumstances, our customers could also seek and obtain damages from us for their losses. A product liability claim brought against us, even if unsuccessful, would likely be time-consuming and costly to defend. The occurrence of these problems would likely harm our business.

Potential strategic alliances may not achieve their objectives, and the failure to do so could impede our growth.

We anticipate that we will enter into strategic alliances. Among other matters, we continually explore strategic alliances designed to enhance or complement our technology or to work in conjunction with our technology; to provide necessary know-how, components, or supplies; and to develop, introduce, and distribute products utilizing our technology. Any strategic alliances may not achieve their intended objectives, and parties to our strategic alliances may not perform as contemplated. The failure of these alliances may impede our ability to introduce new products and enter new markets.

Any acquisitions that we undertake could be difficult to integrate, disrupt our business, dilute stockholder value, and harm our operating results.

We expect to pursue opportunities to acquire other businesses and technologies in order to complement our current user interface solutions, expand the breadth of our markets, enhance our technical capabilities, or otherwise offer growth opportunities. While we have no current definitive agreements underway, we may acquire businesses, products, or technologies in the future. If we make any future acquisitions, we could issue stock that would dilute existing stockholders percentage ownership, incur substantial debt, assume contingent liabilities, or experience higher operating expenses. Our experience in acquiring other businesses and technologies is limited. Potential acquisitions also involve numerous risks, including the following:

- problems assimilating the purchased operations, technologies, or products;
- unanticipated costs associated with the acquisition;
- diversion of management s attention from our core businesses;
- adverse effects on existing business relationships with suppliers and customers;
- risks associated with entering markets in which we have little or no prior experience; and
- potential loss of key employees of purchased organizations.

We cannot assure you that we would be successful in overcoming problems encountered in connection with any acquisitions, and our inability to do so could disrupt our operations and adversely affect our business.

The PC and electronics industries are cyclical and may result in fluctuations in our operating results.

The PC and electronics industries have experienced significant economic downturns at various times. These downturns are characterized by diminished product demand, accelerated erosion of average selling prices, and

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production overcapacity. In addition, the PC and electronics industries are cyclical in nature. We seek to reduce our exposure to industry downturns and cyclicality by providing design and production services for leading companies in rapidly expanding industry segments. We may, however, experience substantial period-to-period fluctuations in future operating results because of general industry conditions or events occurring in the general economy.

The valuation of our technology conducted in connection with our international operating structure may be challenged, which could result in additional taxes, interest, and penalties.

In fiscal 2005, we implemented an international operating structure. Under this structure, generally, one of our affiliates licensed from us certain rights to the pre-existing and in-process technology associated with our products for exploitation in all geographic markets except the U.S., Japanese, and Korean markets, which we refer to as ROW markets. Our affiliate also acquired ownership of all future economic rights to product sales in ROW markets by entering into an agreement to license certain intangibles and a cost-sharing agreement under which we and our affiliate will share research and development costs in accordance with certain tax rules and regulations. We believe this structure appropriately reflects where our profits are generated and may result in future tax advantages to us, but there can be no assurances that this will be the case.

We expect to incur additional expenses in complying with corporate governance and public disclosure requirements.

Changing laws, regulations, and standards relating to corporate governance and public disclosure, including the Sarbanes-Oxley Act of 2002, new SEC regulations, and Nasdaq Global Select Market rules, are creating uncertainty and increased expenses for companies such as ours. These new or changed laws, regulations, and standards are subject to varying interpretations in many cases due to their lack of specificity and, as a result, their application in practice may evolve over time as new guidance is provided by regulatory and governing bodies, which could result in continuing uncertainty regarding compliance matters and higher costs necessitated by ongoing revisions to disclosure and governance practices. We are committed to maintaining high standards of corporate governance and public disclosure. As a result, our efforts to comply with evolving laws, regulations, and standards have resulted in, and are likely to continue to result in, increased general and administrative expenses and a diversion of management time and attention from revenue-generating activities to compliance activities. In particular, our efforts to comply with Section 404 of the Sarbanes-Oxley Act of 2002 and the related regulations regarding our required assessment of our internal control over financial reporting and our external auditors audit of our internal controls over financial reporting has required the commitment of significant financial and managerial resources. We expect these efforts to require the continued commitment of significant resources. In addition, it has become more difficult and more expensive for us to obtain director and officer liability insurance. As a result, we may have difficulty attracting and retaining qualified board members, which could harm our business. If our efforts to comply with new or changed laws, regulations, and standards differ from the activities intended by regulatory or governing bodies due to ambiguities related to practice, our reputation may be harmed.

The accounting requirements for income taxes on certain of our share-based awards will subject our future quarterly and annual effective tax rates to greater volatility and, consequently, our ability to estimate reasonably our future quarterly and annual effective tax rates is greatly diminished.

In accordance with Statement of Financial Accounting Standards (SFAS) No. 123R, Share-Based Payment (SFAS 123R), we recognize tax benefit upon expensing certain share-based awards associated with our share-based compensation plans, including nonqualified stock options and deferred stock unit awards, but under current accounting standards we cannot recognize tax benefit currently for those share-based compensation expenses associated with incentive stock options and employee stock purchase plan shares (qualified stock options). For qualified stock options that vested after our adoption of SFAS 123R, we recognize tax benefit only in the period when disqualifying dispositions of the underlying stock occur and, for qualified stock options that vested prior to our adoption of SFAS 123R, the tax benefit is recorded directly to additional paid-in capital. Accordingly, because we cannot recognize the tax benefit for share-based compensation expense associated with qualified stock options until the occurrence of future disqualifying dispositions of the underlying stock and such disqualified dispositions may happen in periods when our stock price substantially increases, and because a portion of that tax benefit may be directly recorded to additional paid-in capital, our future quarterly and annual effective tax rates will be subject to greater volatility and, consequently, our ability to estimate reasonably our future quarterly and annual effective tax rates is greatly diminished.

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Future changes in financial accounting standards or practices may cause adverse unexpected fluctuations and affect our reported results of operations.

A change in accounting standards or practices could have a significant effect on our reported results of operations. New accounting pronouncements and varying interpretations of accounting pronouncements have occurred in the past and may occur in the future. Changes to existing rules or the questioning of current practices may adversely affect our reported financial results or the way we conduct our business. For example, the Financial Accounting Standards Board issued SFAS 123R requiring us to recognize all share-based payments to employees, including grants of stock options, in the financial statements based on their grant date fair value eliminating the pro forma footnote disclosures that were allowed as an alternative to financial statement recognition. This requirement, while not affecting our cash flow, adversely affected our reported financial results and impaired our ability to provide guidance on our future reported financial results as a result of the variability of the factors used to establish the grant date fair value of stock options and the accounting for income taxes thereon.

We increased our leverage as a result of the sale of our 0.75% convertible senior subordinated notes.

As a result of the sale of our 0.75% convertible senior subordinated notes in fiscal 2005, we incurred $125 million of indebtedness. As a result of this indebtedness, our interest payment obligations have increased. Our interest payment obligations on the notes is approximately $938,000 annually. The degree to which we are now leveraged could have adverse consequences, including the following:

- a limitation on our ability to obtain future financing for working capital, acquisitions, or other purposes;
- an increase in our vulnerability to industry downturns and competitive pressures; and
- a possible competitive disadvantage with less leveraged competitors and competitors that may have better access to capital resources.

Our ability to meet our debt service obligations will depend upon our future performance, which will be subject to the financial, business, and other factors affecting our operations, many of which are beyond our control.

We made an irrevocable election to cash settle the $125 million principal amount of our convertible senior subordinated notes in April 2007. If we do not have sufficient cash resources when settlement occurs we may be in breach of our obligation or we may be required to borrow cash to meet our obligation.

We made an irrevocable election to cash settle the $125 million principal amount of our convertible senior subordinated notes in April 2007. If we do not have sufficient cash resources when settlement occurs, we may be in breach of our obligation or we may be required to borrow cash to meet our obligation, which may not be available on favorable terms or at all.

A substantial portion of our short-term investment portfolio is invested in auction rate securities and if an auction fails for amounts we have invested, our investment will not be liquid. If the issuer is unable to successfully close future auctions and their credit rating deteriorates, we may be required to adjust the carrying value of our investment through an impairment charge.

A substantial portion of our investment portfolio is invested in auction rate securities and if an auction fails for amounts we have invested, our investment will not be liquid. In the event we need to access these funds, we will not be able to until a future auction on these investments is successful. If the issuer is unable to successfully close future auctions and their credit rating deteriorates, we may be required to adjust the carrying value of the investment through an impairment charge.

Legislation affecting the markets in which we compete could adversely affect our ability to implement our growth strategies.

Our ability to expand our business may be adversely impacted by future laws or regulations. Our customers products may be subject to laws relating to environmental regulations, communications, encryption technology, electronic commerce, e-signatures, and privacy. Any of these laws could be expensive to comply with, and the marketability of our products could be adversely affected.

We must finance the growth of our business and the development of new products, which could have an adverse effect on our operating results.

To remain competitive, we must continue to make significant investments in research and development, marketing, and business development. Our failure to increase sufficiently our net revenue to offset these increased costs would adversely affect our operating results.

From time to time, we may seek additional equity or debt financing to provide for funds required to expand our business. We cannot predict the timing or amount of any such requirements at this time. If such financing is not available on satisfactory terms, we may be unable to expand our business or to develop new business at the rate desired and our operating results may suffer. Debt financing increases expenses and must be repaid regardless of operating results. Equity financing could result in additional dilution to existing stockholders.

Continuing uncertainty of the U.S. and global economy may have serious implications for the growth and stability of our business and may negatively affect our stock price.

The revenue growth and profitability of our business depends significantly on the overall demand in the notebook computer market and in the markets for digital lifestyle products and other electronic devices. Softening demand in these markets caused by ongoing economic uncertainty may result in decreased revenue or earnings levels or growth rates. The U.S. and global economy has been historically cyclical, and market conditions continue to be challenging, which has resulted in individuals and companies delaying or reducing expenditures. Further delays or reductions in spending could have a material adverse effect on demand for our products, and consequently on our business, financial condition, results of operations, prospects, and stock price.

The market price of our common stock has been and may continue to be volatile.

The trading price of our common stock has been and may continue to be subject to wide fluctuations in response to various factors, including the following:

- variations in our quarterly results;
- the financial guidance we may provide to the public, any changes in such guidance, or our failure to meet such guidance;
- changes in financial estimates by industry or securities analysts or our failure to meet such estimates;
- various market factors or perceived market factors, including rumors, whether or not correct, involving us, our customers, our suppliers, or our competitors;
- announcements of technological innovations by us or by our competitors;
- introductions of new products or new pricing policies by us or by our competitors;
- acquisitions or strategic alliances by us or by our competitors;
- recruitment or departure of key personnel;
- the gain or loss of significant orders;
- the gain or loss of significant customers;
- market conditions in our industry, the industries of our customers, and the economy as a whole;
- hedging activities by investors holding positions in our convertible senior subordinated notes; and

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general financial market conditions or occurrences.

In addition, stocks of technology companies have experienced extreme price and volume fluctuations that often have been unrelated or disproportionate to these companies operating performance. Public announcements by technology companies concerning, among other things, their performance, accounting practices, or legal problems could cause the market price of our common stock to decline regardless of our actual operating performance.

Our charter documents and Delaware law could make it more difficult for a third party to acquire us, and discourage a takeover.

Our certificate of incorporation and the Delaware General Corporation Law contain provisions that may have the effect of making more difficult or delaying attempts by others to obtain control of our company, even when these attempts may be in the best interests of our stockholders. Our certificate of incorporation also authorizes our board of directors, without stockholder approval, to issue one or more series of preferred stock, which could have voting and conversion rights that adversely affect or dilute the voting power of the holders of common stock. Delaware law also imposes conditions on certain business combination transactions with interested stockholders. Our certificate of incorporation divides our Board of Directors into three classes, with one class to stand for election each year for a three-year term after the initial election. The classification of directors tends to discourage a third party from initiating a proxy solicitation or otherwise attempting to obtain control of our company and may maintain the incumbency of our Board of Directors, as this structure generally increases the difficulty of, or may delay, replacing a majority of directors. Our certificate of incorporation authorizes our Board of Directors to fill vacancies or newly created directorships. A majority of the directors then in office may elect a successor to fill any vacancies or newly created directorships.

Our stockholders rights plan may adversely affect existing stockholders.

Our stockholders rights plan may have the effect of deterring, delaying, or preventing a change in control that might otherwise be in the best interests of our stockholders. In general, stock purchase rights issued under the rights plan become exercisable when a person or group acquires 15% or more of our common stock or a tender offer or exchange offer of 15% or more of our common stock is announced or commenced. After any such event, our other stockholders may purchase additional shares of our common stock at 50% of the then-current market price. The rights will cause substantial dilution to a person or group that attempts to acquire us on terms not approved by our board of directors. The rights should not interfere with any merger or other business combination approved by our board of directors as the rights may be redeemed by us at $0.01 per stock purchase right at any time before any person or group acquires 15% or more of our outstanding common stock. The rights expire in August 2012.

Sales of large numbers of shares could adversely affect the price of our common stock.

All of the 26,238,166 shares of our common stock outstanding as of August 1, 2007 are eligible for resale in the public markets. Of these shares, 1,343,639 shares held by affiliates are eligible for resale in the public markets subject to compliance with the volume and manner of sale rules of Rule 144 or 701 under the Securities Act of 1933, as amended, and the balance of the shares are eligible for resale in the public markets either as unrestricted shares or pursuant to Rule 144(k). In general, under Rule 144 as currently in effect, any person (or persons whose shares are aggregated for purposes of Rule 144) who beneficially owns restricted securities with respect to which at least one year has elapsed since the later of the date the shares were acquired from us, or from an affiliate of ours, is entitled to sell within any three-month period a number of shares that does not exceed the greater of 1% of the then outstanding shares of our common stock and the average weekly trading volume in common stock during the four calendar weeks preceding such sale. Sales under Rule 144 also are subject to certain manner-of-sale provisions and notice requirements and to the availability of current public information about us.

Rule 701, as currently in effect, permits our employees, officers, directors, and consultants who purchase shares pursuant to a written compensatory plan or contract to resell these shares in reliance upon Rule 144, but without compliance with specific restrictions. Rule 701 provides that affiliates may sell their Rule 701 shares under Rule 144 without complying with the holding period requirement and that non-affiliates may sell their shares in reliance on Rule 144 without complying with the holding period, public information, volume limitation, or notice provisions of Rule 144. A person who is not an affiliate, who has not been an affiliate within three months prior to sale, and who beneficially owns restricted securities with respect to which at least two years have elapsed since the later of the date the shares were acquired from us, or from an affiliate of ours, is entitled to sell such shares under

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Rule 144(k) without regard to any of the volume limitations or other requirements described above. Sales of substantial amounts of common stock in the public market could adversely affect prevailing market prices.

We have registered an aggregate of $100 million of common stock and preferred stock for issuance in connection with acquisitions, which shares generally will be freely tradeable after their issuance under Rule 145 of the Securities Act, unless held by an affiliate of the acquired company, in which case such shares will be subject to the volume and manner of sale restrictions of Rule 144 discussed above. The issuance or subsequent sale of these shares in the public market could adversely affect prevailing market prices.

We have registered an aggregate of $125 million of our 0.75% Convertible Senior Subordinated Notes due 2024 and the common stock issuable upon conversion of the notes. The shares issued upon conversion generally will be freely tradeable after their issuance, unless held by an affiliate, in which case such shares will be subject to the volume and manner of sale restrictions of Rule 144 discussed above. The issuance or subsequent sale of these shares in the public market could negatively affect the market price of our common stock.

We have registered for offer and sale the shares of common stock that are reserved for issuance pursuant to our outstanding share-based compensation plans. Shares issued after the effective date of such registration statements in connection with our share-based compensation plans generally will be eligible for sale in the public market, except that affiliates will continue to be subject to volume limitations and other requirements of Rule 144. The issuance or subsequent sale of such shares could depress the market price of our common stock.

ITEM 1B. UNRESOLVED STAFF COMMENTS

Not applicable.

ITEM 2. PROPERTIES

Our principal executive offices as well as our principal research, development, sales, marketing, and administrative functions are located in our 70,000 square foot facility in Santa Clara, California. We believe this facility will be adequate to meet our needs for the foreseeable future. Our Asia/Pacific headquarters are located in Hong Kong where we lease approximately 13,300 square feet. We also maintain approximately 10,000 square feet of office space in Taiwan, approximately 4,600 square feet of office space in China, approximately 2,500 square feet of office space in Korea, and less than 1,000 square feet of office space in both Japan and Switzerland. We have satellite sales support offices in Thailand and Texas.

ITEM 3. LEGAL PROCEEDINGS

In March 2006, Elantech Devices Corporation (Elantech) filed a Complaint for Patent Infringement against us claiming that we infringed one of its patents and seeking damages, attorneys fees, and a permanent injunction against us infringing or inducing others to infringe the patent. In April 2006, we filed our Answer to the Complaint and Counterclaims against Elantech claiming that Elantech has infringed and induced infringement of four of our patents and seeking damages, attorneys fees, and a permanent injunction against infringing or inducing others to infringe.

Elantech responded to our counterclaim denying liability and counterclaimed seeking an injunction and damages for alleged violations of California law. We subsequently filed a motion to dismiss the Elantech counterclaims that was granted in July 2006 with leave to amend the counterclaims after the adjudication of the patent infringement claims. We intend to vigorously defend our patents and pursue our counterclaims. We have not recorded any liability associated with Elantech s claims and have expensed as incurred all legal fees associated with the legal proceedings.

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

Not applicable.

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PART II

ITEM 5. MARKET FOR THE REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Market Information on Common Stock

Our common stock has been listed on the Nasdaq Global Select Market (formerly on the Nasdaq National Market) under the symbol SYNA since January 29, 2002. Prior to that time, there was no public market for our common stock. The following table sets forth for the periods indicated the high and low sales prices of our common stock as quoted on the Nasdaq Global Select Market.

	High	Low
Year ended June 30, 2006:		
First quarter	$21.78	$15.05
Second quarter	$26.97	$17.94
Third quarter	$30.84	$22.35
Fourth quarter	$26.85	$19.87
Year ended June 30, 2007:		
First quarter	$25.87	$18.57
Second quarter	$30.20	$22.34
Third quarter	$32.09	$22.75
Fourth quarter	$36.26	$24.72

On August 1, 2007, the closing sales price of our common stock on the Nasdaq Global Select Market was $35.45 per share.

Stockholders

As of August 1, 2007, there were approximately 250 holders of record of our common stock.

Dividends

We have never declared or paid cash dividends on our preferred stock or our common stock. We currently plan to retain any earnings to finance the growth of our business rather than to pay cash dividends. Payments of any cash dividends in the future will depend on our financial condition, results of operations, and capital requirements as well as other factors deemed relevant by our board of directors.

Our revolving line of credit also places restrictions on the payment of any dividends.

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Share-Based Compensation Plan Information

The following table sets forth information, as of June 30, 2007, with respect to our common stock that may be issued from both stockholder approved and unapproved plans upon delivery of shares for deferred stock units, exercise of outstanding stock options, the weighted average exercise price of outstanding stock options, and the number of securities available for future issuance under our various share-based compensation plans.

Plan Category	(a) Number of Securities to be Issued Upon Delivery of Shares for Deferred Stock Units	(b) Number of Securities to be Issued Upon Exercise of Outstanding Options	(c) Weighted-Average Exercise Price of Outstanding Options	(d) Number of Securities Remaining Available for Future Issuance Under Share-Based Compensation Plans [Excluding Securities Reflected in Columns (a) and (b)]
Share-Based Compensation Plans Approved by Stockholders	257,225	4,620,115	$ 19.25	2,842,110
Share-Based Compensation Plans Not Approved By Stockholders (1)		20,000	$ 3.50	37,584
Total	257,225	4,640,115	$ 19.18	2,879,694

(1) Represents options granted under our 2000 nonstatutory stock option plan. The plan was adopted by our board of directors in September 2000 and provides for the grant of options to purchase up to 200,000 shares of our common stock. Unless

terminated earlier by our board of directors, the plan will terminate in September 2010. The exercise price of options granted under the plan is the fair market value of our common stock on the date of grant. Generally, the shares subject to options granted under the plan vest 25% on the first anniversary of the option grant date and 1/48th in each month thereafter. The exercise price for any options granted under the plan may be paid in cash, in shares of our common stock valued at fair market value on the exercise date, or in any other form of legal consideration that may be acceptable to the board of directors or administrator in their discretion, including through a same-day sale program without any cash outlay by the optionee. The term of options granted under the plan may not exceed 10 years. Outstanding awards and the number of shares remaining available for issuance under the plan will be adjusted in the event of a stock split, stock dividend, or other similar change in our capital stock.

Issuer Purchases of Equity Securities

In April 2007, our board of directors authorized an expansion of our stock repurchase program for up to an additional $80 million of our common stock, raising the aggregate authorization under the stock repurchase program from $80 million to $160 million. The number of shares purchased and the timing of purchases is based on the level of our cash balances, general business and market conditions, and other factors, including alternative investment opportunities. Common stock repurchased under this program is held as treasury stock and through June 30, 2007 purchases under this program totaled 3,588,100 shares for an aggregate cost of $72.3 million or an average cost of $20.16 per share. As of June 30, 2007, we have $87.7 million remaining under our stock repurchase program, of which $7.7 million expires in October 2007 and $80.0 million expires April 2009.

Subsequent to June 30, 2007 and through August 28, 2007, we repurchased 500,000 shares of our common stock at an aggregate cost of approximately $19.0 million, or an average cost of $37.90 per share.

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Performance Graph

The following line graph compares cumulative total stockholder returns for the five years ended June 30, 2007 for (i) our common stock; (ii) the Nasdaq Composite Index; and (iii) the Nasdaq Computer Index. The graph assumes an investment of $100 on June 30, 2002. The calculations of cumulative stockholder return on the Nasdaq Composite Index and the Nasdaq Computer Index include reinvestment of dividends. The calculation of cumulative stockholder return on our common stock does not include reinvestment of dividends because we did not pay any dividends during the measurement period. The historical performance shown is not necessarily indicative of future performance

COMPARISON OF 60 MONTH CUMULATIVE TOTAL RETURN

Among Synaptics Incorporated, The Nasdaq Composite Index,
and The Nasdaq Computer Index

The performance graph above shall not be deemed filed for purposes of Section 18 of the Securities Act of 1934, as amended (the Exchange Act), or otherwise subject to the liability of that section. The performance graph above will not be deemed incorporated by reference into any filing of our company under the Exchange Act or the Securities Act of 1933, as amended.

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ITEM 6. SELECTED FINANCIAL DATA

The following table presents selected financial data for each fiscal year in the five year period ended June 30, 2007. As our past operating results are not necessarily indicative of our future operating results the selected financial data below should be read in conjunction with Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations and our consolidated financial statements and related notes contained elsewhere in this report.

	Years ended June 30,				
	2003	2004	2005	2006	2007
	(in thousands, except for per share data)				
Consolidated Statements of Income Data:					
Net revenue	$ 100,701	$ 133,276	$ 208,139	$ 184,557	$ 266,787
Cost of revenue(1)	58,417	77,244	112,090	101,704	160,913
Gross margin	42,284	56,032	96,049	82,853	105,874
Operating expenses:					
Research and development(1)	19,837	21,419	24,991	35,356	39,386
Selling, general, and administrative(1)	10,733	13,571	18,423	28,019	36,247
Other operating expense (income)			(3,800)		
Amortization of deferred stock compensation(2)	516	517	328		
Amortization of goodwill and other acquired intangible assets	40				
Restructuring		432			915
Total operating expenses	31,126	35,939	39,942	63,375	76,548
Operating income	11,158	20,093	56,107	19,478	29,326
Interest income, net	904	833	2,225	6,045	9,105
Income before provision for income taxes	12,062	20,926	58,332	25,523	38,431
Provision for income taxes	4,344	7,934	20,347	11,822	11,897
Net income	$ 7,718	$ 12,992	$ 37,985	$ 13,701	$ 26,534
Net income per share:					
Basic	$ 0.33	$ 0.53	$ 1.48	$ 0.55	$ 1.04
Diluted	$ 0.31	$ 0.48	$ 1.30	$ 0.51	$ 0.94
Shares used in computing net income per share:					
Basic	23,473	24,418	25,736	24,708	25,558
Diluted	25,132	27,108	29,761	29,075	29,064

(1) Amounts exclude amortization of deferred stock compensation as follows:

Cost of revenue	$ 28	$ 20	$ 12	$	$
Research and development	159	91	8		
Selling, general, and administrative	329	406	308		
Amortization of deferred stock compensation	$ 516	$ 517	$ 328	$	$

(2) Beginning with fiscal 2006, we adopted SFAS 123R and as a result ceased amortizing deferred stock compensation. Accordingly, no amortization of deferred stock compensation was recorded for the years ended June 30, 2006 and 2007.

			June 30,		
	2003	**2004**	**2005**	**2006**	**2007**
			(in thousands)		
Consolidated Balance Sheet Data:					
Cash, cash equivalents, and short-term investments	$ 77,286	$ 96,299	$ 228,921	$ 245,176	$ 265,017
Working capital	83,815	106,624	235,240	257,788	299,921
Total assets	104,508	132,653	311,205	331,421	373,312
Long-term debt, capital leases, and equipment financing obligations, less current portion	1,528	1,500	126,500	126,500	125,000
Total stockholders equity	86,264	109,140	144,660	167,042	208,087

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Basic net income per share amounts for each period presented have been computed using the weighted average number of shares of common stock outstanding. As a result of our irrevocable election in April 2007 to cash settle the principal amount of our convertible notes, no shares of common stock will be issued to settle the principal and cash or common stock may be used to settle the value in excess of the principal. Our election to cash settle the principal of the convertible notes upon conversion resulted in our using the if converted method through the date of the election and the treasury stock method subsequent to the date of the election for purposes of calculating diluted net income per share. Accordingly, diluted net income per share amounts for each period presented have been computed (1) using the weighted average number of potentially dilutive shares issuable in connection with stock options and restricted stock units under the treasury stock method, (2) through April 2007 using the weighted average number of shares issuable in connection with convertible debt under the if-converted method, and (3) from April 2007 using the weighted average number of potentially dilutive shares issuable in connection with our convertible debt under the treasury stock method,when dilutive.

In fiscal 2001, we recorded amortization of goodwill and other intangible assets of $784,000 in connection with the acquisition of Absolute Sensors Limited, or ASL, a United Kingdom company, and the acquisition of the employees of a former Taiwanese sales agent. As a result of the adoption of Statement of Financial Accounting Standard No. 142, Goodwill and Other Intangible Assets in fiscal 2002, we ceased amortizing goodwill. Accordingly, we recorded amortization of other intangible assets of $40,000 in fiscal 2003 associated with the ASL acquisition and the acquisition of the employees of a former Taiwanese sales agent. These assets were fully amortized in fiscal 2003.

ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Forward-Looking Statements and Factors That May Affect Results

You should read the following discussion and analysis in conjunction with our financial statements and related notes contained elsewhere in this report. This discussion contains forward-looking statements that involve risks, uncertainties, and assumptions. Our actual results may differ materially from those anticipated in these forward-looking statements as a result of a variety of factors, including those set forth under Item 1A. Risk Factors.

Overview

We are a leading worldwide developer and supplier of custom-designed user interface solutions that enable people to interact more easily and intuitively with a wide variety of mobile computing, communications, entertainment, and other electronic devices. Through our proprietary TouchPad, we are the world s leading supplier of user interface solutions to the notebook computer market. With our TouchStyk, we offer OEMs the choice of a touch pad, a pointing stick, or a combination of both of our proprietary user interface solutions for dual pointing applications. We believe our market share results from the combination of our customer focus, the strength of our intellectual property, and our engineering know-how, which allow us to design products that meet the demanding design specifications of OEMs.

We recognize revenue from product sales when there is persuasive evidence that an arrangement exists, delivery has occurred or title has transferred, the price is fixed or determinable, and collectibility is reasonably assured. Our net revenue increased from $100.7 million in fiscal 2003 to $266.8 million in fiscal 2007, representing a compound annual growth rate of approximately 28%. In fiscal 2003, we derived 93% of our net revenue from the personal computer market. In fiscal 2007, revenue from the personal computer market accounted for 85% of our net revenue.

In June 2003, we acquired NSM Technology Limited, or NSM, a Hong Kong company. The acquisition of NSM provided us with a highly skilled and experienced work force to expand our global presence and infrastructure to support customers in the Asia/Pacific region. Many of our customers have migrated their manufacturing operations from Taiwan to China, and many of our OEM customers have established design centers in that region. With our expanded global presence, including offices in China, Hong Kong, Japan, Korea, Switzerland, Taiwan, and the United States, we are better positioned to provide local sales, operations, and engineering support services to our existing customers, as well as potential new customers, on a global basis.

Our manufacturing operations are based on a variable cost model in which we outsource all of our production requirements and primarily drop ship our products directly to our customers from our contract manufacturers facilities, eliminating the need for significant capital expenditures and allowing us to minimize our investment in inventories. This approach requires us to work closely with our contract manufacturers to ensure adequate production capacity to meet our forecasted volume requirements. We provide our contract manufacturers with six-month rolling forecasts and issue purchase orders based on our anticipated requirements for the next 90 days. However, we do not have any long-term supply contracts with any of our contract manufacturers. Currently, we use two third-party wafer manufacturers to supply wafers and two third-party packaging manufacturers to package our proprietary ASICs, and in certain cases, we rely on a single source or a limited number of suppliers to provide other key components of our products. Our cost of revenue includes all costs associated with the production of our products, including materials, manufacturing, assembly and test costs paid to third-party manufacturers, and related overhead costs associated with our indirect manufacturing operations personnel. Additionally, all warranty costs, yield losses, and any inventory provisions or write-downs are charged to cost of revenue.

Our gross margin generally reflects the combination of the added value we bring to our customers products in meeting their custom design requirements and the impact of our ongoing cost-improvement programs. These cost-improvement programs include reducing materials and component costs and implementing design and process improvements. Our newly introduced products may have lower margins than our more mature products, which have realized greater benefits associated with our ongoing cost-improvement programs. As a result, new product introductions may initially negatively impact our gross margin.

Our research and development expenses include costs for supplies and materials related to product development, as well as the engineering costs incurred to design user interface solutions for customers prior to and after the customers commitment to incorporate those solutions into their products. These expenses have generally increased, reflecting our continuing commitment to the technological and design innovation required to maintain a leadership position in our existing markets and to adapt our existing technologies or develop new technologies for new markets.

Selling, general, and administrative expenses include expenses related to sales, marketing, and administrative personnel; internal sales and outside sales representatives commissions; market and usability research; outside legal, accounting, and consulting costs; and other marketing and sales activities. These expenses have generally increased, primarily reflecting incremental staffing and related support costs associated with our increased business levels, anticipated growth in our existing markets, and penetration into new markets.

In connection with the grant of stock options to our employees and consultants, we have recorded deferred stock compensation, representing the difference between the deemed fair value of our common stock for financial reporting purposes and the exercise price of these options at the dates of grant. Deferred stock compensation is presented as a reduction of stockholders equity and is amortized on a straight-line basis over the applicable vesting period. Options granted are typically subject to a four-year vesting period. We amortized the deferred stock compensation over the vesting periods of the applicable options and recorded non-cash expense associated with deferred stock compensation of approximately $328,000 in fiscal 2005. Upon the adoption of Statement of Financial Accounting Standards No. 123R, Share-Based Payment (FAS 123R) in fiscal 2006, we ceased amortizing deferred stock compensation, as FAS 123R required us to expense share-based compensation costs based on grant date fair value. The adoption of FAS 123R resulted in a $13.2 million and $14.3 million non-cash charge to our operating income in fiscal 2006 and 2007, respectively.

Critical Accounting Policies and Estimates

The preparation of consolidated financial statements in conformity with U.S. generally accepted accounting principles requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue, expenses, and related disclosure of contingent assets and liabilities. On an ongoing basis, we evaluate our estimates, including those related to revenue recognition, allowance for doubtful accounts, cost of revenue, inventories, product warranty, provision for income taxes, income taxes payable, intangible assets, and contingencies. We base our estimates on historical experience, applicable laws, and various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

The methods, estimates, interpretations, and judgments we use in applying our most critical accounting policies can have a significant impact on the results that we report in our consolidated financial statements. The Securities and Exchange Commission considers an entity s most critical accounting policies to be those policies that are both most important to the portrayal of the entity s financial condition and results of operations and those that require management s most difficult, subjective, or complex judgments, often as a result of the need to make estimates about matters that are inherently uncertain when estimated. We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our consolidated financial statements.

Revenue Recognition

We recognize revenue from product sales when there is persuasive evidence that an arrangement exists, delivery has occurred or title has transferred, the price is fixed or determinable, and collectibility is reasonably assured. We accrue for estimated sales returns and other allowances, based on historical experience, at the time we recognize revenue, which is typically upon shipment. We record contract revenue for research and development as the services are provided under the terms of the contract. We recognize non-refundable contract fees for which no further performance obligations exist and for which there is no continuing involvement by us on the earlier of when the payments are received or when collection is assured.

Inventory

We state our inventories at the lower of cost or market. We base our assessment of the ultimate realization of inventories on our projections of future demand and market conditions. Sudden declines in demand, rapid product improvements, or technological changes, or any combination of these factors can cause us to have excess or obsolete inventories. On an ongoing basis, we review for estimated obsolete or unmarketable inventories and write down our inventories to their net realizable value based upon our forecasts of future demand and market conditions. If actual market conditions are less favorable than our forecasts, additional inventory reserves may be required. The following factors influence our estimates: changes to or cancellations of customer orders, unexpected decline in demand, rapid product improvements and technological advances, and termination or changes by our OEM customers of any product offerings incorporating our product solutions.

Periodically, we purchase inventory from our contract manufacturers when a customer s delivery schedule is delayed or a customer s order is cancelled. In those circumstances in which our customer has cancelled its order and we purchase inventory from our contract manufacturers, we consider a write-down to reduce the carrying value of the inventory purchased to its net realizable value. We charge write-downs to reduce the carrying value of obsolete, slow moving, and non-usable inventory to net realizable value to cost of revenue.

Share-Based Compensation Costs

We account for employee share-based compensation costs in accordance with Statement of Financial Accounting Standards (SFAS) No. 123R, Share-Based Payment (SFAS 123R) and apply the provisions of Staff Accounting Bulletin No. 107, Share-Based Payment (SAB 107). We utilize the Black-Scholes option pricing model to estimate the grant date fair value of employee share-based compensatory awards, which requires the input of highly subjective assumptions, including expected volatility and expected life. Historical and implied volatility were used in estimating the fair value of our share-based awards, while the expected life for our options was estimated to be five years based on historical trends since our initial public offering. Changes in these inputs and assumptions can materially affect the measure of estimated fair value of our share-based compensation. Further, as required under SFAS 123R, we now estimate forfeitures for share-based awards that are not expected to vest. We charge the estimated fair value less estimated forfeitures to earnings on a straight-line basis over the vesting period of the underlying awards, which is generally four years for our stock option and deferred stock unit awards and up to two years for our employee stock purchase plan.

The Black-Scholes option pricing model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. As our stock option and employee stock purchase plan awards have characteristics that differ significantly from traded options, and as changes in the subjective assumptions can materially affect the estimated value, our estimate of fair value may not accurately represent the value assigned by a third party in an arms-length transaction. There currently is no market-based mechanism to verify the reliability and accuracy of the estimates derived from the Black-Scholes option pricing model or other

allowable valuation models, nor is there a means to compare and adjust the estimates to actual values. While our estimate of fair value and the associated charge to earnings materially affects our results of operations, it has no impact on our cash position.

The guidance in SFAS 123R and SAB 107 is relatively new, and the application of these principles may be subject to further interpretation and guidance. There are significant variations among allowable valuation models, and there is a possibility that we may adopt a different valuation model or refine the inputs and assumptions under our current valuation model in the future, resulting in a lack of consistency in future periods. Our current or future valuation model and the inputs and assumptions we make may also lack comparability to other companies that use different models, inputs, or assumptions, and the resulting differences in comparability could be material.

Income Taxes

We recognize federal, foreign, and state current tax liabilities or assets based on our estimate of taxes payable or refundable in the then current fiscal year for each tax jurisdiction. We also recognize federal, foreign, and state deferred tax liabilities or assets for our estimate of future tax effects attributable to temporary differences and carryforwards and record a valuation allowance to reduce any deferred tax assets by the amount of any tax benefits that, based on available evidence and our judgment, are not expected to be realized. If our assumptions, and consequently our estimates, change in the future, the valuation allowance we have established for our deferred tax assets may be changed, which could impact income tax expense.

We account for income tax contingencies in accordance with SFAS No. 5, Accounting for Contingencies. The calculation of tax liabilities involves significant judgment in estimating the impact of uncertainties in the application of complex tax laws. Resolution of these uncertainties in a manner inconsistent with our expectations could have a material impact on our results of operations and financial condition. We believe we have adequately provided for reasonably foreseeable outcomes in connection with the resolution of income tax contingencies. However, our results have in the past, and could in the future, include favorable and unfavorable adjustments to our estimated tax liabilities in the period we evaluate an income tax position, settle an income tax issue, or upon the expiration of a statute of limitations. Accordingly, our effective tax rate could fluctuate materially from period to period.

In accordance with SFAS 123R, we recognize tax benefit upon expensing certain share-based awards associated with our share-based compensation plans, including nonqualified stock options and deferred stock unit awards, but under current accounting standards we cannot recognize tax benefit concurrent with the recognition of share-based compensation expenses associated with incentive stock options and employee stock purchase plan shares (qualified stock options). For qualified stock options that vested after our adoption of SFAS 123R, we recognize tax benefit only in the period when disqualifying dispositions of the underlying stock occur, which historically has been up to several years after vesting and in a period when our stock price substantially increases. For qualified stock options that vested prior to our adoption of SFAS 123R, the tax benefit is recorded directly to additional paid-in capital. Accordingly, because we cannot recognize the tax benefit for share-based compensation expense associated with qualified stock options until the occurrence of future disqualifying dispositions of the underlying stock and such disqualified dispositions may happen in periods when our stock price substantially increases, and because a portion of that tax benefit may be directly recorded to additional paid-in capital, our future quarterly and annual effective tax rates will be subject to greater volatility and, consequently, our ability to estimate reasonably our future quarterly and annual effective tax rates is greatly diminished.

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Results of Operations

Fiscal year ended June 30, 2007 compared with fiscal year ended June 30, 2006

Net Revenue.

(in thousands)

	Year Ended June 30,			
	2006	2007	$ Change	% Change
PC applications	$ 157,511	$ 226,208	$ 68,697	43.6%
% of net revenue	85.3%	84.8%		
Digital lifestyle product applications	27,046	40,579	13,533	50.0%
% of net revenue	14.7%	15.2%		
Net revenue	$ 184,557	$ 266,787	$ 82,230	44.6%

For the year ended June 30, 2007, we generated $226.2 million, or 84.8%, of net revenue from the personal computing market (PC) and we generated $40.6 million, or 15.2%, of net revenue from the digital lifestyle products markets. Net revenue was $266.8 million for the year ended June 30, 2007 compared with $184.6 million for the year ended June 30, 2006, an increase of $82.2 million, or 44.6%. The increase in net revenue for the year ended June 30, 2007 was attributable to a $68.7 million, or 43.6%, increase in PC applications net revenue and a $13.5 million, or 50.0%, increase in digital lifestyle product applications net revenue. The increase in PC applications net revenue was primarily attributable to notebook industry growth, coupled with market share gains, additional penetration in PC peripherals, and continuing adoption by notebook OEMs of our capacitive interface multimedia controls. Digital lifestyle product application net revenue growth resulted from both industry growth and market share gains. The overall increase in net revenue was primarily attributable to an 80% increase in unit shipments, reflecting the combination of industry growth and market share gains, partially offset by a lower-priced product mix and general competitive pricing pressure.

Gross Margin.

(in thousands)

	Year Ended June 30,			
	2006	2007	$ Change	% Change
Gross Margin	$ 82,853	$ 105,874	$ 23,021	27.8%
% of net revenue	44.9%	39.7%		

Gross margin as a percentage of net revenue was 39.7%, or $105.9 million, for the year ended June 30, 2007 compared with 44.9%, or $82.9 million, for the year ended June 30, 2006. As each product we sell utilizes our capacitive sensing technology in a design that is generally unique or specific to a customer s application, gross margin varies on a product-by-product basis, making our cumulative gross margin a blend of our product specific designs and independent of the vertical markets that our products serve. The decline in gross margin as a percentage of net revenue primarily reflected a lower margin product design mix, which included a substantial increase in products containing generally higher third-party content and general competitive pricing pressure, partially offset by lower manufacturing costs, resulting from our continuing design, process-improvement, and cost-reduction programs.

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Operating Expenses.
(in thousands)

	Year Ended June 30, 2006	2007	$ Change	% Change
Research and development expenses	$ 35,356	$ 39,386	$ 4,030	11.4%
% of net revenue	19.1%	14.8%		
Selling, general & administrative expenses	28,019	36,247	8,228	29.4%
% of net revenue	15.2%	13.6%		
Restructuring		915	915	NA
% of net revenue	0.0%	0.3%		
Operating expenses	$ 63,375	$ 76,548	$ 13,173	20.8%
% of net revenue	34.3%	28.7%		

Research and Development Expenses. Research and development expenses decreased as a percentage of net revenue to 14.8% from 19.1%, while the cost of research and development activities increased $4.0 million, or 11.4%, to $39.4 million for the year ended June 30, 2007 compared with $35.4 million for the year ended June 30, 2006. The increase in research and development expenses primarily reflected a $2.3 million increase in employee compensation costs resulting from additional staffing, increased base compensation related to our annual performance review process, employee benefits costs, variable compensation costs, and recruiting costs, a $948,000 increase in infrastructure and support costs, and a $944,000 increase in consulting and outside service costs, partially offset by a $1.0 million reduction of project materials and related costs. Non-cash share-based compensation costs included in research and development expenses were $5.1 million, or 1.9% of net revenue, and $4.8 million, or 2.6% of net revenue, for fiscal 2007 and 2006, respectively.

Selling, General, and Administrative Expenses. Selling, general, and administrative expenses decreased as a percentage of net revenue to 13.6% from 15.2%, while the cost of selling, general, and administrative activities increased $8.2 million, or 29.4%, to $36.2 million for the year ended June 30, 2007 compared with $28.0 million for the year ended June 30, 2006. The increase in selling, general, and administrative expenses primarily reflected a $3.6 million increase in employee compensation and employment related costs, resulting from additional staffing, increased base compensation related to our annual performance review process, employee benefits costs, recruiting costs, and variable compensation costs, a $1.8 million increase in legal fees, and a $1.3 million increase in consulting and outside service costs. The increase in legal fees was primarily related to ongoing patent infringement litigation, which is more fully described in Part I Item 3. Legal Proceedings. Non-cash share-based compensation costs included in selling, general, and administrative expenses were $8.5 million, or 3.2% of net revenue, and $7.7 million, or 4.2% of net revenue, for fiscal 2007 and 2006, respectively.

Restructuring Charge. For fiscal 2007, we incurred a restructuring charge of $915,000 in connection with the closure of our European development center as part of our strategic efforts to realign our development capabilities to better meet the needs of our Asia/Pacific customer base. Included in the restructuring charge were personnel costs, consisting of severance and relocation of $526,000, a lease reserve of $287,000, net of estimated sublease income, and a non-cash impairment of property and equipment of $102,000. As of June 30, 2007, all costs associated with the restructuring have been settled and no additional payment obligation exists.

Operating Income.
(in thousands)

	Year Ended June 30, 2006	2007	$ Change	% Change

Operating Income	$ 19,478	$ 29,326	$ 9,848	50.6%
% of net revenue	10.6%	11.0%		

We generated operating income of $29.3 million, or 11.0% of net revenue, for the year ended June 30, 2007 an increase of $9.8 million compared with $19.5 million, or 10.6% of net revenue, for the year ended June 30, 2006.

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As discussed in the preceding paragraphs, the increase in operating income was primarily attributable to the increase in operating leverage resulting from the 44.6% increase in net revenue, partially offset by a 5.2 point decline in our gross margin percentage and a $13.2 million increase in our operating expenses, which included a $915,000 restructuring charge associated with the closure of our European development center.

Interest Income/(Expense).
(in thousands)

	Year Ended June 30,			
	2006	2007	$ Change	% Change
Interest income	$ 7,984	$ 11,055	$ 3,071	38.5%
% of net revenue	4.3%	4.1%		
Interest expense	(1,939)	(1,950)	(11)	0.6%
% of net revenue	-1.1%	-0.7%		
Net interest income	$ 6,045	$ 9,105	$ 3,060	50.6%
% of net revenue	3.3%	3.4%		

Interest Income. Interest income was $11.1 million for the year ended June 30, 2007 compared with $8.0 million for the year ended June 30, 2006. The $3.1 million increase in interest income resulted from a combination of higher average interest rates and higher average invested cash balances. The increase in cash balances was primarily related to $26.3 million of cash flows from operations and $31.4 million of proceeds and excess tax benefit from stock option and employee stock purchase plan activity, partially offset by $32.3 million used for the purchase of treasury stock and $5.8 million used for capital expenditures.

Interest Expense. Interest expense was $1.9 million for both fiscal 2006 and 2007 and consisted primarily of interest expense and amortization of debt issuance costs related to our convertible senior subordinated notes issued in December 2004. The annual debt service cost on the notes is approximately $938,000, which excludes $860,000 of amortization of debt issuance costs.

Provision for Income Taxes.
(in thousands)

	Year Ended June 30,			
	2006	2007	$ Change	% Change
Income before provision for income taxes	$ 25,523	$ 38,431	$ 12,908	50.6%
Provision for income taxes	11,822	11,897	75	0.6%
% of income before provision for income taxes	46.3%	31.0%		
% of net revenue	6.4%	4.5%		

The provision for income taxes for the year ended June 30, 2007 was approximately $11.9 million compared with $11.8 million for the year ended June 30, 2006, reflecting significantly higher pre-tax profits offset by a significantly lower effective tax. The income tax provision represented estimated federal, foreign, and state taxes for the years ended June 30, 2006 and 2007. The effective tax rate for the year ended June 30, 2007 was approximately 31.0% and diverged from the combined federal and state statutory rate primarily as a result of the incremental research credits associated with stock option activity, tax-exempt interest income, the release of contingency reserves related to statute expirations and amended return filings, the extension of the federal research credit, partially offset by the impact of accounting for share-based compensation and foreign withholding taxes. The effective tax rate for the year ended June 30, 2006 was approximately 46.3% and diverged from the combined federal and state statutory rate primarily as a result of the impact of accounting for share-based compensation and foreign withholding taxes, partially offset by the impact of the release of contingency reserves, tax-exempt interest income, and the benefit of research and development tax credits.

In accordance with SFAS 123R, we recognize tax benefit upon expensing certain share-based awards associated with our share-based compensation plans, including nonqualified stock options and deferred stock unit awards, but under current accounting standards we cannot recognize tax benefit concurrent with the recognition of share-based compensation expenses associated with incentive stock options and employee stock purchase plan shares (qualified stock options). For qualified stock options that vested after our adoption of SFAS 123R, we recognize tax benefit only in the period when disqualifying dispositions of the underlying stock occur, which historically has been up to several years after vesting and in a period when our stock price substantially increases. For qualified stock options that vested prior to our adoption of SFAS 123R, the tax benefit is recorded directly to additional paid-in capital. Tax benefit associated with total share-based compensation was approximately $2.9 million and $4.1 million for the year ended June 30, 2006 and 2007, respectively. Excluding the impact of share-based compensation and the related tax benefit, the effective tax rate for the year ended June 30, 2006 and 2007 would have been 38.1% and 30.4%, respectively. Because we cannot recognize the tax benefit for share-based compensation expense associated with qualified stock options until the occurrence of future disqualifying dispositions of the underlying stock and such disqualified dispositions may happen in periods when our stock price substantially increases, and because a portion of that tax benefit may be recorded directly to additional paid-in capital, our future quarterly and annual effective tax rates will be subject to greater volatility and, consequently, our ability to reasonably estimate our future quarterly and annual effective tax rates is greatly diminished.

Results of Operations

Fiscal year ended June 30, 2006 compared with fiscal year ended June 30, 2005

Net Revenue.

(in thousands)

	Year Ended June 30,			
	2005	2006	$ Change	% Change
PC applications	$ 122,877	$ 157,511	$ 34,634	28.2%
% of net revenue	59.0%	85.3%		
Digital lifestyle product applications	85,262	27,046	(58,216)	-68.3%
% of net revenue	41.0%	14.7%		
Net revenue	$ 208,139	$ 184,557	$ (23,582)	-11.3%

Net revenue was $184.6 million for the year ended June 30, 2006 compared with $208.1 million for the year ended June 30, 2005, a decrease of $23.6 million, or 11.3%. We identify the vertical markets that our products serve as the PC market and the digital lifestyle product markets. The decrease in net revenue was primarily attributable to a $58.2 million, or 68.3%, decrease in digital lifestyle product net revenue, which was $27.0 million for the year ended June 30, 2006, compared with $85.3 million for the year ended June 30, 2005. Our digital lifestyle product revenue declined to approximately 14.7% of net revenue for the year ended June 30, 2006 from approximately 41.0% of net revenue for the year ended June 30, 2005, primarily due to a decline in orders from a customer from the HDD portable digital music player market. The decrease in digital lifestyle product net revenue was partially offset by an increase in PC applications net revenue of $34.6 million, or 28.2%, for the year ended June 30, 2006 compared with the year ended June 30, 2005. The increase in PC applications net revenue was attributable to notebook industry growth, coupled with market share gains, additional penetration in PC peripherals, and adoption by notebook OEMs of our capacitive interface multimedia controls. The overall decrease in net revenue was partially offset by a 6% increase in total unit shipments. Net revenue from PC dual pointing applications declined to approximately 15% of net revenue for the year ended June 30, 2006 compared with 16% of net revenue for the year ended June 30, 2005. The decrease in net revenue from PC dual pointing applications reflected the continuing shift toward single pointing solutions, driven by the combination of consumer and small business demand for low-priced notebook computers relative to high-priced notebook computers for business use and the impact of competitive solutions in the dual pointing segment of the notebook market.

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Gross Margin.
(in thousands)

	Year Ended June 30,			
	2005	2006	$ Change	% Change
Gross Margin	$ 96,049	$ 82,853	$ (13,196)	-13.7%
% of net revenue	46.1%	44.9%		

Gross margin as a percentage of net revenue was 44.9% for the year ended June 30, 2006 compared with 46.1% for the year ended June 30, 2005. As each product we sell utilizes our capacitive technologies in a design that is unique or specific to a customer s application, gross margins vary on a product-by-product basis, making our gross margins product design specific and independent of the vertical markets that our products serve. The decline in gross margin as a percentage of net revenue primarily reflected an unfavorable product design mix, lower average selling prices resulting from general competitive pricing pressure, and the inclusion of non-cash share-based compensation costs of $682,000, partially offset by lower manufacturing costs resulting from our continuing design and process improvement programs and lower materials, assembly, and test costs. Non-cash share-based compensation costs resulted from our adoption of SFAS 123R on a modified prospective basis at the beginning of fiscal 2006 and year-over-year were responsible for a 0.4% decline in our gross margin as a percentage of revenue.

Operating Expenses.
(in thousands)

	Year Ended June 30,			
	2005	2006	$ Change	% Change
Research and development expenses	$ 24,991	$ 35,356	$ 10,365	41.5%
% of net revenue	12.0%	19.1%		
Selling, general & administrative expenses	18,423	28,019	9,596	52.1%
% of net revenue	8.9%	15.2%		
Other operating expense (income)	(3,800)		3,800	-100.0%
% of net revenue	-1.8%	0.0%		
Amortization of deferred stock compensation	328		(328)	-100.0%
% of net revenue	0.1%	0.0%		
Operating expenses	$ 39,942	$ 63,375	$ 23,433	58.7%
% of net revenue	19.2%	34.3%		

Research and Development Expenses. Research and development expenses increased as a percentage of net revenue to 19.1% from 12.0%, while spending on research and development activities increased $10.4 million, or 41.5%, to $35.4 million from $25.0 million for the year ended June 30, 2006 compared with the year ended June 30, 2005. The primary contributor to the increase in research and development expenses was the inclusion of non-cash share-based compensation costs of $4.8 million as a result of adopting SFAS 123R on a modified prospective basis at the beginning of fiscal 2006. Excluding non-cash share-based compensation costs, research and development expenses increased approximately $5.6 million, or 22.3%, primarily reflecting a $3.1 million increase in project spending, a $1.9 million increase in employee compensation costs resulting from additional staffing, increased base compensation related to our annual performance review process, employee benefit costs, and recruiting costs, and a $1.6 million increase in temporary labor and consulting costs, partially offset by a $1.4 million reduction in incentive pay.

Selling, General, and Administrative Expenses. Selling, general, and administrative expenses increased as a percentage of net revenue to 15.2% from 8.9%, while the cost of selling, general, and administrative activities increased $9.6 million, or 52.1%, to $28.0 million from $18.4 million for the year ended June 30, 2006 compared with the year ended June 30, 2005. The increase in selling, general, and administrative expenses reflected the inclusion of non-cash share-based compensation costs of $7.7 million as a result of adopting SFAS 123R on a modified prospective basis at the beginning of fiscal 2006. Excluding non-cash share-based compensation costs, selling, general, and administrative expenses increased $1.9 million, or 10.2%, primarily reflecting a $2.4 million increase in employee compensation costs resulting from additional staffing, increased base compensation related to our annual performance review process, employee benefit costs, and recruiting costs, a $451,000 increase in outside commission costs, a $381,000 increase in temporary labor and consulting costs, and a $140,000 increase in travel and related costs, partially offset by a $1.5 million reduction in incentive pay.

Other operating expense (income). The year ended June 30, 2005 included the receipt of a one-time payment of $3.8 million for a cross license agreement that settled certain intellectual property disputes with a competitor. The cross license agreement does not provide for any future service obligations or commitments from us and contains the mutual releases of the parties respective claims.

Amortization of Deferred Stock Compensation. Beginning with fiscal 2006, we adopted SFAS 123R and as a result ceased amortizing deferred stock compensation. Accordingly, no amortization expense for deferred stock compensation was recorded for the year ended June 30, 2006 while $328,000 was recorded for the year ended June 30, 2005.

Operating Income.

(in thousands)

	Year Ended June 30,			
	2005	2006	$ Change	% Change
Operating Income	$ 56,107	$ 19,478	$ (36,629)	-65.3%
% of net revenue	27.0%	10.6%		

We generated operating income of $19.5 million, or 10.6% of net revenue, for the year ended June 30, 2006 compared with $56.1 million, or 27.0% of net revenue, for the year ended June 30, 2005. As discussed in the preceding paragraphs, the decline in operating income was primarily related to the decrease in operating leverage resulting from the 11.3% decline in net revenue, lower gross margin percentage, and higher operating expenses which included a $13.2 million increase in non-cash share-based compensation costs related to our adoption of SFAS 123R on a modified prospective basis at the beginning of fiscal 2006.

Interest Income/(Expense).

(in thousands)

	Year Ended June 30,			
	2005	2006	$ Change	% Change
Interest income	$ 3,370	$ 7,984	$ 4,614	136.9%
% of net revenue	1.6%	4.3%		
Interest expense	(1,145)	(1,939)	(794)	69.3%
% of net revenue	-0.5%	-1.1%		
Net interest income	$ 2,225	$ 6,045	$ 3,820	171.7%
% of net revenue	1.1%	3.2%		

Interest Income. Interest income was $8.0 million for the year ended June 30, 2006 compared with $3.4 million for the year ended June 30, 2005. The $4.6 million increase in interest income resulted from a combination of substantially higher average interest rates and substantially higher average invested cash balances. The increase in cash balances was primarily the result of the net cash proceeds of $120.7 million received from the issuance of our convertible senior subordinated notes in December 2004 aided by $24.8 million of net cash flows from operations for fiscal 2006.

Interest Expense. Interest expense was $1.9 million for the year ended June 30, 2006 compared with $1.1 million for the year ended June 30, 2005. The $794,000 increase in interest expense resulted from the combination of interest expense and amortization of debt issuance costs related to our convertible senior subordinated notes issued in

December 2004. The annual debt service cost on the notes is approximately $938,000, which excludes $860,000 of amortization of debt issuance costs.

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Provision for Income Taxes.
(in thousands)