

SYNAPTICS INC  
Form 10-Q  
November 08, 2007

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
FORM 10-Q**

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

**For the quarterly period ended September 29, 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., Suite 130  
Santa Clara, California 95054**

(Address of principal executive offices) (Zip code)

**(408) 454-5100**

(Registrant's telephone number, including area code)

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

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

Number of shares of Common Stock outstanding at November 2, 2007: 30,850,927

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**SYNAPTICS INCORPORATED**  
**QUARTERLY REPORT ON FORM 10-Q**  
**FOR THE QUARTER ENDED SEPTEMBER 30, 2007**  
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CONDENSED CONSOLIDATED BALANCE SHEETS**(in thousands, except share data)  
(unaudited)

|                                                                                                        | <b>September<br/>30,<br/>2007</b> | <b>June 30,<br/>2007</b> |
|--------------------------------------------------------------------------------------------------------|-----------------------------------|--------------------------|
| <b>ASSETS</b>                                                                                          |                                   |                          |
| Current assets:                                                                                        |                                   |                          |
| Cash and cash equivalents                                                                              | \$ 101,979                        | \$ 45,915                |
| Short-term investments                                                                                 | 159,192                           | 219,102                  |
| Accounts receivable, net of allowances of \$364 and \$419, respectively                                | 65,664                            | 56,721                   |
| Inventories                                                                                            | 19,476                            | 12,034                   |
| Prepaid expenses and other current assets                                                              | 10,064                            | 4,245                    |
| Total current assets                                                                                   | 356,375                           | 338,017                  |
| Property and equipment, net                                                                            | 19,848                            | 19,400                   |
| Goodwill                                                                                               | 1,927                             | 1,927                    |
| Other assets                                                                                           | 7,739                             | 13,968                   |
|                                                                                                        | \$ 385,889                        | \$ 373,312               |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>                                                             |                                   |                          |
| Current liabilities:                                                                                   |                                   |                          |
| Accounts payable                                                                                       | \$ 21,387                         | \$ 21,552                |
| Accrued compensation                                                                                   | 4,144                             | 5,372                    |
| Income taxes payable                                                                                   |                                   | 3,400                    |
| Other accrued liabilities                                                                              | 6,605                             | 6,272                    |
| Note payable                                                                                           |                                   | 1,500                    |
| Total current liabilities                                                                              | 32,136                            | 38,096                   |
| Other liabilities                                                                                      | 12,991                            | 2,129                    |
| Convertible senior subordinated notes                                                                  | 125,000                           | 125,000                  |
| Stockholders' equity:                                                                                  |                                   |                          |
| Common stock:                                                                                          |                                   |                          |
| \$0.001 par value; 60,000,000 shares authorized; 30,653,597 and 29,666,660 shares issued, respectively | 31                                | 30                       |
| Additional paid-in capital                                                                             | 196,913                           | 180,746                  |
| Less: 4,088,100 and 3,588,100 common treasury shares, respectively, at cost                            | (91,296)                          | (72,345)                 |
| Accumulated other comprehensive loss                                                                   | (943)                             | (139)                    |
| Retained earnings                                                                                      | 111,057                           | 99,795                   |
| Total stockholders' equity                                                                             | 215,762                           | 208,087                  |
|                                                                                                        | \$ 385,889                        | \$ 373,312               |

*See notes to condensed consolidated financial statement (unaudited).*

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**SYNAPTICS INCORPORATED AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF INCOME**

(in thousands, except per share data)

(unaudited)

|                                                                    | <b>Three Months Ended</b> |              |
|--------------------------------------------------------------------|---------------------------|--------------|
|                                                                    | <b>September 30,</b>      |              |
|                                                                    | <b>2007</b>               | <b>2006</b>  |
| Net revenue                                                        | \$ 86,692                 | \$ 54,815    |
| Cost of revenue (1)                                                | 51,228                    | 32,420       |
| <br>Gross margin                                                   | <br>35,464                | <br>22,395   |
| <br>Operating expenses:                                            |                           |              |
| Research and development (1)                                       | 10,402                    | 9,188        |
| Selling, general, and administrative (1)                           | 10,750                    | 7,801        |
| <br>Total operating expenses                                       | <br>21,152                | <br>16,989   |
| <br>Income from operations                                         | <br>14,312                | <br>5,406    |
| Interest income                                                    | 2,995                     | 2,539        |
| Interest expense                                                   | (475)                     | (487)        |
| Gain on settlement of debt                                         | 2,689                     |              |
| Impairment of investment                                           | (4,000)                   |              |
| <br>Income before provision for income taxes                       | <br>15,521                | <br>7,458    |
| Provision for income taxes                                         | 4,259                     | 3,331        |
| <br>Net income                                                     | <br>\$ 11,262             | <br>\$ 4,127 |
| <br>Net income per share:                                          |                           |              |
| Basic                                                              | \$ 0.43                   | \$ 0.16      |
| Diluted                                                            | \$ 0.41                   | \$ 0.15      |
| <br>Shares used in computing net income per share:                 |                           |              |
| Basic                                                              | 26,210                    | 25,134       |
| Diluted                                                            | 27,691                    | 29,253       |
| <br>(1) Amounts include share-based compensation costs as follows: |                           |              |
| Cost of revenue                                                    | \$ 239                    | \$ 147       |
| Research and development                                           | \$ 1,171                  | \$ 1,035     |
| Selling, general, and administrative                               | \$ 1,919                  | \$ 1,919     |

*See notes to condensed consolidated financial statement (unaudited).*



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**SYNAPTICS INCORPORATED AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(in thousands)

(unaudited)

|                                                                                         | <b>Three Months Ended</b> |             |
|-----------------------------------------------------------------------------------------|---------------------------|-------------|
|                                                                                         | <b>September 30,</b>      |             |
|                                                                                         | <b>2007</b>               | <b>2006</b> |
| <b>Cash flows from operating activities</b>                                             |                           |             |
| Net income                                                                              | \$ 11,262                 | \$ 4,127    |
| Adjustments to reconcile net income to net cash provided by operating activities:       |                           |             |
| Share-based compensation costs                                                          | 3,329                     | 3,101       |
| Deferred taxes from share-based compensation                                            | 916                       | (751)       |
| Tax benefit realized from share-based compensation                                      |                           | 234         |
| Excess tax benefit from share-based compensation                                        |                           | (183)       |
| Depreciation of property and equipment                                                  | 855                       | 454         |
| Impairment of property and equipment                                                    | 210                       |             |
| Amortization of debt issuance costs                                                     | 215                       | 215         |
| Gain on settlement of debt                                                              | (2,689)                   |             |
| Impairment of investment                                                                | 4,000                     |             |
| Changes in operating assets and liabilities:                                            |                           |             |
| Accounts receivable, net                                                                | (8,943)                   | (7,779)     |
| Inventories                                                                             | (7,442)                   | 993         |
| Prepaid expenses and other current assets                                               | (77)                      | (325)       |
| Other assets                                                                            | 1,854                     | 1,000       |
| Accounts payable                                                                        | (165)                     | (390)       |
| Accrued compensation                                                                    | (1,413)                   | (978)       |
| Income taxes                                                                            | 1,634                     | 2,891       |
| Other accrued liabilities                                                               | 1,522                     | 2,070       |
| Other liabilities                                                                       | (21)                      | (969)       |
| Net cash provided by operating activities                                               | 5,047                     | 3,710       |
| <b>Cash flows from investing activities</b>                                             |                           |             |
| Purchases of short-term investments                                                     | (61,783)                  | (69,981)    |
| Proceeds from sales and maturities of short-term investments                            | 120,240                   | 82,825      |
| Purchases of property and equipment                                                     | (1,513)                   | (515)       |
| Net cash provided by investing activities                                               | 56,944                    | 12,329      |
| <b>Cash flows from financing activities</b>                                             |                           |             |
| Purchase of treasury stock                                                              | (18,951)                  | (4,612)     |
| Proceeds from issuance of common stock upon exercise of options and stock purchase plan | 13,024                    | 1,462       |
| Excess tax benefit from share-based compensation                                        |                           | 183         |
| Net cash used in financing activities                                                   | (5,927)                   | (2,967)     |



|                                                  |            |           |
|--------------------------------------------------|------------|-----------|
| Net increase in cash and cash equivalents        | 56,064     | 13,072    |
| Cash and cash equivalents at beginning of period | 45,915     | 38,724    |
| Cash and cash equivalents at end of period       | \$ 101,979 | \$ 51,796 |

**Supplemental disclosures of cash flow information**

|                            |       |        |
|----------------------------|-------|--------|
| Cash paid for income taxes | \$ 33 | \$ 247 |
|----------------------------|-------|--------|

*See notes to condensed consolidated financial statements (unaudited).*

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**SYNAPTICS INCORPORATED AND SUBSIDIARIES**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
(unaudited)

**1. Basis of Presentation**

The accompanying unaudited condensed consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (the SEC) and U.S. generally accepted accounting principles. However, certain information or footnote disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles have been condensed or omitted pursuant to such SEC rules and regulations. In our opinion, the financial statements include all adjustments, which are of a normal and recurring nature, necessary for the fair presentation of the results of the interim periods presented. The results of operations for the interim periods are not necessarily indicative of the operating results for the full fiscal year or any future period. These financial statements should be read in conjunction with the audited consolidated financial statements and related notes included in our annual report on Form 10-K for the fiscal year ended June 30, 2007.

The consolidated financial statements include our financial statements and those of our wholly owned subsidiaries. All significant intercompany balances and transactions have been eliminated upon consolidation.

Our fiscal year is the 52- or 53-week period ending on the last Saturday in June. Fiscal 2008 will be a 52-week period ending on June 28, 2008, and fiscal 2007 was a 53-week period ending on June 30, 2007. The fiscal periods presented in this report were 13-week periods for the three months ended September 29, 2007 and September 23, 2006. For ease of presentation, the accompanying consolidated financial statements have been shown as ending on September 30 and calendar quarter end dates for all annual, interim, and quarterly financial statement captions, unless otherwise indicated.

*Use of 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, share-based compensation costs, provision for income taxes, income taxes payable, investments, and contingencies. We base our estimates on historical experience, applicable laws and regulations, 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.

**2. Revenue Recognition**

We recognize revenue from product sales when there is persuasive evidence that an arrangement exists, delivery has occurred and title has transferred, the price is fixed or determinable, and collection is reasonably assured. We accrue for estimated sales returns and other allowances, based on historical experience, at the time we recognize revenue. We record contract revenue for research and development as we provide the services 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.

**3. Net Income Per Share**

We present basic and diluted net income per share amounts in conformity with Statement of Financial Accounting Standards (SFAS) 128, Earnings Per Share, for all periods presented.

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The following table presents the computation of basic and diluted net income per share (in thousands, except per share amounts):

|                                                                                            | Three Months Ended<br>September 30, |          |
|--------------------------------------------------------------------------------------------|-------------------------------------|----------|
|                                                                                            | 2007                                | 2006     |
| Numerator:                                                                                 |                                     |          |
| Basic net income                                                                           | \$ 11,262                           | \$ 4,127 |
| Interest expense and amortization of debt issuance costs on convertible notes (net of tax) |                                     | 266      |
| Diluted net income                                                                         | \$ 11,262                           | \$ 4,393 |
| Denominator:                                                                               |                                     |          |
| Shares, basic                                                                              | 26,210                              | 25,134   |
| Effect of dilutive share-based awards                                                      | 1,481                               | 1,645    |
| Effect of convertible notes                                                                |                                     | 2,474    |
| Shares, diluted                                                                            | 27,691                              | 29,253   |
| Net income per share:                                                                      |                                     |          |
| Basic                                                                                      | \$ 0.43                             | \$ 0.16  |
| Diluted                                                                                    | \$ 0.41                             | \$ 0.15  |

Basic net income per share amounts for each period presented have been computed using the weighted average number of shares of common stock outstanding.

Dilutive net income per share amounts do not include the effect of 836,171 and 2,784,476 share-based awards that were outstanding during the three months ended September 30, 2007 and 2006, respectively. These share-based awards were not included in the computation of diluted net income per share because the proceeds received, if any, from such share-based awards combined with the average unamortized compensation costs adjusted for the hypothetical tax benefit or deficiency creditable or chargeable, respectively, to additional paid-in capital, were greater than the average market price of our common stock, and therefore, their effect would have been antidilutive.

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 our share-based compensation plans under the treasury stock method, (2) through April 2007 using the weighted average number of shares issuable in connection with our 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.

**4. Cash Equivalents and Short-Term Investments**

Cash equivalents consist of highly liquid investments with original maturities of three months or less. Short-term investments consist of marketable securities and are classified as securities available for sale under SFAS 115,

Accounting for Certain Investments in Debt and Equity Securities. Such securities are reported at fair value, with unrealized gains and losses, net of taxes, excluded from earnings and shown separately as a component of accumulated other comprehensive loss within stockholders' equity. We may pay a premium or receive a discount upon the purchase of marketable securities. Interest earned on marketable securities and amortization of discounts received and accretion of premiums paid on the purchase of marketable securities are included in interest income. We determine realized gains and losses on the sale of marketable securities using the specific identification method.

A portion of our investment portfolio is invested in double and triple A rated auction rate securities. During the quarter ended September 30, 2007, \$18.5 million of our auction rate securities, which were purchased subsequent to June 30, 2007, failed to settle in auctions. The failures resulted in the interest rates on the investments resetting at

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Libor plus 50 or 100 basis points. While we now earn a premium interest rate on these investments, the investments are not liquid. In the event we need to access these funds, we will not be able to do so without a loss of principal, unless a future auction on these investments is successful. We have reduced the carrying value of these investments by \$1.6 million through other comprehensive income to reflect the temporary nature of the impairment of these investments. At this time, there is no evidence to suggest that these investments are other-than-temporarily impaired or that they will not be settled in the short term; however, we will evaluate these investments quarterly.

**5. Inventories**

Inventories are stated at the lower of cost (first-in, first-out method) or market (estimated net realizable value) and consisted of the following (in thousands):

|                | September<br>30,<br>2007 | June 30,<br>2007 |
|----------------|--------------------------|------------------|
| Raw materials  | \$ 13,636                | \$ 10,187        |
| Finished goods | 5,840                    | 1,847            |
|                | \$ 19,476                | \$ 12,034        |

Periodically, we purchase inventory from our subcontractors 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 subcontractors, 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.

**6. Product Warranties, Indemnifications, and Legal Proceedings***Product Warranties*

We generally warrant our products for a period of 12 months or more from the date of sale and estimate probable product warranty costs at the time we recognize revenue. Factors that affect our warranty liability include historical and anticipated rates of warranty claims, materials usage, and service delivery costs. Warranty costs incurred have not been material in recent years. However, we assess the adequacy of our warranty obligations periodically and adjust the accrued warranty liability on the basis of our estimates.

Changes in our accrued warranty liability (included in other accrued liabilities) for the three-month periods ended September 30, 2007 and 2006 were as follows (in thousands):

|                                         | Three Months Ended<br>September 30, |        |
|-----------------------------------------|-------------------------------------|--------|
|                                         | 2007                                | 2006   |
| Beginning accrued warranty              | \$ 325                              | \$ 357 |
| Provision for product warranties        | 103                                 | 214    |
| Cost of warranty claims and settlements | (64)                                | (151)  |
| Ending accrued warranty                 | \$ 364                              | \$ 420 |

*Indemnifications*

In connection with certain third-party agreements, we are obligated to indemnify the third party in connection with any technology infringement by us. We have also entered into indemnification agreements with our officers and directors. Maximum potential future payments cannot be estimated because these agreements do not have a maximum stated liability. However, historical costs related to these indemnification provisions have not been significant. We have not recorded any liability in our consolidated financial statements for such indemnification obligations.

*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

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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.

The Elantech patent relates to recognizing the presence of multiple fingers on a touchpad. We have multiple ways to accomplish that and have our own patents for detecting multiple fingers. We have used two types of software in our products ( Type 1 Code and Type 2 Code ) to detect multiple fingers.

In October 2007, the Court heard oral arguments on our motion for summary judgment of noninfringement of the Elantech patent and Elantech's cross-motion for summary judgment of infringement. The Court granted our motion for partial summary judgment of noninfringement as to products containing Type 1 Code and denied our motion for partial summary judgment of noninfringement as to products containing Type 2 Code. In addition, the Court denied Elantech's motion for summary judgment that our Type 1 and Type 2 Codes infringe Elantech's intellectual property. The Court indicated, however that it would grant summary judgment of infringement for products implementing the Type 2 Code with enabled finger counting functionality but Elantech did not move for partial summary judgment. We do not believe any aspect of the Court's decision will have a material effect on our business.

We intend to vigorously defend our patents and pursue our counterclaims. We have not recorded any liability associated with Elantech's claims pursuant to SFAS No. 5 Accounting for Contingencies, and have expensed as incurred all legal fees associated with the legal proceedings.

**7. Convertible Senior Subordinated Notes**

In December 2004, we issued an aggregate of \$125 million of 0.75% Convertible Senior Subordinated Notes maturing December 1, 2024 (the Notes ) in a private offering pursuant to Rule 144A under the Securities Act of 1933, as amended. In connection with issuing the Notes, we incurred debt issuance costs of \$4.3 million, consisting primarily of the initial purchasers' discount and costs related to legal, accounting, and printing, which are being amortized over five years. We expect to use the net proceeds for working capital and general corporate purposes and potentially for future acquisitions.

The Notes bear interest at a rate of 0.75% per annum payable on December 1 and June 1 of each year. However, we will pay additional contingent interest on the Notes if the average trading price of the Notes is at or above 120% of the principal amount of the Notes for a specified period beginning with the six-month period commencing December 1, 2009. The amount of contingent interest payable on the Notes with respect to a six-month period, for which contingent interest applies, will equal 0.375% per annum of the average trading price of the Notes for a specified five trading-day period preceding such six-month period.

As a result of our irrevocable election in April 2007 to cash settle the principal amount of the Notes, no shares of common stock will be issued to settle the principal amount of the Notes and cash or common stock may be used to settle the value of the Notes in excess of \$125 million, if any. Our election to cash settle the principal amount of the 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, we will include on a prospective basis diluted shares underlying the Notes in our diluted net income per share calculation only when the average closing stock price for the accounting period exceeds the conversion price of the Notes, which is currently \$50.53 per share.

Initially the Notes were convertible into shares of our common stock at a conversion rate of 19.7918 shares per \$1,000 principal amount of Notes, or a total of 2,473,975 shares of common stock, which is equivalent to an initial conversion price of approximately \$50.53 per share of common stock, subject to adjustment in certain events. Through April 2007 the denominator of the diluted net income per share calculation included the weighted average effect of the 2,473,975 shares of common stock issuable upon conversion of the Notes in accordance with SFAS 128 as it applies to the method of settling the principal amount of the Notes and Emerging Issues Task Force ( EITF ) Issue No. 04-08, The Effect of Contingently Convertible Instruments on Diluted Earnings per Share, as it applies to the market price conversion trigger embedded in the Notes.





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Through November 30, 2009, upon the occurrence of a fundamental change as defined in the indenture governing the Notes, we could potentially be obligated to issue up to 7.917 shares per \$1,000 of principal amount of Notes, or a total of 989,587 shares of common stock. The 989,587 shares, contingently issuable upon a fundamental change, are not included in the calculation of diluted net income per share.

The Notes may be converted (1) if, during any calendar quarter commencing after December 31, 2004, the last reported sale price of our common stock for at least 20 trading days in the period of 30 consecutive trading days ending on the last trading day of the preceding calendar quarter is greater than or equal to 120% of the applicable conversion price on such last trading day; (2) on or after January 1, 2020; (3) if we have called the Notes for redemption; or (4) during prescribed periods, upon the occurrence of specified corporate transactions or fundamental changes. On or after December 1, 2009, we may redeem for cash all or a portion of the Notes at a redemption price of 100% of the principal amount of the Notes plus accrued and unpaid interest, including contingent interest and additional interest, if any. Noteholders have the right to require us to repurchase all or a portion of their Notes for cash on December 1, 2009, December 1, 2014, and December 1, 2019 at a price equal to 100% of the principal amount of the Notes to be purchased plus accrued and unpaid interest, including contingent interest and additional interest, if any. As of June 30, 2007, none of the conditions for conversion of the Notes had occurred.

The Notes are unsecured senior subordinated obligations and rank junior in right of payment to all of our existing and future senior indebtedness, equal in right of payment with all of our existing and future indebtedness or other obligations that are not, by their terms, either senior or subordinated to the Notes, including trade debt and other general unsecured obligations that do not constitute senior or subordinated indebtedness, and senior in right of payment to all of our future indebtedness that, by its terms, is subordinated to the Notes. There are no financial covenants in the Notes.

Interest expense includes the amortization of debt issuance costs. We recorded \$449,000 of interest expense on the Notes during each of the three-month periods ended September 30, 2007 and 2006, respectively.

**8. Share-Based Compensation**

The purpose of our various share-based compensation plans is to attract, motivate, retain, and reward high-quality employees, directors, and consultants by enabling such persons to acquire or increase their proprietary interest in our common stock in order to strengthen the mutuality of interests between such persons and our stockholders and to provide such persons with annual and long-term performance incentives to focus their best efforts in the creation of stockholder value. Consequently, share-based compensatory awards issued subsequent to the initial award to our employees and consultants are determined primarily on individual performance. Our share-based compensation plans with outstanding awards consist of our 1996 Stock Option Plan, our 2000 Nonstatutory Stock Option Plan, our 2001 Incentive Compensation Plan, and our 2001 Employee Stock Purchase Plan.

Share-based compensation and the related tax benefit recognized in our consolidated statements of income for the three months ended September 30, 2007 and 2006 were as follows (in thousands):

|                                                         | Three Months Ended |          |
|---------------------------------------------------------|--------------------|----------|
|                                                         | September 30,      |          |
|                                                         | 2007               | 2006     |
| Cost of revenue                                         | \$ 239             | \$ 147   |
| Research and development                                | 1,171              | 1,035    |
| Selling, general, and administrative                    | 1,919              | 1,919    |
| Total                                                   | \$ 3,329           | \$ 3,101 |
| Income tax benefit recorded on share-based compensation | \$ 1,697           | \$ 781   |

We utilize the Black-Scholes option pricing model to estimate the grant date fair value of certain employee share-based compensatory awards, which requires the input of highly subjective assumptions, including expected

volatility and expected life. Historical and implied volatilities were used in estimating the fair value of our share-based awards, while the expected life of 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

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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 having no vesting restrictions and being 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. 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.

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.

We determine excess tax benefit using the long-haul method in which we compare the actual tax benefit associated with the tax deduction from share-based award activity to the hypothetical tax benefit on the grant date fair values of the corresponding share-based awards. Under paragraph A94, footnote 82, of SFAS 123R tax benefit associated with excess tax deduction normally creditable to additional paid-in capital is not recognized until the deduction reduces taxes payable. Accordingly, no tax benefit related to excess tax deductions from qualified stock options was recognized during the quarter ended September 30, 2007.

Historically, we have issued new shares in connection with our share-based compensation plans; however, 4.1 million treasury shares were also available for issuance as of September 30, 2007. Any additional shares repurchased under our stock repurchase program would be available for issuance under our share-based compensation plans.

*Deferred Stock Units*

Our 2001 Incentive Compensation Plan ( 2001 Plan ) provides for the grant of deferred stock unit awards ( DSUs ) to our employees, consultants, and directors. A DSU is a promise to deliver shares of our common stock at a future date in accordance with the terms of the DSU grant agreement. We began granting DSU awards in January 2006.

DSUs granted under the 2001 Plan generally vest 25% at the end of 12 months from the vesting commencement date and at a rate of approximately 2% each month thereafter until fully vested at the end of 48 months from the vesting commencement date. Delivery of shares under the plan takes place quarterly for all DSUs vested as of the scheduled delivery dates. Until delivery of shares, the grantee has no rights as a stockholder.

An election to defer delivery of the underlying shares for unvested DSU awards can be made provided the deferral election is made at least one year before vesting and the deferral period is at least five years from the scheduled delivery date.

The following table summarizes DSU activity, including DSUs granted, delivered, and forfeited during the three months ended September 30, 2007, and the balance and aggregate intrinsic value of DSUs as of September 30, 2007. The aggregate intrinsic value is based on the closing price of our common stock on September 28, 2007 of \$47.76.

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|                               | Deferred<br>Stock Unit<br>Awards<br>Outstanding | Aggregate<br>Intrinsic<br>Value<br>(thousands) |
|-------------------------------|-------------------------------------------------|------------------------------------------------|
| Balance at June 30, 2007      | 257,225                                         |                                                |
| Granted                       | 109,315                                         |                                                |
| Delivered                     | (16,504)                                        |                                                |
| Forfeited                     | (7,361)                                         |                                                |
| Balance at September 30, 2007 | 342,675                                         | \$16,366                                       |

*Stock Options*

Our share-based compensation plans with outstanding stock option awards include our 1996 Stock Option Plan, our 2000 Nonstatutory Stock Option Plan, and our 2001 Incentive Compensation Plan ( the Plans ). Under the Plans, we may grant employees, consultants, and directors incentive stock options or nonqualified stock options to purchase shares of our common stock at not less than 100% or 85% of the fair market value, respectively, on the date of grant.

Options issued under the Plans generally vest 25% at the end of 12 months from the vesting commencement date and approximately 2% each month thereafter until fully vested at the end of 48 months from the vesting commencement date. Options not exercised ten years after the date of grant are cancelled.

The following table summarizes stock option activity and weighted average exercise prices for the three months ended September 30, 2007, and for options outstanding and options exercisable, the weighted average exercise prices and the aggregate intrinsic value as of September 30, 2007. The aggregate intrinsic value is based on the closing price of our common stock on September 28, 2007 of \$47.76 and all outstanding stock options were in-the-money.

|                               | Stock<br>Option<br>Awards<br>Outstanding | Weighted<br>Average<br>Exercise<br>Price | Aggregate<br>Intrinsic<br>Value<br>(thousands) |
|-------------------------------|------------------------------------------|------------------------------------------|------------------------------------------------|
| Balance at June 30, 2007      | 4,640,115                                | \$19.18                                  |                                                |
| Granted                       | 422,520                                  | \$40.05                                  |                                                |
| Exercised                     | (975,701)                                | \$13.35                                  |                                                |
| Forfeited and expired         | (87,695)                                 | \$21.06                                  |                                                |
| Balance at September 30, 2007 | 3,999,239                                | \$22.77                                  | \$99,931                                       |
| Exercisable                   | 1,650,098                                | \$16.11                                  | \$52,222                                       |

*Employee Stock Purchase Plan*

Our 2001 Employee Stock Purchase Plan ( ESPP ) became effective on January 29, 2002, the effective date of the registration statement for our initial public offering. The ESPP allows employees to designate up to 15% of their base compensation, subject to legal restrictions and limitations, to purchase shares of common stock at 85% of the lesser of the fair market value ( FMV ) at the beginning of the offering period or the exercise date. The offering period extends for up to two years and includes four exercise dates occurring at six month intervals. Under the terms of the plan, if the FMV at an exercise date is less than the FMV at the beginning of the offering period, the current offering period will terminate and a new offering period of up to two years will commence.

The current two year offering period began on July 1, 2007; accordingly, there were no purchases under our ESPP during the quarter ended September 30, 2007.



**Table of Contents****9. Gain from Settlement of Debt and Impairment of Investment***Gain from Settlement of Debt*

In fiscal 1998, we entered into agreements with National Semiconductor Corporation ( National ) with respect to the formation of a development-stage company, Foveonics, Inc. (now known as Foveon, Inc. and referred to herein as Foveon), which was formed to develop and produce digital imaging products. We contributed technology for which we had no accounting basis for a 30% interest in Foveon in the form of voting convertible preferred stock. Under the agreements, we had the right to acquire additional shares of convertible preferred stock at a specified price in exchange for a limited-recourse loan from National. National loaned us \$1.5 million under a limited-recourse note, which we utilized to purchase 900,000 Series A preferred shares of Foveon, which increased our ownership interest in Foveon to 43%.

In fiscal 1998, we recorded our share of losses incurred by Foveon under the equity accounting method on the basis of our proportionate ownership of voting convertible preferred stock and reduced the carrying value of this equity investment to zero as our share of losses incurred by Foveon exceeded the carrying value of our investment. The \$1.5 million note to National plus accrued interest of \$1.2 million came due in August 2007, and, in accordance with the security agreement, we relinquished our 900,000 Series A preferred shares securing the note to National in full settlement of the principal and accrued interest. Consequently, we recognized a one-time non-operating gain upon settlement of debt in the amount of \$2.7 million in the quarter ended September 30, 2007.

*Impairment of Investment*

In fiscal 2005, we participated in an equity financing, receiving 3,943,217 shares of Foveon Series E preferred for a cash investment of \$4.0 million. The Series E preferred shares are convertible into common shares on a one-for-one basis at any time at our option, upon a firm underwritten public offering of Foveon common stock of not less than \$20 million at a price per share of not less than three times the original issue price, or upon the written agreement of the holders of at least 60% of the outstanding preferred shares voting as a single class. The Series E preferred shares are also entitled to liquidation preference up to two times the original issue price over the earlier non-Series E preferred shares and common shares. We are not obligated to provide additional funding to Foveon.

In fiscal 2007, Foveon completed a Series F preferred financing receiving net proceeds of \$13.8 million. The Series F preferred shareholders are entitled to a liquidation preference over the earlier non-Series F preferred shares and common shares.

We accounted for our Series E preferred stock investment in Foveon under the cost method in accordance with APB Opinion No. 18 and EITF Issues No. 02-14 and No. 03-1 because the investment is not in-substance common stock. We review this investment for impairment at least annually or more frequently as we become aware of information that might affect the carrying value of our investment.

Based on our review at September 30, 2007, we determined there was an other-than-temporary impairment of the carrying value of our investment in Foveon, due to liquidity visibility and liquidation preferences for the most recent preferred equity round. Assuming book value equals fair value of certain of Foveon's assets such as cash, accounts receivable, and accounts payable and no value for other tangible and intangible assets, a hypothetical liquidation of Foveon at September 30, 2007 would benefit only Series F preferred shareholders.

Consequently, we recognized a \$4.0 million other-than-temporary impairment charge as of September 30, 2007.

**10. Income Taxes**

We account for income taxes under the asset and liability method in accordance with SFAS No. 109 Accounting for Income Taxes. We consider the operating earnings of our foreign subsidiaries to be indefinitely invested outside the United States. Accordingly, no provision has been made for the U.S. federal, state, or foreign taxes that may result from future remittances of undistributed earnings of our foreign subsidiaries.

The provision for income taxes of \$4.3 million and \$3.3 million for the three months ended September 30, 2007 and 2006, respectively, represented estimated federal, foreign, and state taxes. The effective tax rate for the three months ended September 30, 2007 was 27.4% and diverged from the combined federal and state statutory rate primarily due to increased foreign income taxed at lower tax rates, accounting for share-based compensation, the

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benefit of research tax credits, and the impact of tax-exempt interest income, partially offset by foreign withholding taxes and the impairment of an investment for which a valuation allowance was established against the deferred tax asset. The effective tax rate for the three months ended September 30, 2006 was 44.7% and diverged from the combined federal and state statutory rate primarily due to the impact of accounting for share-based compensation and foreign withholding taxes, partially offset by the impact of tax-exempt interest income and the release of contingency reserves.

*Unrecognized Tax Benefits*

We adopted FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement No. 109, ( FIN 48 ), effective as of the beginning of the first quarter of fiscal year 2008. In connection with our adoption of FIN 48, we did not recognize a cumulative effect adjustment. Historically, we have classified unrecognized tax benefits as current income taxes payable; however, consistent with the provisions of FIN 48, as of adoption we reclassified gross unrecognized tax benefits of \$8.4 million and accrued interest and penalties expense of \$500,000 as non-current income taxes payable included in other liabilities on our balance sheet. The additional amount of unrecognized tax benefits recognized during the first quarter of fiscal 2008 was \$1.4 million. No unrecognized tax benefit is expected to be paid within one year, nor can we make a reliable estimate when cash settlement with a taxing authority may occur. Any prospective adjustments to our unrecognized tax benefits will be recorded as an increase or decrease to income tax expense and cause a corresponding change to our effective tax rate. Accordingly, our effective tax rate could fluctuate materially from period to period.

*Classification of Interest and Penalties*

Under FIN 48 our policy to classify interest expense and penalties, if any, as components of income tax expense did not change. An additional \$81,000 of interest and penalties has been accrued during the first quarter of fiscal 2008.

*Tax Years and Examination*

Currently, we are required to file income tax returns in the United States, California, and the foreign tax jurisdictions in which we operate. Our major tax jurisdictions are the United States and California. The fiscal years that remain subject to examination by these jurisdictions are 2003 and onward. On September 10, 2007 we were notified by the Franchise Tax Board that our fiscal year 2003 through 2005 returns were subject to audit. The audit is ongoing and no proposed assessments have been received.

**11. Segment, Customers, and Geographic Information**

We operate in one segment: the development, marketing, and sale of interactive user interface solutions for electronic devices and products. We generate our revenue from two broad product categories: the PC market and digital lifestyle product markets. The PC market accounted for 81% and 90% of net revenue for the three months ended September 30, 2007 and 2006, respectively.

The following is a summary of net revenue from sales to unaffiliated customers within geographic areas based on the customer location (in thousands):

|        | Three Months Ended<br>September 30, |           |
|--------|-------------------------------------|-----------|
|        | 2007                                | 2006      |
| China  | \$ 62,857                           | \$ 46,553 |
| Taiwan | 11,834                              | 3,273     |
| Korea  | 7,223                               | 408       |
| Other  | 4,778                               | 4,581     |
|        | \$ 86,692                           | \$ 54,815 |

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Major customer net revenue data as a percentage of net revenue:

|            | Three Months Ended<br>September 30, |      |
|------------|-------------------------------------|------|
|            | 2007                                | 2006 |
| Customer A | 11%                                 | *    |
| Customer B | 10%                                 | *    |
| Customer C | *                                   | 15%  |
| Customer D | *                                   | 14%  |
| Customer E | *                                   | 11%  |

Major customer accounts receivable as a percentage of accounts receivable:

|            | As of<br>September<br>30,<br>2007 | As of<br>June 30,<br>2007 |
|------------|-----------------------------------|---------------------------|
| Customer A | 12%                               | *                         |
| Customer B | 11%                               | *                         |
| Customer C | 11%                               | 12%                       |
| Customer D | *                                 | 17%                       |

\* Less than 10%

**12. Comprehensive Income**

Our comprehensive income consists of net income plus the effect of unrealized gains and losses on our short-term investments due to reductions in market value of certain of our auction rate securities and interest rate fluctuations on our fixed interest rate investments. The unrealized gains and losses on our short-term investments are considered to be temporary in nature. We use the United States dollar as the functional currency in accounting for our foreign entities and recognize remeasurement adjustments in our consolidated statement of income.

Our comprehensive income for the three months ended September 30, 2007 and 2006 is as follows:

|                                                                          | Three Months Ended<br>September 30, |       |
|--------------------------------------------------------------------------|-------------------------------------|-------|
| (In thousands)                                                           | 2007                                | 2006  |
| Net income                                                               | 11,262                              | 4,127 |
| Net unrealized gain (loss) on available-for-sale investments, net of tax | (804)                               | 259   |
| Total comprehensive income                                               | 10,458                              | 4,386 |

Included in our net unrealized gain (loss) on available-for-sale investments we recorded a pre-tax temporary impairment charge for investments in auction rate securities that failed to settle in auctions in the amount of \$1.6 million, which was partially offset by gains in certain fixed rate investments as of September 30, 2007. When evaluating our investments for possible impairment, we review factors such as the length of time and extent to which fair value has been below cost basis, the financial condition of the investee, and our ability and intent to hold the investment for a period of time which may be sufficient for anticipated recovery in market value. At this time, there is no evidence to suggest that these investments are other-than-temporarily impaired or that they will not be settled in the short term; however, we will evaluate these investments quarterly.



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**13. Recent Accounting Pronouncements**

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements, ( SFAS 157 ). SFAS 157 defines fair value, establishes a framework for measuring fair value in U.S. generally accepted accounting principles, and expands disclosure about fair value measurements. SFAS 157 applies under other accounting standards that require or permit fair value measurements. Accordingly, SFAS 157 does not require any new fair value measurement. SFAS 157 is effective beginning in our first quarter of fiscal 2009. We do not expect the adoption of SFAS 157 to have a material impact on our financial position, results of operations, or cash flows.

In February 2007, the FASB issued SFAS 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115, ( SFAS 159 ). SFAS 159 expands the use of fair value accounting to many financial instruments and certain other items. The fair value option is irrevocable and generally made on an instrument-by-instrument basis, even if a company has similar instruments that it elects not to measure based on fair value. Subsequent unrealized gains and losses on items for which the fair value option has been elected will be reported in earnings. SFAS 159 is effective beginning in our first quarter of fiscal 2009. We do not expect adoption of SFAS 159 to have a material impact on our financial position, results of operations, or cash flows.

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**ITEM 2. 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 condensed consolidated financial statements and notes in Item 1 and with our audited consolidated financial statements and notes included in our Annual Report on Form 10-K for the year ended June 30, 2007.

In addition to the historical information contained in this report, this report contains forward-looking statements, including those related to market penetration and market share in the notebook and digital lifestyle product markets; competition in the notebook and digital lifestyle product markets; revenue from the notebook and digital lifestyle product markets; growth rates of these markets; average selling prices; product design mix; manufacturing costs; cost-improvement programs; gross margins; customer relationships; research and development expenses; selling, general, and administrative expenses; legal proceedings; and liquidity and anticipated cash requirements. These forward-looking statements involve risks and uncertainties that could cause actual results to differ materially.

We caution that these statements are qualified by various factors that may affect future results, including the following: changes in the market for our products and the success of our customers' products; our success in moving products from the design phase into the manufacturing phase; changes in the competitive environment; infringement claims; warranty obligations related to product failures; the failure of key technologies to deliver commercially acceptable performance; our dependence on certain key markets; penetration into new markets; the absence of both long-term purchase and supply commitments; and our lengthy development and product acceptance cycles. This report should be read in conjunction with our Annual Report on Form 10-K for the year ended June 30, 2007, including particularly 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, entertainment, communications, and other electronic devices. We are a leading supplier of interface solutions to the notebook computer market and the hard-disk drive, or HDD, portable digital music player market. In fiscal 2007, we believe we were the market leader in providing interface solutions for notebook computers and HDD portable digital music players. 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 allows us to design products that meet the demanding design specifications of original equipment manufacturers, or OEMs.

Our manufacturing operations are based on a virtual manufacturing model in which we outsource all of our production requirements, eliminating the need for significant capital expenditures for manufacturing facilities and equipment and allowing us to reduce our investment in inventories. This approach requires us to work closely with our manufacturing subcontractors to ensure adequate production capacity to meet our forecasted production requirements. We provide our manufacturing subcontractors with six-month rolling forecasts and generally 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 manufacturing subcontractors. Currently, we use two third-party manufacturers to provide our proprietary capacitive based 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 manufacturing operations personnel. Additionally, all warranty costs 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 our ongoing cost-improvement programs. These cost-improvement programs include reducing materials and component costs, assembly and test costs, and implementing design and process improvements. As each custom-designed module 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. Generally, our products, which contain a higher percentage of third-party content, may have lower gross margins. Our newly introduced products may have lower gross margins than our more mature products that have

realized greater benefits associated with our ongoing cost-improvement programs. As a result, new product introductions may initially negatively impact our gross margins.

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Our research and development expenses include costs for supplies and materials related to product development, as well as the engineering costs incurred to design 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.

**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, share-based compensation costs, provision for income taxes, income taxes payable, and contingencies. We base our estimates on historical experience, applicable laws and regulations, 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 SEC considers an entity's most critical accounting policies to be those policies that are both most important to the portrayal of a company'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 collection 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 we provide the services 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 subcontractors 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 subcontractors, 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.

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**Table of Contents***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 volatilities 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. Further, as required under SFAS 123R, we now estimate forfeitures for share-based awards that are not expected to vest. Changes in these inputs and assumptions can materially affect the measure of estimated fair value of our share-based compensation. We charge the estimated fair value 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 adopted FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement No. 109 ( FIN 48 ) at the beginning of the first quarter of fiscal 2008. FIN 48 contains a two-step approach to recognizing and measuring uncertain tax positions accounted for in accordance with FIN 48. The first step is to determine when it is more-likely-than-not that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes. The second step is to measure the tax benefit as the largest amount that is more than 50% likely of being realized upon ultimate settlement with a taxing authority. The calculation of tax liabilities involves significant judgment in estimating the impact of uncertainties in the application of highly 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 uncertainties. 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 a determination of such estimated tax liability is made or resolved, upon the filing of an amended return, upon a change in facts, circumstances or interpretation, or upon the expiration of a statute of limitation. 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

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(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.



**Table of Contents****Results of Operations****Three months ended September 30, 2007 compared with the three months ended September 30, 2006***Net Revenue.*

| (In thousands)                         | Three Months Ended September 30, |           |           | %      |
|----------------------------------------|----------------------------------|-----------|-----------|--------|
|                                        | 2007                             | 2006      | \$ Change | Change |
| PC applications                        | \$ 70,195                        | \$ 49,256 | \$ 20,939 | 42.5%  |
| <i>% of net revenue</i>                | 81.0%                            | 89.9%     |           |        |
| Digital lifestyle product applications | 16,497                           | 5,559     | 10,938    | 196.8% |
| <i>% of net revenue</i>                | 19.0%                            | 10.1%     |           |        |
| Net revenue                            | \$ 86,692                        | \$ 54,815 | \$ 31,877 | 58.2%  |

For the quarter ended September 30, 2007, we generated \$70.2 million, or 81.0%, of net revenue from the personal computing market ( PC ) and we generated \$16.5 million, or 19.0%, of net revenue from the digital lifestyle products markets. Net revenue was \$86.7 million for the quarter ended September 30, 2007 compared with \$54.8 million for the quarter ended September 30, 2006, an increase of \$31.9 million, or 58.2%. The increase in net revenue for the quarter ended September 30, 2007 was attributable to a \$20.9 million, or 42.5%, increase in PC applications net revenue and a \$10.9 million, or 196.8%, 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 82% 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)          | Three Months Ended September 30, |          |           | % Change |
|-------------------------|----------------------------------|----------|-----------|----------|
|                         | 2007                             | 2006     | \$ Change | % Change |
| Gross Margin            | \$35,464                         | \$22,395 | \$13,069  | 58.4%    |
| <i>% of net revenue</i> | 40.9%                            | 40.9%    |           |          |

Gross margin as a percentage of net revenue was 40.9% for both the quarter ended September 30, 2007 and the quarter ended September 30, 2006 and was \$35.5 million and \$22.4 million, respectively. As each custom-designed module 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.

**Table of Contents***Operating Expenses.*

| (In thousands)                                | Three Months Ended September 30, |           |              |             |
|-----------------------------------------------|----------------------------------|-----------|--------------|-------------|
|                                               | 2007                             | 2006      | \$<br>Change | %<br>Change |
| Research and development expenses             | \$ 10,402                        | \$ 9,188  | \$ 1,214     | 13.2%       |
| <i>% of net revenue</i>                       | 12.0%                            | 16.8%     |              |             |
| Selling, general, and administrative expenses | 10,750                           | 7,801     | 2,949        | 37.8%       |
| <i>% of net revenue</i>                       | 12.4%                            | 14.2%     |              |             |
| Operating expenses                            | \$ 21,152                        | \$ 16,989 | \$ 4,163     | 24.5%       |
| <i>% of net revenue</i>                       | 24.4%                            | 31.0%     |              |             |

*Research and Development Expenses.* Research and development expenses decreased as a percentage of net revenue to 12.0% from 16.8%, while the cost of research and development activities increased \$1.2 million, or 13.2%, to \$10.4 million for the three months ended September 30, 2007 compared with \$9.2 million for the three months ended September 30, 2006. The increase in research and development expenses primarily reflected a \$756,000 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 \$154,000 increase in project expenses, including materials and related costs; and a \$136,000 increase non-cash share-based compensation costs. Non-cash share-based compensation costs included in research and development expenses were approximately \$1.2 million, or 1.4% of net revenue, and approximately \$1.0 million, or 1.9% of net revenue, for the three months ended September 30, 2007 and 2006, respectively.

*Selling, General, and Administrative Expenses.* Selling, general, and administrative expenses decreased as a percentage of net revenue to 12.4% from 14.2%, while the cost of selling, general, and administrative activities increased \$2.9 million, or 37.8%, to approximately \$10.7 million for the three months ended September 30, 2007 compared with \$7.8 million for the three months ended September 30, 2006. The increase in selling, general, and administrative expenses primarily reflected a \$1.3 million increase in outside consulting, outside service, and commission costs; a \$1.1 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; and a \$485,000 increase in travel and related costs. Non-cash share-based compensation costs included in selling, general, and administrative expenses were \$1.9 million in both the three month periods ended September 30, 2007 and 2006, representing 2.2% and 3.5% of net revenue, respectively.

*Income from Operations.*

| (In thousands)          | Three Months Ended September 30, |          |              |             |
|-------------------------|----------------------------------|----------|--------------|-------------|
|                         | 2007                             | 2006     | \$<br>Change | %<br>Change |
| Income from operations  | \$ 14,312                        | \$ 5,406 | \$ 8,906     | 164.7%      |
| <i>% of net revenue</i> | 16.5%                            | 9.9%     |              |             |

We generated operating income of \$14.3 million, or 16.5% of net revenue, for the three months ended September 30, 2007 compared with approximately \$5.4 million, or 9.9% of net revenue, for the three months ended September 30, 2006. The increase in operating income primarily reflected the impact of the increase in operating leverage resulting from the 58.2% increase in net revenue, partially offset by a \$4.2 million increase in operating expenses.

**Table of Contents***Non-Operating Income/(Loss)*

| (In thousands)             | Three Months Ended September 30, |          |           | %<br>Change |
|----------------------------|----------------------------------|----------|-----------|-------------|
|                            | 2007                             | 2006     | \$ Change |             |
| Interest income            | \$ 2,995                         | \$ 2,539 | \$ 456    | 18.0%       |
| <i>% of net revenue</i>    | 3.5%                             | 4.6%     |           |             |
| Interest expense           | (475)                            | (487)    | 12        | -2.5%       |
| <i>% of net revenue</i>    | -0.5%                            | -0.9%    |           |             |
| Gain on settlement of debt | 2,689                            |          | 2,689     |             |
| <i>% of net revenue</i>    | 3.1%                             | 0.0%     |           |             |
| Impairment of investment   | (4,000)                          |          | (4,000)   |             |
| <i>% of net revenue</i>    | -4.6%                            | 0.0%     |           |             |
| Net interest income        | \$ 1,209                         | \$ 2,052 | \$ (843)  | -41.1%      |
| <i>% of net revenue</i>    | 1.4%                             | 3.7%     |           |             |

*Interest Income.* Interest income was \$3.0 million for the three months ended September 30, 2007 compared with \$2.5 million for the three months ended September 30, 2006. The \$456,000 increase in interest income resulted from a combination of higher average interest rates and higher average invested cash balances. The increase in average invested cash balances during the past 12 months was primarily attributable to \$27.7 million of net cash flows from operations, and \$42.7 million from option activity, including excess tax benefit thereon, partially offset by \$46.7 million of treasury stock purchases under our common stock repurchase program.

*Interest Expense.* Interest expense was \$475,000 for the three months ended September 30, 2007, slightly down compared with interest expense of \$487,000 for the three months ended September 30, 2006. Interest expense primarily reflected 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.

*Gain on Settlement of Debt.* In fiscal 1998, National Semiconductor ( National ) loaned us \$1.5 million under a limited-recourse note, which we utilized to purchase 900,000 Series A preferred shares of Foveon. The note and accrued interest became due and payable in August 2007. National's sole remedy under the note was to require us to return to National a portion of Foveon Series A preferred shares purchased with the proceeds of the note.

In fiscal 1998, under the equity method of accounting, we recorded our share of losses incurred by Foveon and reduced the carrying value of this equity investment to zero. The note plus accrued interest of \$1.2 million came due in August 2007, and, in accordance with the security agreement, we relinquished the 900,000 Series A preferred shares securing the note to National in full settlement of the principal and accrued interest. Consequently, we recognized a non-operating gain upon settlement of debt in the amount of \$2.7 million in the quarter ended September 30, 2007.

*Impairment of Investment.* In fiscal 2005, we participated in an equity financing, receiving 3.9 million Series E preferred shares of Foveon for a cash investment of \$4.0 million and we are not obligated to provide additional funding to Foveon. We accounted for our Series E preferred shares of Foveon under the cost method in accordance with APB Opinion No. 18 and EITF Issues No. 02-14 and No. 03-1 because the investment is not in-substance common stock. We review this investment for impairment at least annually or more frequently as we become aware of information that might affect the carrying value of our investment.

Based on our review at September 30, 2007, we determined there was an other-than-temporary impairment of the carrying value of our investment in Foveon, due to liquidity visibility and liquidation preferences for the most recent preferred equity round. Consequently, we recognized a \$4.0 million other-than-temporary impairment charge as of September 30, 2007.



**Table of Contents***Provision for Income Taxes.*

| (In thousands)                                       | Three Months Ended September 30, |              |           |          |
|------------------------------------------------------|----------------------------------|--------------|-----------|----------|
|                                                      | 2007                             | 2006         | \$ Change | % Change |
| Income before provision for income taxes             | \$15,521                         | \$7,458      | \$8,063   | 108.1%   |
| Provision for income taxes                           | 4,259                            | 3,331        | 928       | 27.9%    |
| <i>% of income before provision for income taxes</i> | <i>27.4%</i>                     | <i>44.7%</i> |           |          |

The provision for income taxes for the three months ended September 30, 2007 was \$4.3 million compared with \$3.3 million for the three months ended September 30, 2006, reflecting higher pre-tax profit levels, partially offset by a lower effective tax rate. The provision for income tax represented estimated federal, foreign, and state taxes for the three months ended September 30, 2007 and 2006. The effective tax rate for the three months ended September 30, 2007 was 27.4% and diverged from the combined federal and state statutory rate primarily due to increased foreign income taxed at lower tax rates, accounting for share-based compensation, the benefit of research tax credits, and the impact of tax-exempt interest income, partially offset by foreign withholding taxes and the impairment of an investment for which a valuation allowance was established against the deferred tax asset. The effective tax rate for the three months ended September 30, 2006 was 44.7% and diverged from the combined federal and state statutory rate primarily due to the impact of accounting for share-based compensation and foreign withholding taxes, partially offset by the impact of tax-exempt interest income and the release of contingency reserves.

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 \$1.7 million and \$781,000 for the three months ended September 30, 2007 and 2006, respectively. Excluding the impact of share-based compensation and the related tax benefit, the effective tax rate for the three months ended September 30, 2007 and 2006 would have been 31.6% and 38.9%, 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.

Beginning in fiscal 2008, we adopted FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement No. 109 (FIN 48). As a result of our adoption of FIN 48, we now recognize liabilities for uncertain tax positions based on a two-step approach to recognizing and measuring uncertain tax positions. The first step is to determine when it is more-likely-than-not that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes. The second step is to measure the tax benefit as the largest amount that is more than 50% likely of being realized upon ultimate settlement with a taxing authority. This estimate is subjective and complex since it requires us to determine the likelihood of a number of possible outcomes. Quarterly, we reassess our uncertain tax positions, based on changes to our facts, changes in tax laws, effectively settled audits, and new audit activity. Such a change in recognition or measurement would result in the recognition of a tax benefit or an additional charge to the provision for tax in the period. Accordingly, our effective tax rate could fluctuate materially from period to period.

**Liquidity and Capital Resources**

Our cash, cash equivalents, and short-term investments of \$261.2 million as of September 30, 2007 compared with \$265.0 million as of June 30, 2007, a decline of \$3.8 million. During the three months ended September 30, 2007,

cash, cash equivalents, and short-term investments included the impact of \$5.0 million from operating cash flows and \$13.0 million from stock option exercises, offset by \$19.0 million of cash used for the repurchase of 500,000 shares of our common stock and \$1.5 million used for the purchase of property and equipment.

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*Cash Flows from Operating Activities.* Operating activities during the three months ended September 30, 2007 generated cash of approximately \$5.0 million compared with approximately \$3.7 million of cash generated during the three months ended September 30, 2006. For the three months ended September 30, 2007, net cash provided by operating activities was primarily attributable to net income of \$11.3 million plus adjustments for non-cash charges, including impairment of investment, share-based compensation costs, deferred taxes, depreciation, amortization of debt issuance costs, and the impairment of property and equipment aggregating \$9.5 million, partially offset by a \$13.1 million net increase in operating assets and liabilities and a non-cash benefit of \$2.7 million on the settlement of debt. The increase in operating assets and liabilities was primarily attributable to an \$8.9 million increase in accounts receivable, reflecting the substantial increase in our net revenue during the period and a \$7.4 million increase in inventory, reflecting an increase in our die bank, additional finished goods related to timing of delivery, and some hub inventory related to specific customers. For the three months ended September 30, 2006, net cash provided by operating activities was primarily attributable to net income of \$4.1 million plus adjustments for non-cash charges, including share-based compensation costs, depreciation, and amortization of debt issuance costs totaling \$3.8 million, partially offset by deferred tax, net of realized and excess tax benefit generated from share-based compensation aggregating \$700,000, and a \$3.5 million net increase in operating assets and liabilities.

*Cash Flows from Investing Activities.* Our investing activities typically relate to purchases of government-backed securities and investment-grade fixed income instruments and purchases of property and equipment. Investing activities during the three months ended September 30, 2007 generated net cash of \$56.9 million compared with \$12.3 million of net cash generated during the three months ended September 30, 2006. During the three months ended September 30, 2007, net cash generated by investing activities consisted of \$120.2 million in proceeds from sales and maturities of short-term investments, partially offset by \$61.8 million used for the purchase of short-term investments and \$1.5 million used for the purchase of property and equipment. During the three months ended September 30, 2006, net cash provided by investing activities consisted of proceeds from sales and maturities of short-term investments of \$82.8 million, partially offset by purchases of \$70 million of short-term investments and purchases of \$515,000 of property and equipment.

*Cash Flows from Financing Activities.* Net cash used in financing activities for the three months ended September 30, 2007 was approximately \$5.9 million compared with net cash used in financing activities of \$3.0 million for the three months ended September 30, 2006. Cash used in our financing activities for the three months ended September 30, 2007 consisted primarily of approximately \$19.0 million of cash used for the purchase of 500,000 shares of treasury stock, partially offset by approximately \$13.0 million in proceeds from common stock issued under our stock option plans. Our financing activities for the three months ended September 30, 2006 consisted primarily of \$4.6 million of cash used for the purchase of treasury stock, partially offset by \$1.5 million in proceeds from common stock issued under our stock option plans and employee stock purchase plan and \$183,000 of excess tax benefit from share-based compensation.

*Common Stock Repurchase Program.* In April 2007, our board of directors authorized an additional \$80 million for our stock repurchase program, raising the aggregate authorization level to \$160 million. The program authorizes us to repurchase our common stock on the open market or in privately negotiated transactions depending upon market conditions and other factors. 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 September 30, 2007 purchases under this program totaled 4,088,100 shares for an aggregate cost of \$91.3 million or an average cost of \$22.33 per share. As of September 30, 2007, we had \$68.7 million remaining under our stock repurchase program, which expires in April 2009.

*Convertible Senior Subordinated Notes.* In December 2004, we issued an aggregate of \$125 million of 0.75% Convertible Senior Subordinated Notes maturing December 1, 2024 (the Notes) in a private offering pursuant to Rule 144A under the Securities Act of 1933, as amended. In connection with issuing the Notes, we incurred debt issuance costs of \$4.3 million, consisting primarily of the initial purchasers' discount and costs related to legal, accounting, and printing, which are being amortized over five years. We expect to use the net proceeds for working capital and general corporate purposes and potentially for future acquisitions.

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The Notes bear interest at a rate of 0.75% per annum payable on December 1 and June 1 of each year. However, we will pay additional contingent interest on the Notes if the average trading price of the Notes is at or above 120% of the principal amount of the Notes for a specified period beginning with the six-month period commencing December 1, 2009. The amount of contingent interest payable on the Notes with respect to a six-month period, for

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which contingent interest applies, will equal 0.375% per annum of the average trading price of the Notes for a specified five trading-day period preceding such six-month period.

As a result of our irrevocable election in April 2007 to cash settle the principal amount of the Notes, no shares of common stock will be issued to settle the principal amount of the Notes and cash or common stock may be used to settle the value of the Notes in excess of \$125 million. Our election to cash settle the principal amount of the 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, we will include on a prospective basis diluted shares underlying the Notes in our diluted net income per share calculation only when the average closing stock price for the accounting period exceeds the conversion price of the Notes, which is currently \$50.53 per share.

Initially, the Notes were convertible into shares of our common stock at a conversion rate of 19.7918 shares per \$1,000 principal amount of Notes, or a total of 2,473,975 shares of common stock, which is equivalent to an initial conversion price of approximately \$50.53 per share of common stock, subject to adjustment in certain events. Through April 2007, the denominator of the diluted net income per share calculation included the weighted average effect of the 2,473,975 shares of common stock issuable upon conversion of the Notes in accordance with SFAS 128 as it applies to the method of settling the principal amount of the Notes and Emerging Issues Task Force ( EITF ) Issue No. 04-08, *The Effect of Contingently Convertible Instruments on Diluted Earnings per Share*, as it applies to the market price conversion trigger embedded in the Notes.

Through November 30, 2009, upon the occurrence of a fundamental change as defined in the indenture governing the Notes, we could potentially be obligated to issue up to 7.917 shares per \$1,000 of principal amount of Notes, or a total of 989,587 shares of common stock. The 989,587 shares, contingently issuable upon a fundamental change, are not included in the calculation of diluted net income per share.

The Notes may be converted (1) if, during any calendar quarter commencing after December 31, 2004, the last reported sale price of our common stock for at least 20 trading days in the period of 30 consecutive trading days ending on the last trading day of the preceding calendar quarter is greater than or equal to 120% of the applicable conversion price on such last trading day; (2) on or after January 1, 2020; (3) if we have called the Notes for redemption; or (4) during prescribed periods, upon the occurrence of specified corporate transactions or fundamental changes. On or after December 1, 2009, we may redeem for cash all or a portion of the Notes at a redemption price of 100% of the principal amount of the Notes plus accrued and unpaid interest, including contingent interest and additional interest, if any. Noteholders have the right to require us to repurchase all or a portion of their Notes for cash on December 1, 2009, December 1, 2014, and December 1, 2019 at a price equal to 100% of the principal amount of the Notes to be purchased plus accrued and unpaid interest, including contingent interest and additional interest, if any. As of September 30, 2007, none of the conditions for conversion of the Notes had occurred.

The Notes are unsecured senior subordinated obligations and rank junior in right of payment to all of our existing and future senior indebtedness, equal in right of payment with all of our existing and future indebtedness or other obligations that are not, by their terms, either senior or subordinated to the Notes, including trade debt and other general unsecured obligations that do not constitute senior or subordinated indebtedness, and senior in right of payment to all of our future indebtedness that, by its terms, is subordinated to the Notes. There are no financial covenants in the Notes.

*\$100 Million Shelf Registration.* 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.

*\$125 Million Shelf Registration.* 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.

*Liquidity and Capital Resources.* We believe our existing cash, cash equivalents, and short-term investment balances and anticipated cash flows from operating activities will be sufficient to meet our working capital and other

cash requirements over the course of at least the next 12 months. Our future capital requirements will depend on many factors, including our business levels, the timing and extent of spending to support product development efforts, costs

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related to protecting our intellectual property, the expansion of sales and marketing activities, the timing of introductions of new products and enhancements to existing products, the costs to ensure access to adequate manufacturing capacity, the continuing market acceptance of our product solutions, our common stock repurchase program, and the amount and timing of our investments in, or acquisitions of, other technologies or companies. Further equity or debt financing may not be available to us on acceptable terms or at all. If sufficient funds are not available or are not available on acceptable terms, our ability to take advantage of unexpected business opportunities or to respond to competitive pressures could be limited or severely constrained.

A portion of our investment portfolio is invested in double and triple A rated auction rate securities. During the quarter ended September 30, 2007, \$18.5 million of our auction rate securities failed to settle in auctions. The failures resulted in the interest rates on the investments resetting at Libor plus 50 or 100 basis points. While we now earn a premium interest rate on these investments, the investments are not liquid. In the event we need to access these funds, we will not be able to do so without a loss of principal, unless a future auction on these investments is successful. We have reduced the carrying value of these investments by \$1.6 million through other comprehensive income to reflect the temporary nature of the impairment of these investments. At this time, there is no evidence to suggest that these investments are other-than-temporarily impaired or that they will not be settled in the short term; however, we will evaluate these investments quarterly. Based on our ability to access our cash and other short-term investments, our expected operating cash flows, and our other sources of cash, we do not anticipate the lack of liquidity on these investments will affect our ability to operate our business as usual.

**Contractual Obligations and Commercial Commitments**

The following table sets forth a summary of our material contractual obligations and commercial commitments as of September 30, 2007 (in millions):

| Contractual Obligations                          | Total  | Payments due by period |           |           |                   |
|--------------------------------------------------|--------|------------------------|-----------|-----------|-------------------|
|                                                  |        | Less than 1 year       | 1-3 Years | 3-5 Years | More than 5 Years |
| Convertible senior subordinated notes (1)<br>(2) | \$ 142 | \$ 1                   | \$ 2      | \$ 2      | \$ 137            |
| Building leases                                  | 1      | 1                      |           |           |                   |
| Total                                            | \$ 143 | \$ 2                   | \$ 2      | \$ 2      | \$ 137            |

(1) Represents both principal and interest payable through the maturity date of the underlying contractual obligation.

(2) Our convertible senior subordinated notes include a provision allowing the noteholders to

require us, at the noteholders discretion, to repurchase their notes at a redemption price of 100% of the principal amount of the notes plus accrued and unpaid interest (including contingent interest and additional interest, if any) on December 1, 2009, December 1, 2014, and December 1, 2019 and in the event of a fundamental change as described in the indenture governing the notes. The early repayment of the notes is not reflected in the above schedule, but if all the noteholders elected to exercise their rights to require us to repurchase their notes on December 1, 2009, then our contractual obligations for the one-to-three year period would be increased by \$125 million and no amounts

would be due in  
more than three  
years.

**Recent Accounting Pronouncements**

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements, ( SFAS 157 ). SFAS 157 defines fair value, establishes a framework for measuring fair value under U.S. generally accepted accounting principles, and expands disclosure about fair value measurements. SFAS 157 applies under other accounting standards that require or permit fair value measurements. Accordingly, SFAS 157 does not require any new fair value measurement. SFAS 157 is effective beginning in our first quarter of fiscal 2009. We do not expect the adoption of SFAS 157 to have a material impact on our financial position, results of operations, or cash flows.

In February 2007, the FASB issued SFAS 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115, ( SFAS 159 ). SFAS 159 expands the use of fair value accounting to many financial instruments and certain other items. The fair value option is irrevocable and generally made on an instrument-by-instrument basis, even if a company has similar instruments that it elects not to measure based on fair value. Subsequent unrealized gains and losses on items for which the fair value option has been

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ected will be reported in earnings. SFAS 159 is effective beginning in our first quarter of fiscal 2009. We do not expect adoption of SFAS 159 to have a material impact on our financial position, results of operations, or cash flows.

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Our market risk has not changed significantly from the interest rate and foreign currency risks disclosed in Item 7A of our Annual Report on Form 10-K for the fiscal year ended June 30, 2007.

**ITEM 4. CONTROLS AND PROCEDURES**

As of the end of the period covered by this report, our Chief Executive Officer and Chief Financial Officer have reviewed and evaluated the effectiveness of our disclosure controls and procedures, which included inquiries made to certain other of our employees. Based on their evaluation, our Chief Executive Officer and Chief Financial Officer have each concluded that our disclosure controls and procedures are designed to ensure that information required to be disclosed is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, to allow timely decisions regarding required disclosure and are effective and sufficient to ensure that we record, process, summarize, and report information required to be disclosed by us in our periodic reports filed under the Securities Exchange Act within the time periods specified by the Securities and Exchange Commission's rules and forms.

During the fiscal quarter covered by this report, there have not been any changes in our internal control over financial reporting that have materially affected, or a reasonably likely to materially affect, our internal control over financial reporting.

**Table of Contents****PART II OTHER INFORMATION****ITEM 1. 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.

The Elantech patent relates to recognizing the presence of multiple fingers on a touchpad. We have multiple ways to accomplish that and have our own patents for detecting multiple fingers. We have used two types of software in our products ( Type 1 Code and Type 2 Code ) to detect multiple fingers.

In October 2007, the Court heard oral arguments on our motion for summary judgment of noninfringement of the Elantech patent and Elantech's cross-motion for summary judgment of infringement. The Court granted our motion for partial summary judgment of noninfringement as to products containing Type 1 Code and denied our motion for partial summary judgment of noninfringement as to products containing Type 2 Code. In addition, the Court denied Elantech's motion for summary judgment that our Type 1 and Type 2 Codes infringe Elantech's intellectual property. The Court indicated, however that it would grant summary judgment of infringement for products implementing the Type 2 Code with enabled finger counting functionality but Elantech did not move for partial summary judgment. We do not believe any aspect of the Court's decision will have a material effect on our business.

We intend to vigorously defend our patents and pursue our counterclaims. We have not recorded any liability associated with Elantech's claims pursuant to SFAS No. 5 Accounting for Contingencies, and have expensed as incurred all legal fees associated with the legal proceedings.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS****Issuer Purchases of Equity Securities**

In April 2007, our board of directors authorized a further expansion of our stock repurchase program for up to an additional \$80 million, raising the aggregate authorization level to \$160 million and extending the period for repurchase to April 2009. The following sets forth purchases of our common stock under the repurchase program for each fiscal month during the three month period ended September 29, 2007:

| Period                               | Total<br>Number<br>of Shares<br>Purchased | Average<br>Price<br>Paid<br>per<br>Share | Total<br>Number of<br>Shares<br>Purchased<br>as Part of<br>Publicly<br>Announced<br>Program | Maximum<br>Dollar Value<br>of Shares<br>that May<br>Yet Be<br>Purchased<br>Under the<br>Program |
|--------------------------------------|-------------------------------------------|------------------------------------------|---------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------|
| July 1, 2007 - July 28, 2007         |                                           |                                          | 3,588,100                                                                                   | \$87,655,000                                                                                    |
| July 29, 2007 - August 25, 2007      | 500,000                                   | \$37.90                                  | 4,088,100                                                                                   | \$68,704,000                                                                                    |
| August 26, 2007 - September 29, 2007 |                                           |                                          | 4,088,100                                                                                   | \$68,704,000                                                                                    |
| Total                                | 500,000                                   | \$37.90                                  |                                                                                             |                                                                                                 |

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**ITEM 6. EXHIBITS**

|         |                                                                                                        |
|---------|--------------------------------------------------------------------------------------------------------|
| 10.6(d) | Amended and Restated 2001 Incentive Compensation Plan (as amended through January 23, 2007)            |
| 10.7(c) | Corrected Amended and Restated 2001 Employee Stock Purchase Plan (as amended through January 23, 2007) |
| 31.1    | Certification of Chief Executive Officer                                                               |
| 31.2    | Certification of Chief Financial Officer                                                               |
| 32.1    | Section 1350 Certification of Chief Executive Officer                                                  |
| 32.2    | Section 1350 Certification of Chief Financial Officer                                                  |

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**SIGNATURES**

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

**SYNAPTICS INCORPORATED**

Date: November 8, 2007

By: /s/ Francis F. Lee

Name:

Francis F. Lee

Title: President and Chief Executive Officer

By: /s/ Russell J. Knittel

Name: Russell J. Knittel

Title: Executive Vice President, Chief  
Financial Officer, and Chief  
Administrative Officer

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