

SYNAPTICS INC
Form 10-K
September 07, 2006

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**SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-K
ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934
For the Fiscal Year Ended June 24, 2006
Commission File Number 000-49602
SYNAPTICS INCORPORATED
(Exact name of registrant as specified in its charter)**

Delaware	77-0118518
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
3120 Scott Blvd., Ste 130 Santa Clara, California	95054
(Address of principal executive offices)	(Zip Code)
(408) 454-5100	

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

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

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

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

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

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.

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 Act). Yes No

The aggregate market value of Common Stock held by nonaffiliates of the registrant (20,082,352 shares) based on the closing price of the registrant's Common Stock as reported on the Nasdaq Global Select Market on December 23, 2005, was \$494,025,859. For purposes of this computation, all officers, directors, and 10% beneficial owners of the registrant are deemed to be affiliates. Such determination should not be deemed to be an admission that such officers, directors, or 10% beneficial owners are, in fact, affiliates of the registrant.

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As of September 1, 2006, there were outstanding 25,046,353 shares of the registrant's Common Stock, par value \$.001 per share.

Documents Incorporated by Reference

Portions of the registrant's definitive Proxy Statement for the 2006 Annual Meeting of Stockholders are incorporated by reference into Part III of this Form 10-K.

SYNAPTICS INCORPORATED
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Statement Regarding Forward-Looking Statements

The statements contained in this report on Form 10-K that are not purely historical are forward-looking statements within the meaning of applicable securities laws. Forward-looking statements include statements regarding our expectations, anticipation, intentions, beliefs, or strategies regarding the future, whether or not those words are used. Forward-looking statements also include statements regarding revenue, margins, expenses, and earnings analysis for fiscal 2007 and thereafter; technological innovations; products or product development, including their performance, market position, and potential; our product development strategies; potential acquisitions or strategic alliances; the success of particular product or marketing programs; the amounts of revenue generated as a result of sales to significant customers; and liquidity and anticipated cash needs and availability. All forward-looking statements included in this report are based on information available to us as of the filing date of this report, and we assume no obligation to update any such forward-looking statements. Our actual results could differ materially from the forward-looking statements. Among the factors that could cause actual results to differ materially are the factors discussed in Item 1A. Risk Factors.

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PART I

ITEM 1. BUSINESS

Overview

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

We are the market leader in providing interface solutions for notebook computers. Our original equipment manufacturer, or OEM, customers include tier one PC OEMs. We generally supply our OEM customers through their contract manufacturers, which take delivery of our products and pay us directly for them.

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

PC Market

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

The latest industry projections for notebook unit growth for the period 2006-2010 show a compound annual growth rate of 16.1% compared with 5.4% for desktop computers, reflecting the continued migration of desktops to notebooks fueled by users' desire for mobile computing and on-the-go access to applications, information, and digital content, which is expanding on a daily basis. Based on the strength of our technology and engineering know-how, we believe we are well positioned to take advantage of the growth opportunity in the notebook market and to provide innovative, value-added interface solutions for each of the key end-user preferences. We estimate that in fiscal 2006 approximately 80% of all notebook computers sold used solely a touch pad interface; 4% used solely a pointing stick interface; and 16% used a dual pointing interface, which consists of both a touch pad and a pointing stick. Our notebook product lines of touch pads and pointing sticks allow us to address 100% of the notebook market.

Digital Lifestyle Product Markets

We believe our extensive intellectual property portfolio, our experience in providing interface solutions to major OEMs of electronic devices, and our proven track record of growth in our expanding core notebook computer interface business position us to be a key technological enabler for multiple consumer electronic devices targeted to meet the growing digital lifestyle trend. Based on these strengths, we are addressing the opportunities created by the growth of mobile computing, communications, and entertainment devices within the digital lifestyle products markets. Digital lifestyle products include portable digital music and video players, mobile phones, remote controls, personal digital assistants, or PDAs, as well as a variety of mobile, handheld, wireless, and entertainment devices. We believe our existing technologies, our range of product solutions, and our emphasis on ease of use, small size,

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low power consumption, advanced functionality, durability, and reliability will enable us to serve multiple aspects of the markets for digital lifestyle products and other electronic devices.

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

Industry projections for the portable digital music player market for the period 2006-2009 suggest a compound annual growth rate of 9.3% for the overall market and a compound annual growth rate exceeding 16.7% for the hard disk drive, or HDD, portion of the market, reflecting the trend toward portable digital music player products containing greater data storage capacities. These products require a simple, durable, and intuitive user interface solution to navigate efficiently through menus and scroll through extensive play lists and songs contained in the host device. We believe we are well positioned to take advantage of this growing market based on our technology, engineering know-how, and the acceptance of our custom-designed user interface solutions by OEMs in this market.

Our Strategy

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

Extend Our Technological Leadership

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

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

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

Capitalize on Growth of New Markets

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

Emphasize and Expand Customer Relationships

We plan to emphasize and expand our strong and long-lasting customer relationships and to provide the most advanced interface solutions for our customers' products. We believe that our interface solutions enable our customers to deliver a positive user experience and to differentiate their products from those of their competitors.

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We continually attempt to enhance the competitive position of our customers by providing them with innovative, distinctive, and high-quality interface solutions on a timely and cost-effective basis. To do so, we work continually to improve our productivity, to reduce costs, and to speed the delivery of our interface solutions. We endeavor to streamline the entire design and delivery process through our ongoing design, engineering, and production improvement efforts. We also devote considerable effort to support our customers after the purchase of our interface solutions.

Pursue Strategic Relationships and Acquisitions

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

Continue Virtual Manufacturing

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

Product Solutions

We develop, enhance, and acquire interface technologies that enrich the interaction between people and their mobile computing, communications, and entertainment devices. Our innovative and intuitive interfaces can be engineered to accommodate many diverse platforms, and our expertise in human factors and usability can be utilized to improve the features and functionality of our solutions. Our extensive array of technologies includes ASICs, firmware, software, and pattern recognition and touch sensing technologies

Our interface solutions are custom engineered, total solutions for our customers and include sensor design, module layout, ASICs, firmware, and software features for which we provide manufacturing and design support and device testing. This allows us to be a one-stop supplier for complete interface design from the early design stage, to manufacturing, to testing and support. Through our technologies and expertise, we seek to provide our customers with customized solutions that address their individual design issues and result in high-performance, feature-rich, and reliable interface solutions. We believe our interface solutions offer the following characteristics:

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

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

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

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

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

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

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

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

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

customized, modular integration;

reduced product development costs;

shorter product time to market;

compact and efficient platforms;

improved product functionality and utility; and

product differentiation.

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

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

Products

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

TouchPad

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

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

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

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

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

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

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

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

TouchStyk

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

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

Dual Pointing Solutions

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

cost-effective and simplified OEM integration;

simplified OEM product line because one device contains both solutions;

single-source supplier, which eliminates compatibility issues; and

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

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

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LuxPad

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

Dual Mode TouchPad

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

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

QuickStroke

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

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

TouchRing

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

ScrollStrip

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

LightTouch

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

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MobileTouch

MobileTouch is a new product solution specifically designed for the mobile phone environment that combines our expertise in ease of use with our technology capabilities. The result is custom designed modules that can combine our scrolling, selection, and navigation capabilities into a simple, easy to use interface solution that improves access to mobile phone content and applications. Our MobileTouch solutions are currently shipping in Samsung and Pantech & Curitel mobile phone designs in Korea.

ClearPad

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

NavPoint

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

Technologies

We have developed and own an extensive array of technologies encompassing ASICs, firmware, software, pattern recognition, and touch sensing technologies. With 81 U.S. patents issued and 55 U.S. patents pending, including many non-U.S. counterparts, we continue to develop technology in these areas. We believe these technologies and the related intellectual property create barriers for competitors and allow us to provide interface solutions in a variety of high-growth market segments.

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

capacitive position sensing technology;

capacitive force sensing technology;

transparent capacitive position sensing technology;

pattern recognition technology;

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

proprietary microcontroller technology.

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

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

Capacitive Force Sensing Technology. This technology senses the direction and magnitude of a force applied to an object. The object can either move when force is applied, like a typical joystick used for gaming

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

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

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

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

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

Competing Technology

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

Research and Development

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

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

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development capabilities, leverage our technology, and shorten our time to market with new technological applications.

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

As of June 30, 2006, we employed 145 people in our technology, engineering, and product design functions in the United States, the United Kingdom, Taiwan, and Hong Kong. Our research and development expenses were approximately \$21.4 million, \$25.0 million, and \$35.4 million in fiscal 2004, 2005, and 2006, respectively.

Intellectual Property Rights

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

As of June 30, 2006, we held 81 U.S. patents and had 55 U.S. pending patent applications, including many non-U.S. counterparts to the U.S. patents and U.S. pending patent applications. Collectively, these patents and patent applications cover various aspects of our key technologies, including touch sensing, pen sensing, handwriting recognition, customizable tap zones, edge motion, and virtual scrolling technologies. Our proprietary software is protected by copyright laws. The source code for our proprietary software is also protected under applicable trade secret laws.

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

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

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

Other companies, including our competitors, may develop technologies that are similar or superior to our technologies, duplicate our technologies, or design around our patents and may have or obtain patents or other proprietary rights that would prevent, limit, or interfere with our ability to make, use, or sell our products. Effective intellectual property protection may be unavailable or limited in some foreign countries in which we operate, such as

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China and Taiwan. Unauthorized parties may attempt to copy or otherwise use aspects of our technologies and products that we regard as proprietary. There can be no assurance that our means of protecting our proprietary rights in the United States or abroad will be adequate or that competitors will not independently develop similar technologies. If our intellectual property protection is insufficient to protect our intellectual property rights, we could face increased competition in the market for our technologies and products.

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

Customers

Our customers include many of the world's largest PC OEMs, based on unit shipments, as well as a variety of consumer electronics manufacturers. Our demonstrated track record of technological leadership, design innovation, product performance, cost effectiveness, and on-time delivery have resulted in our leadership position in providing interface solutions to the notebook market. We believe our strong relationship with our OEM customers, many of which are currently developing digital lifestyle products, will position us as a source of supply for their product offerings.

In fiscal 2006, our OEM customers included the following:

Acer

Asustek

Creative Labs

Dell

ECS

Fujitsu

Gateway

Hewlett-Packard

IBM

Lenovo

NEC

Philips

Samsung

Toshiba

We generally supply products to our OEM customers through their contract manufacturers. We sell our products directly to these contract manufacturers, which include Compal, Inventec, Kangzhun Electronical, Lenovo, Sincere Joy, and Wistron. Sales to Inventec and Wistron in the aggregate accounted for approximately 24% of our net

revenue in fiscal 2006, and sales to Inventec accounted for approximately 34% of our net revenue in fiscal 2005. No other customer accounted for more than 10% of our net revenue during either fiscal 2005 or 2006.

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

Strategic Relationships

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

Sales and Marketing

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

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management, design engineers, and our sales personnel interacting with our customers' decision makers throughout the product development and order process.

We currently employ 51 sales and marketing professionals. We maintain seven customer support offices domestically and internationally, which are located in the United States, the United Kingdom, Taiwan, Japan, China, and Hong Kong. In addition, we utilize sales representatives in Singapore, Malaysia, Korea, and Europe and sales distributors in Japan.

International sales, primarily in the Asian and European markets, constituted approximately 96%, 98%, and 98% of our revenue in fiscal 2004, 2005, and 2006, respectively. A significant portion of these sales were made to companies located in China and Taiwan that provide manufacturing services for major notebook computer and digital lifestyle product OEMs. All of these sales were denominated in U.S. dollars.

Manufacturing

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

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

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

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

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. Write-downs to reduce the carrying value of obsolete, slow moving, and non-usable inventory to net realizable value are charged to cost of revenue.

Backlog

As of June 30, 2006, we had a backlog of orders of approximately \$28.7 million, an increase of \$3.3 million compared with our backlog of orders as of June 30, 2005 of approximately \$25.4 million. The increase in backlog is primarily related to the increase in demand for our products. Our backlog consists of product orders for which purchase orders have been received and which are generally scheduled for shipment within three months. Most orders are subject to rescheduling or cancellation with limited penalties. Because of the possibility of customer changes in product shipments, our backlog as of a particular date may not be indicative of net sales for any succeeding period.

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Competition

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

In the notebook interface market we plan to continue to compete primarily on the basis of our technological expertise, design innovation, customer service, and the long track record of performance of our interface solutions, including their ease of use, reliability, and cost-effectiveness as well as their timely design, production, and delivery schedules. Our pointing stick solutions, including our proprietary TouchStyk, enable us to address the approximate 4% of the notebook computer market that uses solely a pointing stick rather than a touch pad as the user interface as well as the approximate 16% of the notebook market that uses dual pointing interfaces. Our ability to supply OEMs with TouchPads, TouchStyks, and dual pointing alternatives enhances our market position as we can provide OEMs with the following advantages:

single source supplier to eliminate compatibility issues;

cost-effective and simplified integration;

simplified product line to address both interface preferences;

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

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

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

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

Employees

As of June 30, 2006, we employed a total of 254 persons, including 58 in finance, administration, and operations; 51 in sales and marketing; and 145 in research and development. Of these employees, 184 were located in North America, 48 in Asia/Pacific, and 22 in Europe. We consider our relationship with our employees to be good, and none of our employees are represented by a union in collective bargaining with us.

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

Executive Officers

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

Name	Age	Position
Francis F. Lee	54	President, Chief Executive Officer, and Director
Thomas J. Tiernan	43	Senior Vice President and General Manager
Russell J. Knittel	56	Senior Vice President, Chief Financial Officer, Chief Administrative Officer, Secretary, and Treasurer
Shawn P. Day, Ph.D.	40	Vice President of Research and Development
Thomas D. Spade	40	Vice President of Worldwide Sales
William T. Stacy, Ph.D.	64	Vice President of Operations
Clark F. Foy	42	Vice President of Marketing

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

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

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

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

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Thomas D. Spade has been the Vice President of Worldwide Sales of our company since July 1999. From May 1998 until June 1999, he served as our Director of Sales. From May 1996 until April 1998, Mr. Spade was the Director of International Sales for Alliance Semiconductor. Mr. Spade previously has held additional sales and management positions at Alliance Semiconductor, Anthem Electronics, Arrow Electronics, and Andersen Consulting. Mr. Spade holds a Bachelor of Arts degree in economics and management from Albion College.

William T. Stacy, Ph.D. has been the Vice President of Operations of our company since October 2001. From August 1992 to June 2001, Mr. Stacy held a number of business management positions in the Data Management and Analog Groups of National Semiconductor. Most recently, from April 1999 until June 2001, he was Vice President of the Wireless Division. Prior to joining National Semiconductor, he held a series of operational and business management positions at Philips Semiconductors. He started his career in Philips Research Laboratories in Eindhoven, where he worked on magnetic and semiconducting device structures. Mr. Stacy holds a Bachelor of Science degree in physics and mathematics from Oregon State University and a Masters and Ph.D. degree in physics from the University of Illinois.

Clark F. Foy has been Vice President of Marketing of our company since February 2003. Mr. Foy was the Vice President of Product Marketing for the Optical Storage Group of Oak Technology, Inc. from January 2002 to February 2003. Mr. Foy served as Vice President of Marketing at Gadzoox Networks, a provider of networking infrastructure products from June 2000 to January 2002. Mr. Foy has also held various management positions at Quantum Corporation and Compaq Computer Corporation. Mr. Foy holds a Bachelor's Degree in Business Administration from Miami University and a Masters of Management from Northwestern University's Kellogg Graduate School of Management.

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ITEM 1A. RISK FACTORS

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

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

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

Sales of our interface solutions for digital lifestyle products have been volatile in the past two years, and we cannot assure you that our net revenue from our interface solutions for digital lifestyle products will increase or be less volatile in the future.

Sales of our interface solutions for digital lifestyle products have been volatile in the past. We cannot assure you that our net revenue from our interface solutions for digital lifestyle products will increase or be less volatile in the future. Sales of our interface solutions for digital lifestyle products were \$85.3 million, or 41% of our net revenue, in fiscal 2005 and \$27.0 million, or 15% of our net revenue, in fiscal 2006. Further, our interface business for digital lifestyle products faces many uncertainties. Our inability to address these uncertainties successfully and to become a leading supplier of interfaces for digital lifestyle products would result in a slower growth rate than we currently anticipate. We do not know whether our user interface solutions for the digital lifestyle product market will gain market acceptance or will ever result in a substantial portion of our revenue on a consistent basis. The failure to succeed in these other markets would result in no return on the substantial investments we have made to date and plan to make in the future to penetrate these markets.

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

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

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

the development and growth of these markets;

the ability of our technologies and product solutions to address the needs of these markets, the requirements of OEMs, and the preferences of end users; and

our ability to provide OEMs with interface solutions that provide advantages in terms of size, power consumption, reliability, durability, performance, and value-added features compared to alternative solutions.

Many manufacturers of these products have well-established relationships with competitive suppliers. Penetrating these markets will require us to offer better performance alternatives to existing solutions at competitive costs. We generally do not have a significant backlog of orders for our interface solutions to be incorporated in products in these markets. The failure of any of these target markets to develop as we expect, or our failure to

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penetrate these markets to a significant extent, will impede our anticipated sales growth and could result in substantially reduced earnings from those we anticipate. We cannot predict the size or growth rate of these markets or the market share we will achieve in these markets in the future.

Our historical financial performance is based on sales of interface solutions to the notebook computer market and may not be indicative of our future performance in other markets.

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

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

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

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

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

Because our success depends on the widespread market acceptance of our customers products, we must continue to maintain our relationships with the leading notebook computer and portable digital music player OEMs. In additio