IMMERSION CORP
Form 10-Q
May 10, 2007

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

FORM 10-Q

(MARK ONE)

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

For the quarterly period ended March 31, 2007

OR

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

For the transition period from __________ to __________.

Commission file number 000-27969

IMMERSION CORPORATION

(Exact name of registrant as specified in its charter)

Delaware	**94-3180138**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*

801 Fox Lane, San Jose, California 95131

(Address of principal executive offices)(Zip Code)

(408) 467-1900

(Registrant s telephone number, including area code)

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

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 o	Accelerated filer þ	Non-accelerated filero

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o	No þ

Number of shares of common stock outstanding at May 4, 2007: 25,997,715

IMMERSION CORPORATION

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

	March 31, 2007	December 31, 2006
ASSETS		
Current assets:		
Cash and cash equivalents	$ 137,586	$ 32,012
Accounts receivable (net of allowances for doubtful accounts of: March 31, 2007 $72 and December 31, 2006 $139)	3,261	5,153
Inventories, net	3,287	2,639
Deferred income taxes	4,267	
Prepaid expenses and other current assets	1,071	1,179
Total current assets	149,472	40,983
Property and equipment, net	1,597	1,647
Intangibles and other assets, net	8,758	7,385
Total assets	$ 159,827	$ 50,015
LIABILITIES AND STOCKHOLDERS EQUITY (DEFICIT)		
Current liabilities:		
Accounts payable	$ 1,352	$ 2,334
Accrued compensation	1,673	1,526
Income taxes payable	11,035	
Other current liabilities	2,134	1,750
Deferred revenue and customer advances	4,819	1,716
Total current liabilities	21,013	7,326
Long-term debt, less current portion	18,280	18,122
Long-term deferred revenue, less current portion	12,200	31,784
Long-term customer advance from Microsoft		15,000
Other long-term liabilities	783	775
Total liabilities	52,276	73,007
Contingencies (Note 15)		
Stockholders equity (deficit):		

Common stock and additional paid-in capital $0.001 par value; 100,000,000 shares authorized; shares issued and outstanding: March 31, 2007 25,918,242 and December 31, 2006 24,797,572	118,618	110,501
Warrants	3,679	3,686
Accumulated other comprehensive income	67	67
Accumulated deficit	(14,813)	(137,246)
Total stockholders equity (deficit)	107,551	(22,992)
Total liabilities and stockholders equity (deficit)	$ 159,827	$ 50,015

See accompanying Notes to Condensed Consolidated Financial Statements.

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

	Three Months Ended March 31, 2007	Three Months Ended March 31, 2006
Revenues:		
Royalty and license	$ 2,211	$ 1,910
Product sales	3,590	3,366
Development contracts and other	613	756
Total revenues	6,414	6,032
Costs and expenses:		
Cost of product sales (exclusive of amortization of intangibles shown separately below)	1,543	1,355
Sales and marketing	2,703	3,077
Research and development	2,543	1,729
General and administrative	3,259	2,811
Amortization of intangibles	254	210
Litigation conclusions and patent license	(134,900)	(650)
Total costs and expenses	(124,598)	8,532
Operating income (loss)	131,012	(2,500)
Interest and other income	361	103
Interest expense	(406)	(407)
Income (loss) before provision for income taxes	130,967	(2,804)
Provision for income taxes	(8,534)	(102)
Net income (loss)	$ 122,433	$ (2,906)
Basic net income (loss) per share	$ 4.83	$ (0.12)
Shares used in calculating basic net income (loss) per share	25,343	24,419
Diluted net income (loss) per share	$ 4.13	$ (0.12)
Shares used in calculating diluted net income (loss) per share	29,683	24,419

See accompanying Notes to Condensed Consolidated Financial Statements.

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

	Three Months Ended March 31,	
	2007	**2006**
Cash flows from operating activities:		
Net income (loss)	$ 122,433	$ (2,906)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	213	168
Amortization of intangibles	254	210
Stock-based compensation	634	723
Excess tax benefits from stock-based compensation	(2,940)	(16)
Interest expense accretion on 5% Convertible Debenture	158	158
Fair value adjustment of Put Option and Registration Rights	(1)	(5)
Loss on disposal of equipment		3
Changes in operating assets and liabilities:		
Accounts receivable	1,894	884
Inventories	(648)	(6)
Deferred income taxes	(5,508)	
Prepaid expenses and other current assets	110	53
Accounts payable	(1,082)	(1,277)
Accrued compensation and other current liabilities	528	231
Income taxes payable	13,975	
Deferred revenue and customer advances	(31,481)	4,555
Other long-term liabilities	10	
Net cash provided by operating activities	98,549	2,775
Cash flows used in investing activities:		
Intangibles and other assets	(386)	(280)
Purchases of property and equipment	(163)	(198)
Net cash used in investing activities	(549)	(478)
Cash flows from financing activities:		
Issuance of common stock under employee stock purchase plan	147	126
Exercise of stock options and warrants	4,389	350
Excess tax benefits from stock-based compensation	2,940	16
Payments on notes payable and capital leases		(3)
Net cash provided by financing activities	7,476	489
Effect of exchange rates on cash and cash equivalents	98	(12)
Net increase in cash and cash equivalents	105,574	2,774

Cash and cash equivalents:		
Beginning of the period	32,012	28,171
End of the period	$ 137,586	$ 30,945
Supplemental disclosure of cash flow information:		
Cash paid for taxes	$ 10	$ 6
Cash paid for interest	$ 250	$ 254

See accompanying Notes to Condensed Consolidated Financial Statements.

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IMMERSION CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
March 31, 2007
(Unaudited)

1. SIGNIFICANT ACCOUNTING POLICIES

Description of Business Immersion Corporation (the Company) was incorporated in 1993 in California and reincorporated in Delaware in 1999 and develops, manufactures, licenses, and supports a wide range of hardware and software technologies and products that enhance digital devices with touch interaction.

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

The accompanying condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial information and with the instructions for Form 10-Q and Article 10 of Regulation S-X and, therefore, do not include all information and footnotes necessary for a complete presentation of the financial position, results of operations, and cash flows, in conformity with accounting principles generally accepted in the United States of America. These condensed consolidated financial statements should be read in conjunction with the Company s audited consolidated financial statements included in the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 2006. In the opinion of management, all adjustments consisting of only normal recurring items necessary for the fair presentation of the financial position and results of operations for the interim periods have been included.

The results of operations for the interim periods ended March 31, 2007 are not necessarily indicative of the results to be expected for the full year.

Revenue Recognition The Company recognizes revenues in accordance with applicable accounting standards, including Staff Accounting Bulletin (SAB) No. 104, Revenue Recognition (SAB No. 104), Emerging Issues Task Force (EITF) No. 00-21, Accounting for Revenue Arrangements with Multiple Deliverables (EITF No. 00-21), and the American Institute of Certified Public Accountants (AICPA) Statement of Position (SOP) 97-2, Software Revenue Recognition, as amended. Revenue is recognized when persuasive evidence of an arrangement exists, delivery has occurred or service has been rendered, the fee is fixed and determinable, and collectibility is probable. The Company derives its revenues from three principal sources: royalty and license fees, product sales, and development contracts.

Royalty and license revenue The Company recognizes royalty and license revenue based on royalty reports or related information received from the licensee as well as time-based licenses of its intellectual property portfolio. Up-front payments under license agreements are deferred and recognized as revenue based on either the royalty reports received or amortized over the license period depending on the nature of the agreement. Advance payments under license agreements that also require the Company to provide future services to the licensee are deferred and recognized over the service period when vendor-specific objective evidence (VSOE) related to the value of the services does not exist.

The Company generally recognizes revenue from its licensees under one or a combination of the following models:

License revenue model	Revenue recognition
Perpetual license of intellectual property portfolio based on per unit royalties, no services contracted.	Based on royalty reports received from licensees. No further obligations to licensee exist.
Time-based license of intellectual property portfolio with up-front payments and/or annual minimum royalty requirements, no services contracted. Licensees have certain rights to updates to the intellectual property portfolio during the contract period.	Based on straight-line amortization of annual minimum/up-front payment recognized over contract period or annual minimum period.

Perpetual license of intellectual property portfolio or technology license along with contract for development work.	Based on cost-to-cost percentage-of-completion accounting method over the service period. Obligation to licensee exists until development work is complete.
License of software or technology, no modification necessary, no services contracted.	Up-front revenue recognition based on SOP 97-2 criteria or EITF No. 00-21, as applicable.

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Individual contracts may have characteristics that do not fall within a specific license model or may have characteristics of a combination of license models. Under those circumstances, the Company recognizes revenue in accordance with SAB No. 104, EITF No. 00-21, and SOP 97-2, as amended, to guide the accounting treatment for each individual contract. See also the discussion regarding Multiple element arrangements below. If the information received from the Company s licensees regarding royalties is incorrect or inaccurate, the Company s revenues in future periods may be adversely affected. To date, none of the information the Company has received from its licensees has caused any material adjustment to period revenues.

Product sales The Company recognizes revenues from product sales when the product is shipped, provided that collection is determined to be probable and no significant obligation remains. The Company sells the majority of its products with warranties ranging from 3 to 24 months. The Company records the estimated warranty costs during the quarter the revenue is recognized. Historically, warranty-related costs and related accruals have not been significant. The Company offers a general right of return on the MicroScribe® product line for 14 days after purchase. The Company recognizes revenue at the time of shipment of a MicroScribe digitizer and provides an accrual for potential returns based on historical experience. The Company offers no other general right of return on its products.

Development contracts and other revenue Development contracts and other revenue is comprised of professional services (consulting services and/or development contracts), customer support, and extended warranty contracts. Development contract revenues are recognized under the cost-to-cost percentage-of-completion accounting method based on physical completion of the work to be performed. Losses on contracts are recognized when determined. Revisions in estimates are reflected in the period in which the conditions become known. Customer support and extended warranty contract revenue is recognized ratably over the contractual period.

Multiple element arrangements The Company enters into revenue arrangements in which the customer purchases a combination of patent, technology, and/or software licenses, products, professional services, support, and extended warranties (multiple element arrangements). When VSOE of fair value exists for all elements, the Company allocates revenue to each element based on the relative fair value of each of the elements. The price charged when the element is sold separately generally determines the fair value or VSOE.

The Company s revenue recognition policies are significant because the Company s revenues are a key component of its results of operations. In addition, the Company s revenue recognition policies determine the timing of certain expenses, such as commissions and royalties.

Recent Accounting Pronouncements In June 2006, the Financial Accounting Standards Board (FASB) issued Financial Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with Statement of Financial Accounting Standard (SFAS) No. 109 Accounting for Income Taxes, (SFAS No. 109). FIN 48 prescribes a two-step process to determine the amount of benefit to be recognized. First, the tax position must be evaluated to determine the likelihood that it will be sustained upon examination. If the tax position is deemed more-likely-than-not to be sustained, the tax position is then measured to determine the amount of benefit to recognize in the financial statements. The tax position is measured at the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement. The Company adopted the provisions of FIN 48 on January 1, 2007. The adoption of FIN 48 resulted in no adjustment to beginning retained earnings as the Company had a full valuation allowance on the deferred tax assets as of the adoption date. See Note 11.

In September 2006, the FASB issued Statement No. 157, Fair Value Measurements, (SFAS No. 157). SFAS No. 157 establishes a framework for measuring fair value by providing a standard definition for fair value as it applies to assets and liabilities. SFAS No. 157, which does not require any new fair value measurements, clarifies the application of other accounting pronouncements that require or permit fair value measurements. The effective date for the Company

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is January 1, 2008. The Company is currently evaluating the effect that the adoption of SFAS No. 157 will have on its financial position and results of operations.

In February 2007, the FASB issued Statement No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (SFAS No. 159). The new Statement allows entities to choose, at specified election dates, to measure eligible financial assets and liabilities at fair value in situations in which they are not otherwise required to be measured at fair value. If a company elects the fair value option for an eligible item, changes in that item s fair value in subsequent reporting periods must be recognized in current earnings. SFAS No. 159 also establishes presentation and disclosure requirements designed to draw comparison between entities that elect different measurement attributes for similar assets and liabilities. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. Early adoption is permitted subject to specific requirements outlined in the new Statement. The Company is currently evaluating the effect that the adoption of SFAS No. 159 will have on its financial position and results of operations.

2. INVENTORIES

	March 31, 2007	December 31, 2006
	(In thousands)	
Raw materials and subassemblies	$ 2,583	$ 2,267
Work in process	121	110
Finished goods	583	262
Inventories, net	$ 3,287	$ 2,639

3. PROPERTY AND EQUIPMENT

	March 31, 2007	December 31, 2006
	(In thousands)	
Computer equipment and purchased software	$ 3,034	$ 2,980
Machinery and equipment	2,907	2,817
Furniture and fixtures	1,282	1,280
Leasehold improvements	832	824
Total	8,055	7,901
Less accumulated depreciation	(6,458)	(6,254)
Property and equipment, net	$ 1,597	$ 1,647

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4. INTANGIBLES AND OTHER ASSETS

	March 31, 2007	December 31, 2006
	(In thousands)	
Patents and technology	$ 13,385	$ 13,011
Deferred income taxes	1,241	
Other assets	105	105
Gross intangibles and other assets	14,731	13,116
Accumulated amortization of patents and technology	(5,973)	(5,731)
Intangibles and other assets, net	$ 8,758	$ 7,385

The estimated annual amortization expense for intangible assets as of March 31, 2007 is $937,000 in 2007, $830,000 in 2008, $827,000 in 2009, $756,000 in 2010, $714,000 in 2011, and $3.6 million thereafter.

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

	March 31, 2007	December 31, 2006
	(In thousands)	
Accrued legal	$ 412	$ 256
Other current liabilities	1,722	1,494
Total other current liabilities	$ 2,134	$ 1,750
Deferred revenue	$ 4,770	$ 1,646
Customer advances	49	70
Total current deferred revenue and customer advances	$ 4,819	$ 1,716

Deferred revenue at March 31, 2007 includes $3.0 million representing the current portion of deferred revenue from Sony Computer Entertainment. See Note 10 for further discussion.

6. LONG-TERM DEBT

5% Senior Subordinated Convertible Debenture (5% Convertible Debenture)   On December 23, 2004, the Company issued an aggregate principal amount of $20.0 million of 5% Convertible Debentures. The 5% Convertible Debentures will mature on December 22, 2009. The amount payable at maturity of each 5% Convertible Debenture is the initial principal plus all accrued but unpaid interest thereon, to the extent such principal amount and interest have not been converted into common shares or previously paid in cash. The Company cannot prepay the 5% Convertible Debenture except as described below in Mandatory Conversion and Mandatory Redemption of 5% Convertible Debentures at the Company s Option. Interest accrues daily on the principal amount of the 5% Convertible Debenture at a rate of 5% per year and is payable on the last day of each calendar quarter. Interest will cease to accrue on that portion of the 5% Convertible Debenture that is converted or paid, including pursuant to conversion rights or rights of redemption. The holder of a 5% Convertible Debenture has the right to convert the outstanding principal amount and accrued and unpaid interest, in whole or in part, into the Company s common shares at a price of $7.0265 per common share, the Conversion Price. In the event of a change of control, a holder may require the Company to redeem all or a portion of its 5% Convertible Debenture. This is referred to as the Put Option. The redeemed portion shall be redeemed at a price equal to the redeemed amount multiplied by 100% of the principal amount of the 5% Convertible Debenture. The Conversion Price will be reduced in certain instances when the Company sells, or is deemed to have sold shares of common stock at a price less than the applicable Conversion Price, including the issuance of certain options, the issuance of convertible securities, or the change in exercise price or rate of conversion for options or convertible securities. The Conversion Price will be proportionately adjusted if the Company subdivides (by stock split, stock dividend, recapitalization, or otherwise) or combines (by combination, reverse stock split, or otherwise) one or more classes of its common stock. So long as any 5% Convertible Debentures are outstanding, the Company will not, nor will the Company permit any of its subsidiaries to directly or indirectly incur or guarantee, assume or suffer to exist, any indebtedness other than permitted indebtedness under the 5% Convertible Debenture agreement. If an event of default occurs, and is continuing with respect to any of the Company s 5% Convertible Debentures, the holder may, at its option, require the Company to redeem all or a portion of the 5% Convertible Debenture.

Mandatory Conversion and Mandatory Redemption of 5% Convertible Debentures at the Company s Option If the daily volume-weighted average price of the Company s common shares is at or above 200% of the Conversion Price for at least 20 consecutive trading days and certain other conditions are met, the Company has the right to (i) require the holder of a 5% Convertible Debenture to convert the 5% Convertible Debenture in whole, including interest, into shares of the Company s common stock at a price of $7.0265 per common share, as may be adjusted under the debenture, as set forth and subject to the conditions in the 5% Convertible Debenture, or (ii) redeem the 5% Convertible Debenture. If the Company makes either of the foregoing elections with respect to any 5% Convertible Debenture, the Company must make the same election with respect to all 5% Convertible Debentures.

Warrants On December 23, 2004, in connection with the issuance of the 5% Convertible Debentures, the Company issued warrants to purchase an aggregate of 426,951 shares of its common stock at an exercise price of $7.0265. The warrants may be exercised at any time prior to 5:00 p.m. Eastern time, on December 23, 2009. Any warrants not exercised prior to such time will expire. The exercise price will be reduced in certain instances where shares of common stock are sold or deemed to be sold at a price less than the applicable exercise price, including the issuance of certain options, the issuance of convertible securities, or the change in exercise price or rate of conversion for option or convertible securities. The exercise price will be proportionately adjusted if the Company subdivides (by stock split, stock dividend, recapitalization, or otherwise) or combines (by combination, reverse stock split, or otherwise) one or more classes of its common stock.

Registration Rights On April 18, 2005, the Company s registration statement relating to the 5% Convertible Debentures and the shares of common stock issuable upon conversion of the debentures and exercise of the warrants was declared effective by the Securities and Exchange Commission (SEC). The Company expects to keep this registration statement effective until the earlier of (i) such time as all of the shares covered by the prospectus have been disposed of pursuant to and in accordance with the registration statement, or (ii) the date on which the shares may be sold pursuant to Rule 144(k) of the Securities Act.

The Company incurred approximately $1.3 million in issuance costs and other expenses in connection with the offering. This amount has been deferred and is being amortized to interest expense over the term of the 5% Convertible Debenture. Additionally, the Company evaluated the various instruments included in the agreements entered into on December 22, 2004 and allocated the relative fair values to be as follows: warrants $1.7 million, Put Option $0.1 million, Registration Rights $0.1 million, issuance costs $1.3 million, 5% Convertible Debenture $16.8 million. The 5% Convertible Debentures will be accreted to $20.0 million over their five-year life, resulting in additional interest expense. The value of the warrants has been included in Stockholders Equity (Deficit); the value of the Put Option and Registration Rights have been recorded as a liability and are subject to future value adjustments; and the value of the 5% Convertible Debentures has been recorded as long-term debt.

Annual maturities of long-term debt as of March 31, 2007 are $20.0 million due on December 23, 2009.

7. LONG-TERM DEFERRED REVENUE

On March 31, 2007, long-term deferred revenue was $12.2 million and included approximately $8.5 million of deferred revenue from Sony Computer Entertainment. On December 31, 2006, long-term deferred revenue was $31.8 million and included approximately $27.9 million of compulsory license fees and interest from Sony Computer Entertainment pursuant to Court orders dated January 10 and February 9, 2005. See Note 10 for further discussion.

8. LONG-TERM CUSTOMER ADVANCE FROM MICROSOFT

On July 25, 2003, the Company contemporaneously executed a series of agreements with Microsoft Corporation (Microsoft) that (1) settled the Company s lawsuit against Microsoft, (2) granted Microsoft a worldwide royalty-free, irrevocable license to the Company s portfolio of patents (the License Agreement) in exchange for a payment of $19.9 million, (3) provided Microsoft with sublicense rights to pursue certain license arrangements directly with third parties including Sony Computer Entertainment which, if consummated, would result in payments to the Company (the Sublicense Rights), and conveyed to Microsoft the right to a payment of cash in the event of a settlement within certain parameters of the Company s patent litigation against Sony Computer Entertainment of America Inc. and Sony Computer Entertainment Inc. (the Participation Rights) in exchange for a payment of $0.1 million, (4) issued Microsoft shares of the Company s Series A Redeemable Convertible Preferred Stock (Series A Preferred Stock) for a payment of $6.0 million, and (5) granted the Company the right to sell up to $9.0 million of debentures to Microsoft under the terms and conditions established in newly authorized 7% Debentures with annual draw down rights over a 48-month period. The sublicense rights provided to Microsoft to contract directly with Sony Computer Entertainment expired in July 2005. None of the 7% Debentures had been sold at March 31, 2007, and as of that date, none were available after the litigation with Sony Computer Entertainment was concluded.

Under these agreements, in the event that the Company elects to settle the action in the United States District Court for the Northern District of California entitled *Immersion Corporation v. Sony Computer Entertainment of America, Inc., Sony Computer Entertainment Inc. and Microsoft Corporation*, Case No. C02-00710 CW (WDB), as such action pertains to Sony Computer Entertainment, the Company would be obligated to pay Microsoft a minimum of $15.0 million for amounts up to $100.0 million received from Sony Computer Entertainment on account of the Company s granting certain rights, plus 25% of amounts over $100.0 million up to $150.0 million, and 17.5% of amounts over $150.0 million. As of December 31, 2006, the Company reflected a liability of $15.0 million in its financial statements, being the minimum amount the Company would be obliged to pay to Microsoft upon a settlement with Sony Computer Entertainment.

In March 2007, the Company concluded its patent infringement litigation against Sony Computer Entertainment at the U.S. Court of Appeals for the Federal Circuit. Additionally, the Company and Sony Computer Entertainment entered into a new business agreement to explore the inclusion of the Company s technology in PlayStation format products. The Company has determined that the conclusion of its litigation with Sony Computer Entertainment does not trigger any payment obligations under its Microsoft agreements. Accordingly, the liability of $15.0 million that was in the Company s financial statements at December 31, 2006 has been extinguished and the Company has accounted for this sum as litigation conclusions and patent license income in the three months ended March 31, 2007. See Note 15, Contingencies. As the patent infringement litigation with Sony Computer Entertainment has concluded, the Company s right to sell 7% Debentures has expired.

9. STOCK-BASED COMPENSATION

On January 1, 2006, the Company adopted the provisions of, and accounted for stock-based compensation in accordance with, SFAS No. 123 revised 2004, Share-Based Payment (SFAS No. 123R) which replaced SFAS No. 123, Accounting for Stock-Based Compensation (SFAS No. 123) and supersedes Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees (APB No. 25). Under the fair value recognition provisions of SFAS No. 123R, stock-based compensation cost is measured at the grant date based on the fair value of the award and is recognized as expense on a straight-line basis over the requisite service period, which is the vesting period. The valuation provisions of SFAS No. 123R apply to new grants and to grants that were outstanding as of the effective date and are subsequently modified. Estimated compensation for grants that were outstanding as of the effective date will be recognized over the remaining service period using the compensation cost estimated for the SFAS No. 123 pro forma disclosures. Prior to the adoption of SFAS No. 123R, the Company used the Black-Scholes-Merton option-pricing model (Black-Scholes model), multi-option approach to determine the fair value of stock options and employee stock purchase plan shares for pro forma disclosures.

Stock Options The Company s stock option program is a long-term retention program that is intended to attract, retain, and provide incentives for talented employees, officers, and directors, and to align stockholder and employee interests. The Company considers its option programs critical to its operation and productivity; essentially all of its employees participate. Since inception, under the Company s stock option plans, the Company may grant options to purchase up to 17,577,974 shares of its common stock to employees, directors, and consultants at prices not less than the fair market value on the date of grant for incentive stock options and not less than 85% of fair market value on the date of grant for nonstatutory stock options. These options generally vest over 4 years and expire 10 years from the date of grant. At March 31, 2007, options to purchase 2,815,280 shares of common stock were available for grant, and options to purchase 7,389,467 shares of common stock were outstanding.

Employee Stock Purchase Plan The Company has an employee stock purchase plan (ESPP). Under the ESPP, eligible employees may purchase common stock through payroll deductions at a purchase price of 85% of the lower of the fair market value of the Company s stock at the beginning of the offering period or the purchase date. Participants may not purchase more than 2,000 shares in a six-month offering period or purchase stock having a value greater than

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$25,000 in any calendar year as measured at the beginning of the offering period. A total of 500,000 shares of common stock are reserved for the issuance under the ESPP plus an automatic annual increase on January 1, 2001 and on each January 1 thereafter through January 1, 2010 by an amount equal to the lesser of 500,000 shares per year or a number of shares determined by the Board of Directors. As of March 31, 2007, 322,367 shares had been purchased under the ESPP. Under SFAS No. 123R, the ESPP is considered a compensatory plan and the Company is required to recognize compensation cost for sales made under the ESPP.

The Company did not modify its stock option or employee stock purchase plans in the quarter ended March 31, 2007.

General Stock Option Information The following table sets forth the summary of option activity under the Company s stock option program for the three months ended March 31, 2007:

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at December 31, 2006 (5,403,314 exercisable at a weighted average price of $7.65 per share)	7,585,423	$ 7.40		
Granted (weighted average fair value of $5.45 per share)	991,208	8.91		
Exercised	(1,089,353)	4.02		
Canceled	(97,811)	6.67		
Outstanding at March 31, 2007	7,389,467	$ 8.11	6.53	$15.6 million
Exercisable at March 31, 2007	4,696,682	$ 8.40	5.18	$11.7 million

The expected to vest balance as of March 31, 2007 is equal to the outstanding balance at that date without consideration of forfeitures.

The aggregate intrinsic value is calculated as the difference between the exercise price of the underlying awards and the quoted price of the Company s common stock for the options that were in-the-money at March 31, 2007. The aggregate intrinsic value of options exercised under the Company s stock option plans, determined as of the date of option exercise was $4.5 million for the quarter ended March 31, 2007.

Additional information regarding options outstanding as of March 31, 2007 is as follows: