

SYNAPTICS INC  
Form 10-Q  
October 27, 2006

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

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

**For the quarterly period ended September 23, 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., Suite 130  
Santa Clara, California 95054**

(Address of principal executive offices) (Zip code)

**(408) 454-5100**

(Registrant's telephone number, including area code)

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

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

Yes  No

Number of shares of Common Stock outstanding at October 24, 2006: 25,319,607

**SYNAPTICS INCORPORATED**  
**QUARTERLY REPORT ON FORM 10-Q**  
**FOR THE QUARTER ENDED SEPTEMBER 30, 2006**  
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CONDENSED CONSOLIDATED BALANCE SHEETS**(in thousands, except share data)  
(unaudited)

	<b>September 30, 2006</b>	<b>June 30, 2006</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 51,796	\$ 38,724
Short-term investments	193,867	206,452
Accounts receivable, net of allowances of \$222 and \$189, respectively	41,813	34,034
Inventories	9,017	10,010
Prepaid expenses and other current assets	3,732	3,407
Total current assets	300,225	292,627
Property and equipment, net	16,099	16,038
Goodwill	1,927	1,927
Other assets	20,365	20,829
	\$ 338,616	\$ 331,421
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 16,152	\$ 16,542
Accrued compensation	3,864	4,842
Income taxes payable	10,969	8,078
Other accrued liabilities	7,447	5,377
Note payable to a related party	1,500	
Total current liabilities	39,932	34,839
Note payable to a related party		1,500
Other liabilities	2,071	3,040
Convertible senior subordinated notes	125,000	125,000
Stockholders' equity:		
Common stock:		
\$0.001 par value; 60,000,000 shares authorized; 27,575,943 and 27,462,125 shares issued, respectively	28	27
Additional paid-in capital	139,013	134,217
Less: 2,521,100 and 2,306,100 common treasury shares, respectively, at cost	(44,611)	(39,999)
Accumulated other comprehensive loss	(205)	(464)
Retained earnings	77,388	73,261
Total stockholders' equity	171,613	167,042

\$ 338,616 \$ 331,421

*See notes to condensed consolidated financial statements.*

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

(in thousands, except per share data)

(unaudited)

	<b>Three Months Ended</b>	
	<b>September 30,</b>	
	<b>2006</b>	<b>2005</b>
Net revenue	\$ 54,815	\$ 51,725
Cost of revenue (1)	32,420	28,053
Gross margin	22,395	23,672
Operating expenses:		
Research and development (1)	9,188	8,289
Selling, general, and administrative (1)	7,801	6,728
Total operating expenses	16,989	15,017
Income from operations	5,406	8,655
Interest income	2,539	1,551
Interest expense	(487)	(484)
Income before provision for income taxes	7,458	9,722
Provision for income taxes	3,331	4,210
Net income	\$ 4,127	\$ 5,512
Net income per share:		
Basic	\$ 0.16	\$ 0.22
Diluted	\$ 0.15	\$ 0.20
Shares used in computing net income per share:		
Basic	25,134	24,769
Diluted	29,253	29,036

(1) Amounts include share-based compensation costs as follows:

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Cost of revenue	\$ 147	\$ 192
Research and development	\$ 1,035	\$ 1,292
Selling, general, and administrative	\$ 1,919	\$ 1,826

*See notes to condensed consolidated financial statements.*

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

(in thousands)

(unaudited)

	<b>Three Months Ended</b>	
	<b>September 30,</b>	
	<b>2006</b>	<b>2005</b>
<b>Cash flows from operating activities</b>		
Net income	\$ 4,127	\$ 5,512
Adjustments to reconcile net income to net cash provided by operating activities:		
Share-based compensation costs	3,101	3,310
Deferred taxes from share-based compensation	(751)	(688)
Tax benefit realized from share-based compensation	234	184
Excess tax benefit from share-based compensation	(183)	(139)
Depreciation of property and equipment	454	377
Amortization of debt issuance costs	215	215
Changes in operating assets and liabilities:		
Accounts receivable, net	(7,779)	893
Inventories	993	614
Prepaid expenses and other current assets	(325)	151
Other assets	1,000	149
Accounts payable	(390)	(757)
Accrued compensation	(978)	(2,304)
Income taxes payable	2,891	2,302
Other accrued liabilities	2,070	116
Other liabilities	(969)	69
Net cash provided by operating activities	3,710	10,004
<b>Cash flows from investing activities</b>		
Purchases of short-term investments	(69,981)	(50,994)
Proceeds from sales and maturities of short-term investments	82,825	39,788
Purchases of property and equipment	(515)	(1,656)
Net cash provided by (used in) investing activities	12,329	(12,862)
<b>Cash flows from financing activities</b>		
Purchase of treasury stock	(4,612)	(18,819)
Proceeds from issuance of common stock upon exercise of options and stock purchase plan	1,462	1,209
Excess tax benefit from share-based compensation	183	139
Net cash used in financing activities	(2,967)	(17,471)
Net increase (decrease) in cash and cash equivalents	13,072	(20,329)
Cash and cash equivalents at beginning of period	38,724	72,232
Cash and cash equivalents at end of period	\$ 51,796	\$ 51,903



**Supplemental disclosures of cash flow information**

Cash paid for income taxes	\$ 247	\$ 2,409
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*See notes to condensed consolidated financial statements.*

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

**1. Basis of Presentation**

The accompanying unaudited condensed consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (the SEC) and U.S. generally accepted accounting principles. However, certain information or footnote disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles have been condensed or omitted pursuant to such SEC rules and regulations. In our opinion, the financial statements include all adjustments, which are of a normal and recurring nature, necessary for the fair presentation of the results of the interim periods presented. The results of operations for the interim periods are not necessarily indicative of the operating results for the full fiscal year or any future period. These financial statements should be read in conjunction with the audited consolidated financial statements and related notes included in our annual report on Form 10-K for the fiscal year ended June 30, 2006.

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

Our fiscal year is the 52- or 53-week period ending on the last Saturday in June. Fiscal 2007 is a 53-week period and fiscal 2006 is a 52-week period. For ease of presentation, the accompanying consolidated financial statements have been shown as ending on June 30 and calendar quarter end dates for all annual, interim, and quarterly financial statement captions, unless otherwise indicated.

*Use of Estimates*

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

**2. Revenue Recognition**

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

**3. Net Income Per Share**

Basic net income per share amounts for each period presented were computed using the weighted average number of shares of common stock outstanding. Diluted net income per share amounts for each period presented were computed (1) using the weighted average number of potentially dilutive shares issuable in connection with stock options under the treasury stock method, and (2) using the weighted average number of shares issuable in connection with convertible debt under the if-converted method, when dilutive.

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

	Three Months Ended September 30,	
	2006	2005
Numerator:		
Basic net income	\$ 4,127	\$ 5,512
Interest expense and amortization of debt issuance costs on convertible notes (net of tax)	266	266
Diluted net income	\$ 4,393	\$ 5,778
Denominator:		
Shares, basic	25,134	24,769
Effect of dilutive share-based awards	1,645	1,793
Effect of convertible notes	2,474	2,474
Shares, diluted	29,253	29,036
Net income per share:		
Basic	\$ 0.16	\$ 0.22
Diluted	\$ 0.15	\$ 0.20

Dilutive net income per share does not include the effect of 2,784,476 and 2,290,831 share-based awards that were outstanding during the three months ended September 30, 2006 and 2005, respectively. These share-based awards were not included in the computation of diluted net income per share because the proceeds received, if any, from such share-based awards combined with the average unamortized compensation costs adjusted for the hypothetical tax benefit or deficiency creditable or chargeable, respectively, to additional paid-in capital, were greater than the average market price of our common stock, and therefore, their effect would have been antidilutive.

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

Cash equivalents consist of highly liquid investments with original maturities of three months or less. Short-term investments consist of marketable securities and are classified as securities available for sale under Statement of Financial Accounting Standards ( SFAS ) No. 115, Accounting for Certain Investments in Debt and Equity Securities. Such securities are reported at fair value, with unrealized gains and losses, net of taxes, excluded from earnings and shown separately as a component of accumulated other comprehensive income within stockholders equity. Interest earned on marketable securities is included in interest income. Realized gains and losses on the sale of marketable securities are determined using the specific identification method.

**5. Inventories**

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

	September 30, 2006	June 30, 2006
Raw materials	\$ 8,652	\$ 9,743

Finished goods	365	267
	\$ 9,017	\$ 10,010

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.

**Table of Contents****6. Product Warranties, Indemnifications, and Legal Proceedings***Product Warranties*

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

Changes in our accrued warranty liability (included in other accrued liabilities) for the three-month periods ended September 30, 2006 and 2005 were as follows (in thousands):

	Three Months Ended September 30,	
	2006	2005
Beginning accrued warranty	\$ 357	\$ 369
Provision for product warranties	214	154
Cost of warranty claims and settlements	(151)	(181)
Ending accrued warranty	\$ 420	\$ 342

*Indemnifications*

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

*Legal Proceedings*

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

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

**7. Convertible Senior Subordinated Notes**

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

The Notes bear interest at a rate of 0.75% per annum payable on December 1 and June 1 of each year, beginning June 1, 2005. However, we will pay additional contingent interest on the Notes if the average trading price of the Notes is at or above 120% of the principal amount of the Notes for a specified period beginning with the six-month period commencing December 1, 2009. The amount of contingent interest payable on the Notes with respect to a six-month period, for which contingent interest applies, will equal 0.375% per annum of the average trading price of



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the Notes for a specified five trading day period preceding such six-month period. We are also obligated to file and maintain a shelf registration statement with the SEC covering resales by the holders of the Notes and the common stock issuable upon conversion of the Notes. In the event of a registration default, we will be obligated to pay additional interest of up to 0.5% per annum until such registration default is cured. On June 1, 2005, our Registration Statement for these securities was declared effective by the SEC.

The Notes are convertible into shares of our common stock, initially at a conversion rate of 19.7918 shares per \$1,000 principal amount of Notes, or a total of 2,473,975 shares of common stock, which is equivalent to an initial conversion price of approximately \$50.53 per share of common stock, subject to adjustment in certain events. The denominator of the diluted net income per share calculation includes the weighted average effect of the 2,473,975 shares of common stock issuable upon conversion of the Notes in accordance with Emerging Issues Task Force ( EITF ) Issue No. 04-08. Through November 30, 2009, upon the occurrence of a fundamental change as defined in the indenture governing the Notes, we could potentially be obligated to issue up to 27.7085 shares per \$1,000 of principal amount of Notes, or a total of 3,463,562 shares of common stock, which is equivalent to a conversion price of \$36.09 per share of common stock. The additional 989,587 shares, contingently issuable upon a fundamental change, are not included in the calculation of diluted net income per share.

The Notes may be converted (1) if, during any calendar quarter commencing after December 31, 2004, the last reported sale price of our common stock for at least 20 trading days in the period of 30 consecutive trading days ending on the last trading day of the preceding calendar quarter is greater than or equal to 120% of the applicable conversion price on such last trading day; (2) on or after January 1, 2020; (3) if we have called the Notes for redemption; or (4) during prescribed periods, upon the occurrence of specified corporate transactions or fundamental changes. On or after December 1, 2009, we may redeem for cash all or a portion of the notes at a redemption price of 100% of the principal amount of the notes plus accrued and unpaid interest, including contingent interest and additional interest, if any. Noteholders have the right to require us to repurchase all or a portion of their notes for cash on December 1, 2009, December 1, 2014, and December 1, 2019 at a price equal to 100% of the principal amount of the notes to be purchased plus accrued and unpaid interest, including contingent interest and additional interest, if any. Upon conversion of the Notes, in lieu of delivering common stock, we may, at our discretion, deliver cash or a combination of cash and common stock. As of September 30, 2006, none of the conditions for conversion of the Notes had occurred.

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

During each of the three month periods ended September 30, 2006 and 2005, we recorded interest expense of \$449,000 on the Notes, which included amortization of debt issuance costs.

**8. Share-Based Compensation**

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

Share-based compensation awards available for grant or issuance for each plan as of the beginning of the fiscal year, including changes in the balance of awards available for grant during the three months ended September 30, 2006, are as follows:





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	Awards Available Under All Share-Based Award Plans	1996 Stock Option Plan	2000 Nonstatutory Stock Option Plan	2001 Incentive Compensation Plan	2001 Employee Stock Purchase Plan
Balance at June 30, 2006	3,292,246	226,465	37,584	2,414,826	613,371
Additional shares authorized	378,155			378,155	
Stock options granted	(477,909)			(477,909)	
Deferred stock units granted	(67,081)			(67,081)	
Purchases under employee stock purchase plan	(52,469)				(52,469)
Forfeited and expired	46,668	500		46,168	
Balance at September 30, 2006	3,119,610	226,965	37,584	2,294,159	560,902

We adopted SFAS No. 123R, Share-Based Payment ( SFAS 123R ), in fiscal 2006 and applied the provisions of Staff Accounting Bulletin No. 107, Share-Based Payment, to our existing share-based compensation plans in accordance with the modified prospective transition method. Previously, we followed Accounting Principles Board ( APB ) Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations in accounting for employee share-based compensation, as permitted by SFAS No. 123, Accounting for Stock-Based Compensation, ( SFAS 123 ), and we did not recognize compensation expense for stock option grants to employees and directors with an exercise price equal to the fair market value of the shares at the date of grant. Accordingly, no share-based compensation costs based on grant date fair value were included in our consolidated statements of income for any period prior to fiscal 2006.

Share-based compensation and the related tax benefit recognized in our consolidated statements of income for the three months ended September 30, 2006 and 2005 were (in thousands):

	2006	2005
Cost of revenue	\$ 147	\$ 192
Research and development	1,035	1,292
Selling, general, and administrative	1,919	1,826
Total	\$ 3,101	\$ 3,310
Income tax benefit on share-based compensation	\$ 781	\$ 690

We utilize the Black-Scholes option pricing model to estimate the grant date fair value of certain employee share-based compensatory awards, which requires the input of highly subjective assumptions, including expected volatility and expected life. Historical and implied volatility were used in estimating the fair value of our share-based awards, while the expected life of our options was estimated to be five years based on historical trends since our initial public offering. Further, as required under SFAS 123R, we now estimate forfeitures for share-based awards that are not expected to vest. Changes in these inputs and assumptions can materially affect the measure of estimated fair value of our share-based compensation. We charge the estimated fair value to earnings on a straight-line basis over the vesting period of the underlying awards, which is generally four years for our stock option and deferred stock unit awards and up to two years for our employee stock purchase plan. The Black-Scholes option pricing model was developed for use in estimating the fair value of traded options having no vesting restrictions and being fully

transferable. As our stock option and employee stock purchase plan awards have characteristics that differ significantly from traded options, and as changes in the subjective assumptions can materially affect the estimated value, our estimate of fair value may not accurately represent the value assigned by a third party in an arms-length transaction. While our estimate of fair value and the associated charge to earnings materially affects our results of operations, it has no impact on our cash position.

Stock options granted to consultants under our share-based compensation plans are accounted for at fair value determined by using the Black-Scholes option pricing model in accordance with EITF Issue No. 96-18, Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or In Conjunction with Selling, Goods or Services. These awards are subject to periodic revaluation over their vesting term, if any. The assumptions used to value share-based awards to consultants are similar to those used for employees, except that we use the contractual life of the award rather than the expected life.

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In accordance with SFAS 123R, we recognize tax benefit upon expensing certain share-based awards associated with our share-based compensation plans, including nonqualified stock options and deferred stock unit awards, but under current accounting standards we cannot recognize tax benefit concurrent with the recognition of share-based compensation expenses associated with incentive stock options and employee stock purchase plan shares (qualified stock options). For qualified stock options that vested after our adoption of SFAS 123R, we recognize tax benefit only in the period when disqualifying dispositions of the underlying stock occur, and for qualified stock options that vested prior to our adoption of SFAS 123R, the tax benefit is recorded directly to additional paid-in capital. For the three months ended September 30, 2006, we realized tax benefit from non-qualified stock option exercises and disqualifying dispositions of qualified stock options totaling \$264,000, of which \$27,000 of the tax benefit was recognized as a reduction of the provision for income taxes, \$3,000 reduced deferred tax assets established after our adoption of SFAS 123R, and the remaining tax benefit was recorded directly to additional paid-in capital.

We determine excess tax benefit using the long-haul method in which we compare the actual tax benefit associated with the tax deduction from share-based award activity to the hypothetical tax benefit on the grant date fair values of the corresponding share-based awards. Actual tax benefit related to the tax deduction for share-based awards exceeded the hypothetical tax benefit on the grant date fair values of the corresponding share-based awards resulting in excess tax benefit of \$183,000 for the three months ended September 30, 2006.

Historically, we have issued new shares in connection with our share-based compensation plans; however, 2,521,100 treasury shares are also available for issuance as of September 30, 2006. As of September 30, 2006, we have \$35.4 million remaining under our stock repurchase program, which expires in October 2007. Any incremental shares repurchased under the stock repurchase program would be available for issuance.

*Deferred Stock Units*

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

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

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

The following table summarizes DSU activity including DSUs granted, delivered, and forfeited during the three months ended September 30, 2006 and the balance and aggregate intrinsic value of DSUs as of September 30, 2006. The aggregate intrinsic value is based on the closing price of our common stock on September 22, 2006 of \$24.44.

	Deferred Stock Unit Awards Outstanding	Aggregate Intrinsic Value (thousands)	Weighted Average Grant Date Fair Value
Balance at June 30, 2006	38,280		\$ 29.68
Granted	67,081		\$ 21.03
Delivered			
Forfeited	(2,250)		\$ 26.38
Balance at September 30, 2006	103,111	\$ 2,520	\$ 24.13

Unrecognized share-based compensation costs for DSUs granted under the 2001 Plan are approximately \$1.9 million as of September 30, 2006, to be recognized over a weighted average period of approximately three years.



**Table of Contents***Stock Options*

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

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

In October 2002, we granted 200,000 options to a consultant that at the time were to vest over four years; however, in December 2002 we hired the consultant as an employee. In accordance with FIN 44, Accounting for Certain Transactions Involving Stock Compensation, we remeasured the intrinsic value of the option grant on the date the consultant became an employee and recorded deferred stock compensation that we were amortizing over the remaining vesting period of the options. With the adoption of SFAS 123R, we ceased amortizing deferred stock compensation, reclassified the remaining balance of deferred stock compensation on our balance sheet to additional paid-in capital, and began expensing the remaining fair value, as previously determined under SFAS 123, of the underlying options over their remaining vesting periods.

In August 2002, our board approved an option regrant offer to several employees who had received option grants under the 2001 Incentive Compensation Plan having option exercise prices of \$12.98 and \$18.70. The option exercise prices were substantially higher than the price of our stock at the time of the regrant offer. Under the terms of the regrant, the employees were allowed to elect to have their option cancelled and in consideration thereof to receive a new option for the same number of shares as cancelled six months and one day after the date of cancellation. On March 3, 2003, new options to acquire a total of 106,500 shares were granted pursuant to the regrant offer with a new exercise price of \$6.56 per share. The vesting period and schedule for the new options remained the same as the vesting period and schedule of the cancelled options.

The following table summarizes stock option activity and weighted average exercise prices for the three months ended September 30, 2006, and for options outstanding, options vested and expected to vest, and options exercisable, the weighted average exercise prices, the weighted average remaining contractual life, and the aggregate intrinsic value as of September 30, 2006. The aggregate intrinsic value is based on the closing price of our common stock on September 22, 2006 of \$24.44 and excludes the impact of options that were not in-the-money.

	Stock Option Awards Outstanding	Weighted Average Exercise Price	Remaining Contractual Life (years)	Aggregate Intrinsic Value (thousands)
Balance at June 30, 2006	5,808,011	\$ 14.55		
Granted	477,909	\$ 21.03		
Exercised	(61,349)	\$ 8.48		
Forfeited and expired	(44,418)	\$ 22.12		
Balance at September 30, 2006	6,180,153	\$ 15.05	7.05	\$ 61,982
Vested and expected to vest	5,875,475	\$ 14.67	6.95	\$ 61,019
Exercisable	3,477,765	\$ 10.03	5.74	\$ 51,108

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The following table summarizes cash received and the aggregate intrinsic value for stock options exercised during the three months ended September 30, 2006 and 2005 (in thousands):

	Three Months Ended September 30,	
	2006	2005
Cash received	\$520	\$345
Aggregate intrinsic value	\$825	\$847

The grant date fair value of each award granted from our Plans during the three months ended September 30, 2006 was estimated at the date of grant using the Black-Scholes option pricing model, assuming no expected dividends and the following assumptions:

Expected volatility	60.5%
Expected life in years	5.0
Risk-free interest rate.	5.02%
Grant date fair value per award	\$11.81

The expected volatility is based on a weighting of implied and historical volatility; the expected life is based on historical option exercise trends; and the risk free interest rate is based on U. S. Treasury yields in effect at the time of grant for the expected life of the option.

Unrecognized share-based compensation costs for stock options granted under the Plans are approximately \$30.3 million as of September 30, 2006, to be recognized over a weighted average period of approximately three years.

*Employee Stock Purchase Plan*

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

The following table summarizes shares purchased, weighted average purchase price, cash received, and the aggregate intrinsic value for ESPP purchases during the three months ended September 30, 2006 and 2005 (in thousands, except for shares purchased and weighted average purchase price):

	Three Months Ended September 30,	
	2006	2005
Shares purchased	52,469	49,442
Weighted average purchase price	\$ 17.96	\$ 17.47
Cash received	\$ 942	\$ 864
Aggregate intrinsic value	\$ 181	\$ 192

In accordance with FASB Technical Bulletin No. 97-1, Accounting under Statement 123 for Certain Employee Stock Purchase Plans with a Look-Back Option, the early termination of an offering period followed by the commencement of a new offering period represents a modification to the terms of the related awards. Under the terms of our ESPP, the offering periods that commenced on January 1, 2005 and 2006 were terminated on June 30, 2005 and 2006 and new offering periods commenced on July 1, 2005 and 2006, respectively. The June 30, 2005 modification affected 169 employees and the June 30, 2006 modification affected 13 employees. Both modifications resulted in incremental compensation costs which are being recognized on a straight-line basis over the period from the modification date through June 30, 2007.



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The grant date fair value of each award granted under our ESPP during the three months ended September 30, 2006 was estimated using the Black-Scholes option pricing model, assuming no expected dividends and the following weighted average assumptions:

Expected volatility	47.7% - 50.2%
Expected life in years	0.5 - 1.0
Risk-free interest rate.	5.3%
Grant date fair value per award	\$ 6.31 - \$7.84

The expected volatility is based on either implied volatility or a weighting of implied and historical volatility; the expected life is based on each period that begins with the enrollment date until each purchase date remaining in the offering period at the date of enrollment in the plan; and the risk free interest rate is based on U. S. Treasury yields or yield curve in effect for each expected life.

Unrecognized share-based compensation costs for awards granted under our ESPP are approximately \$843,000 as of September 30, 2006, and will be recognized over the remainder of fiscal 2007.

**9. Income Taxes**

We account for income tax contingencies in accordance with SFAS No. 5, Accounting for Contingencies. Accordingly, our tax rate may be favorably or unfavorably affected by the release or establishment, respectively, of tax contingency reserves related to tax uncertainties.

The income tax provision of \$3.3 million and \$4.2 million for the three months ended September 30, 2006 and 2005, respectively, represented estimated federal, foreign, and state taxes. The effective tax rate for the three months ended September 30, 2006 was 44.7% and diverged from the combined federal and state statutory rate primarily due to the impact of accounting for share-based compensation and foreign withholding taxes, partially offset by the impact of tax-exempt interest income and the release of contingency reserves. The effective tax rate for the three months ended September 30, 2005 was 43.3% and diverged from the combined federal and state statutory rate primarily as a result of the impact of accounting for share-based compensation and other permanent taxable differences, partially offset by the impact of higher income from foreign operations, the benefit of tax exempt interest income, and research and development tax credits.

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

We operate in one segment: the development, marketing, and sale of interactive user interface solutions for electronic devices and products. We generate our revenue from two broad product categories: the PC market and digital lifestyle product markets. The PC market accounted for 90% and 73% of net revenue for the three months ended September 30, 2006 and 2005, respectively.

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

	Three Months Ended September 30,	
	2006	2005
China	\$ 46,553	\$ 40,209
Taiwan	3,273	7,244
Other	4,989	4,272
	\$ 54,815	\$ 51,725



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

	Three Months Ended September 30,	
	2006	2005
Customer A	15%	*
Customer B	14%	*
Customer C	11%	26%

Major customer accounts receivable as a percentage of accounts receivable:

	As of September 30, 2006	As of June 30, 2006
Customer A	20%	18%
Customer B	11%	*
Customer C	10%	11%
Customer D	*	11%

\* Less than 10%

**11. Comprehensive Income**

Our comprehensive income consists of net income plus the effect of unrealized gains and losses on our short-term investments due to interest rate fluctuations. The unrealized gains and losses on our short-term investments are considered to be temporary in nature and were not material for the three months ended September 30, 2006 and 2005. Accordingly, comprehensive income closely approximated net income.

**12. Recent Accounting Pronouncements**

In June 2006, the Financial Accounting Standards Board issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* an interpretation of FASB Statement No. 109, ( FIN 48 ) which clarifies the accounting for uncertainty in income taxes recognized in an entity's financial statements in accordance with SFAS No. 109,

*Accounting for Income Taxes* ( SFAS 109 ). FIN 48 is designed to reduce the disparity in accounting treatment for uncertain tax positions resulting from diverse interpretations of SFAS 109 among companies. FIN 48 prescribes a recognition threshold and measurement attribute for financial statement disclosure of tax positions taken or expected to be taken on a tax return. FIN 48 is effective beginning in our first quarter of fiscal 2008. We are currently evaluating the requirements of FIN 48 and have not yet determined the impact of adoption, if any, on our financial position, results of operations, or cash flows.

In September 2006, the U.S. Securities and Exchange Commission released Staff Accounting Bulletin No. 108, ( SAB 108 ), which provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. SAB 108 provides transition guidance for correcting errors and requires registrants to quantify misstatements using both the balance-sheet and income-statement approaches and to evaluate whether either approach results in quantifying an error that is material in light of relevant quantitative and qualitative factors. In the year of adoption only, if the effect is determined to be material, SAB 108 allows registrants to record the effect as a cumulative-effect adjustment to beginning-of-year retained earnings. SAB 108 does not change the requirements within SFAS No. 154, *Accounting Changes and Error Corrections—a replacement of APB No. 20 and FASB Statement No. 3*, for the correction of an error on financial statements. Further, SAB 108 does not change the Staff's previous guidance in SAB 99 on evaluating the materiality of misstatements. SAB 108 is effective for our fiscal 2007. We are currently evaluating the requirements of SAB 108 and have not yet determined the impact of adoption, if any, on our financial position, results of operations, or cash flows.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, ( SFAS 157 ). SFAS 157 defines fair value, establishes a framework for measuring fair value in U.S. generally accepted accounting principles,



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and expands disclosure about fair value measurements. SFAS 157 applies under other accounting standards that require or permit fair value measurements. Accordingly, SFAS 157 does not require any new fair value measurement. SFAS 157 is effective beginning in our first quarter of fiscal 2009. We are currently evaluating the requirements of SFAS 157 and have not yet determined the impact of adoption, if any, on our financial position, results of operations, or cash flows.

**Table of Contents****ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS****Forward-Looking Statements and Factors That May Affect Results**

You should read the following discussion and analysis in conjunction with our condensed consolidated financial statements and notes in Item 1 and with our audited consolidated financial statements and notes included in our Annual Report on Form 10-K for the year ended June 30, 2006.

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

We caution that these statements are qualified by various factors that may affect future results, including the following: changes in the market for our products and the success of our customers' products, our success in moving products from the design phase into the manufacturing phase, changes in the competitive environment, infringement claims, warranty obligations related to product failures, the failure of key technologies to deliver commercially acceptable performance, our dependence on certain key markets, penetration into new markets, the absence of both long-term purchase and supply commitments, and our lengthy development and product acceptance cycles. This report should be read in conjunction with our Annual Report on Form 10-K for the year ended June 30, 2006, including particularly the section captioned Risk Factors.

**Overview**

We are a leading worldwide developer and supplier of custom-designed user interface solutions that enable people to interact more easily and intuitively with a wide variety of mobile computing, entertainment, communications, and other electronic devices. From our inception in 1986 through fiscal year 1995, we were a development stage company, focused on developing and refining our pattern recognition and capacitive sensing technologies, and generated revenue by providing contract engineering and design services. In fiscal year 1996, we began shipping our proprietary TouchPad. We are a leading supplier of interface solutions to the notebook computer market and the hard-disk drive, or HDD, portable digital music player market. In fiscal year 2006, we believe we were the market leader in providing interface solutions for notebook computers and HDD portable digital music players. We believe our market share results from the combination of our customer focus, the strength of our intellectual property, and our engineering know-how, which allows us to design products that meet the demanding design specifications of original equipment manufacturers, or OEMs.

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

Our gross margin generally reflects the combination of the added value we bring to our customers' products in meeting their custom design requirements and our ongoing cost-improvement programs. These cost improvement programs include reducing materials and component costs, assembly and test costs, and implementing design and process improvements. Our newly introduced products may have lower margins than our more mature products that

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

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

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

**Critical Accounting Policies and Estimates**

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

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

*Revenue Recognition*

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

*Inventory*

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

Periodically, we purchase inventory from our 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.

**Table of Contents***Share-Based Compensation Costs*

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

The Black-Scholes option pricing model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. As our stock option and employee stock purchase plan awards have characteristics that differ significantly from traded options, and as changes in the subjective assumptions can materially affect the estimated value, our estimate of fair value may not accurately represent the value assigned by a third party in an arms-length transaction. There currently is no market-based mechanism to verify the reliability and accuracy of the estimates derived from the Black-Scholes option pricing model or other allowable valuation models, nor is there a means to compare and adjust the estimates to actual values. While our estimate of fair value and the associated charge to earnings materially affects our results of operations, it has no impact on our cash position.

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

*Income Taxes*

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

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

In accordance with SFAS 123R, we recognize tax benefit upon expensing certain share-based awards associated with our share-based compensation plans, including nonqualified stock options and deferred stock unit awards, but under current accounting standards we cannot recognize tax benefit concurrent with the recognition of share-based compensation expenses associated with incentive stock options and employee stock purchase plan shares (qualified stock options). For qualified stock options that vested after our adoption of SFAS 123R, we recognize tax benefit only in the period when disqualifying dispositions of the underlying stock occur and, for qualified stock options that vested



prior to our adoption of SFAS 123R, the tax benefit is recorded directly to additional paid-in capital. Accordingly, because we cannot recognize the tax benefit for share-based compensation expense associated with qualified stock options until the occurrence of future disqualifying dispositions of the underlying stock, and because a

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portion of that tax benefit may be directly recorded to additional paid-in capital, our future quarterly and annual effective tax rates will be subject to greater volatility and, consequently, our ability to estimate reasonably our future quarterly and annual effective tax rates is greatly diminished.

**Results of Operations****Three months ended September 30, 2006 compared with the three months ended September 30, 2005**

Net Revenue.

(in thousands)

	Three Months Ended September 30,			%
	2006	2005	\$ Change	
PC applications	\$ 49,256	\$ 37,661	\$ 11,595	30.8%
<i>% of net revenue</i>	89.9%	72.8%		
Digital lifestyle product applications	5,559	14,064	(8,505)	-60.5%
<i>% of net revenue</i>	10.1%	27.2%		
Net revenue	\$ 54,815	\$ 51,725	\$ 3,090	6.0%

Net revenue was \$54.8 million for the three months ended September 30, 2006 compared with \$51.7 million for the three months ended September 30, 2005, an increase of \$3.1 million, or 6.0%. We identify the vertical markets that our products serve as the personal computing market ( PC ) and the digital lifestyle product markets. The increase in net revenue for the three months ended September 30, 2006 was primarily attributable to an \$11.6 million, or 30.8%, increase in PC applications net revenue, partially offset by an \$8.5 million decrease in digital lifestyle product applications net revenue. The growth of our PC applications revenue was attributable to notebook market share gains, coupled with notebook industry growth, and a significant increase in demand for our capacitive multimedia control modules. Our digital lifestyle product applications revenue declined to approximately 10% of net revenue for the three months ended September 30, 2006 from approximately 27% of net revenue for the three months ended September 30, 2005, primarily due to a decline in orders for our portable digital music player interface solutions. The increase in net revenue reflects a 33% increase in overall unit shipments including our multimedia control modules that generally are integrated into notebook computers utilizing our touchpads, and was partially offset by lower average selling prices due primarily to product design mix and general competitive pricing pressure. Net revenue from PC dual pointing applications as a percent of net revenue was essentially unchanged at 15% for both the three months ended September 30, 2006 and the three months ended September 30, 2005.

*Gross Margin.* Gross margin as a percentage of net revenue was 40.9%, or \$22.4 million, for the three months ended September 30, 2006 compared with 45.8%, or \$23.7 million, for the three months ended September 30, 2005. As each product we sell utilizes our capacitive technologies in a design that is generally unique or specific to a customer's application, gross margin varies on a product-by-product basis, making our cumulative gross margin a blend of our product specific designs and independent of the vertical markets that our products serve. The decline in gross margin as a percentage of net revenue primarily reflected an unfavorable product design mix, which included a substantial increase in multi-media oriented products containing a greater percentage of third party content and general competitive pricing pressure, partially offset by lower manufacturing costs resulting from our continuing design and process improvement programs. Non-cash share-based compensation costs included in cost of revenue were \$147,000, or 0.3% of net revenue, and \$192,000, or 0.4% of net revenue, for the three months ended September 30, 2006 and 2005, respectively.

**Table of Contents***Operating Expenses.*  
(in thousands)

	Three Months Ended September 30,			
	2006	2005	\$ Change	% Change
Research and development expenses	\$ 9,188	\$ 8,289	\$ 899	10.8%
<i>% of net revenue</i>	16.8%	16.0%		
Selling, general, and administrative expenses	7,801	6,728	1,073	15.9%
<i>% of net revenue</i>	14.2%	13.0%		
Operating expenses	\$ 16,989	\$ 15,017	\$ 1,972	13.1%
<i>% of net revenue</i>	31.0%	29.0%		

*Research and Development Expenses.* Research and development expenses increased as a percentage of net revenue to 16.8% from 16.0%, while the cost of research and development activities increased \$899,000, or 10.8%, to \$9.2 million for the three months ended September 30, 2006 compared with \$8.3 million for the three months ended September 30, 2005. The increase in research and development expenses primarily reflected a \$617,000 increase in temporary labor and consulting costs, a \$324,000 increase in employee cash compensation costs resulting from additional staffing, increased base compensation related to our annual performance review process, employee benefit costs, and recruiting costs, partially offset by a \$257,000 reduction in non-cash share-based compensation costs. Non-cash share-based compensation costs included in research and development expenses were \$1.0 million, or 1.9% of net revenue, and \$1.3 million, or 2.5% of net revenue, for the three months ended September 30, 2006 and 2005, respectively.

*Selling, General, and Administrative Expenses.* Selling, general, and administrative expenses increased as a percentage of net revenue to 14.2% from 13.0%, while the cost of selling, general, and administrative activities increased \$1.1 million, or 15.9%, to \$7.8 million for the three months ended September 30, 2006 compared with \$6.7 million for the three months ended September 30, 2005. The increase in selling, general, and administrative expenses primarily reflected a \$556,000 increase in employee cash compensation costs resulting from additional staffing, increased base compensation related to our annual performance review process, employee benefit costs, and recruiting costs, and a \$410,000 increase in legal fees. The increase in legal fees is primarily related to our ongoing patent infringement litigation with Elantech Devices Corporation, which is more fully described in Part II Other Information Item 1 Legal Proceedings. Non-cash share-based compensation costs included in selling, general, and administrative expenses were \$1.9 million, or 3.5% of net revenue, and \$1.8 million, or 3.5% of net revenue, for the three months ended September 30, 2006 and 2005, respectively.

*Income from Operations.*  
(in thousands)

	Three Months Ended September 30,			
	2006	2005	\$ Change	% Change
Income from operations	\$ 5,406	\$ 8,655	\$ (3,249)	-37.5%
<i>% of net revenue</i>	9.9%	16.7%		

We generated operating income of \$5.4 million, or 9.9% of net revenue, for the three months ended September 30, 2006 compared with \$8.7 million, or 16.7% of net revenue, for the three months ended September 30, 2005. As noted above, the decrease in operating income primarily reflected the impact of a lower gross margin percentage combined with higher operating expenses, partially offset by the increase in operating leverage resulting from the 6.0% increase in net revenue.



**Table of Contents***Interest Income/(Expense).*  
(in thousands)

	Three Months Ended September 30,			
	2006	2005	\$ Change	% Change
Interest income	\$ 2,539	\$ 1,551	\$ 988	63.7%
<i>% of net revenue</i>	4.6%	3.0%		
Interest expense	(487)	(484)	(3)	0.6%
<i>% of net revenue</i>	-0.9%	-0.9%		
Net interest income	\$ 2,052	\$ 1,067	\$ 985	92.3%
<i>% of net revenue</i>	3.7%	2.1%		

*Interest Income.* Interest income was \$2.5 million for the three months ended September 30, 2006 compared with \$1.6 million for the three months ended September 30, 2005. The \$988,000 increase in interest income resulted from a combination of substantially higher average interest rates and higher average invested cash balances. The increase in average invested cash balances was primarily attributable to \$18.5 million of net cash flows from operations during the past twelve months.

*Interest Expense.* Interest expense was \$487,000 for the three months ended September 30, 2006 essentially unchanged when compared with interest expense of \$484,000 for the three months ended September 30, 2005. Interest expense primarily reflects the combination of interest expense and amortization of debt issuance costs related to our convertible senior subordinated notes issued in December 2004. The annual debt service cost on the notes is approximately \$938,000, which excludes \$860,000 of amortization of debt issuance costs.

*Provision for Income Taxes.*  
(in thousands)

	Three Months Ended September 30,			
	2006	2005	\$Change	% Change
Income before provision for income taxes	\$7,458	\$9,722	\$(2,264)	-23.3%
Provision for income taxes	3,331	4,210	(879)	-20.9%
<i>% of income before provision for income taxes</i>	44.7%	43.3%		

The provision for income taxes for the three months ended September 30, 2006 was approximately \$3.3 million compared with \$4.2 million for the three months ended September 30, 2005, reflecting lower pre-tax profit levels. The income tax provision represented estimated federal, foreign, and state taxes for the three months ended September 30, 2006 and 2005. The effective tax rate for the three months ended September 30, 2006 was 44.7% and diverged from the combined federal and state statutory rate primarily due to the impact of accounting for share-based compensation and foreign withholding taxes, partially offset by the impact of tax-exempt interest income and the release of contingency reserves. The effective tax rate for the three months ended September 30, 2005 was 43.3% and diverged from the combined federal and state statutory rate primarily as a result of the impact of accounting for share-based compensation and other permanent taxable differences, partially offset by the impact of higher income from foreign operations, the benefit of tax exempt interest income, and research and development tax credits.

In accordance with SFAS 123R, we recognize tax benefit upon expensing certain share-based awards associated with our share-based compensation plans, including nonqualified stock options and deferred stock unit awards, but under current accounting standards, we cannot recognize tax benefit concurrent with the recognition of share-based compensation expenses associated with incentive stock options and employee stock purchase plan shares (qualified stock options). For qualified stock options that vested after our adoption of SFAS 123R, we recognize tax benefit only in the period when disqualifying dispositions of the underlying stock occur, and for qualified stock options that vested prior to our adoption of SFAS 123R, the tax benefit is recorded directly to additional paid-in capital. Tax benefit

associated with total share-based compensation was approximately \$781,000 for the three months ended September 30, 2006. Excluding the impact of share-based compensation and the related tax benefit, the effective tax rate for the three months ended September 30, 2006 and 2005 would have been 38.9% and 37.6%, respectively. Because we cannot recognize the tax benefit for share-based compensation expense associated with qualified stock

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options until the occurrence of future disqualifying dispositions of the underlying stock and because a portion of that tax benefit may be recorded directly to additional paid-in capital, our future quarterly and annual effective tax rates will be subject to greater volatility and, consequently, our ability to reasonably estimate our future quarterly and annual effective tax rates is greatly diminished.

**Liquidity and Capital Resources**

Our cash, cash equivalents, and short-term investments were \$245.7 million as of September 30, 2006 compared with \$245.2 million as of June 30, 2006, an increase of \$487,000. The increase in cash, cash equivalents, and short-term investments was primarily attributable to cash generated from operating activities of \$3.7 million and proceeds from stock option exercises and our employee stock purchase plan activity of \$1.5 million, partially offset by \$4.6 million of cash used for the repurchase of 215,000 shares of our common stock.

*Cash Flows from Operating Activities.* Operating activities during the three months ended September 30, 2006, generated cash of approximately \$3.7 million compared with \$10.0 million of cash generated during the three months ended September 30, 2005. For the three months ended September 30, 2006, net cash provided by operating activities was primarily attributable to net income of \$4.1 million plus adjustments for non-cash charges, including share-based compensation costs, depreciation, and amortization of debt issuance costs totaling \$3.8 million, partially offset by deferred tax, net of realized and excess tax benefit generated from share-based compensation aggregating \$700,000, and a \$3.5 million net increase in operating assets and liabilities. For the three months ended September 30, 2005, net cash provided by operating activities was primarily attributable to net income of \$5.5 million plus adjustments for non-cash charges, including share-based compensation costs, depreciation, and amortization of debt issuance costs totaling \$3.9 million and a net decrease in operating assets and liabilities of 1.2 million, partially offset by deferred tax, net of realized and excess tax benefit generated from share-based compensation aggregating \$643,000.

*Cash Flows from Investing Activities.* Our investing activities typically relate to purchases of government-backed securities and investment-grade fixed income instruments and purchases of property and equipment. Investing activities during the three months ended September 30, 2006 generated net cash of \$12.3 million compared with net cash used of \$12.9 million during the three months ended September 30, 2005. During the three months ended September 30, 2006, net cash provided by investing activities consisted of proceeds from sales and maturities of short-term investments of \$82.8 million, partially offset by purchases of \$70 million of short-term investments and purchases of \$515,000 of property and equipment. Cash used by investing activities during the three months ended September 30, 2005 consisted of purchases of \$51.0 million of short-term investments and purchases of \$1.7 million of property and equipment, which included \$1.3 million for building improvements, partially offset by \$39.8 million in proceeds from sales and maturities of short-term investments.

*Cash Flows from Financing Activities.* Net cash used in financing activities for the three months ended September 30, 2006 was \$3.0 million compared with net cash used in financing activities of \$17.5 million for the three months ended September 30, 2005. Our financing activities for the three months ended September 30, 2006 consisted primarily of \$4.6 million of cash used for the purchase of treasury stock, partially offset by \$1.5 million in proceeds from common stock issued under our stock option plans and employee stock purchase plan and \$183,000 of excess tax benefit from share-based compensation. Our financing activities for the three months ended September 30, 2005 consisted primarily of \$18.8 million of cash used for the purchase of treasury stock, partially offset by \$1.2 million in proceeds from common stock issued under our stock option plans and employee stock purchase plan and \$139,000 of excess tax benefit from share-based compensation.

*Common Stock Repurchase Program.* In October 2005, our board of directors authorized an additional \$40 million for our stock repurchase program, raising the aggregate authorization level to \$80 million. The program authorizes us to repurchase our common stock on the open market or in privately negotiated transactions depending upon market conditions and other factors. The number of shares purchased and the timing of purchases is based on the level of our cash balances, general business and market conditions, and other factors, including alternative investment opportunities. Common stock repurchased under this program is held as treasury stock. Purchases under this program totaled 2,521,100 shares through September 30, 2006 for an aggregate cost of \$44.6 million, or an average cost of \$17.69 per share. The authorization for the remaining \$35.4 million available under the stock repurchase program will expire in October 2007.

*Convertible Senior Subordinated Notes.* During December 2004, we issued \$125 million of 0.75% Convertible Senior Subordinated Notes maturing on December 1, 2024 (the Notes ) in a private offering pursuant to Rule 144A under the Securities Act of 1933, as amended. The Notes bear interest at a rate of 0.75% per annum



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

The Notes are convertible into 2,473,975 shares of our common stock, subject to adjustment in certain events. The denominator of the diluted net income per share calculation includes the weighted average effect of the 2,473,975 shares of common stock issuable upon conversion of the Notes. Through November 30, 2009, upon the occurrence of a fundamental change as defined in the indenture governing the Notes, we could potentially be obligated to issue up to 989,587 additional shares, or a total of 3,463,562 shares of common stock. These additional shares, contingently issuable upon a fundamental change, are not included in the calculation of diluted net income per share.

The Notes may be converted (1) if, during any calendar quarter commencing after December 31, 2004, the last reported sale price of our common stock for at least 20 trading days in the period of 30 consecutive trading days ending on the last trading day of the preceding calendar quarter is greater than or equal to 120% of the applicable conversion price on such last trading day; (2) on or after January 1, 2020; (3) if we have called the Notes for redemption; or (4) during prescribed periods, upon the occurrence of specified corporate transactions or fundamental changes. On or after December 1, 2009, we may redeem for cash all or a portion of the notes at a redemption price of 100% of the principal amount of the notes plus accrued and unpaid interest, including contingent interest and additional interest, if any. Noteholders have the right to require us to repurchase all or a portion of their notes for cash on December 1, 2009, December 1, 2014, and December 1, 2019 at a price equal to 100% of the principal amount of the Notes to be purchased plus accrued and unpaid interest, including contingent interest and additional interest, if any. Upon conversion of the Notes, in lieu of delivering common stock, we may, at our discretion, deliver cash or a combination of cash and common stock. As of September 30, 2006, none of the conditions for conversion or redemption of the Notes had occurred.

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

*Note Payable to a Related Party.* The note payable of \$1.5 million to National Semiconductor Corporation (National) due August 2007 represents limited-recourse debt that is secured solely by a portion of our stockholdings in Foveon, Inc., or Foveon, in which National is also an investor. We do not anticipate making any payments under the limited-recourse loan with National, either prior to or at maturity, unless Foveon is participating in a liquidity event, such as an initial public offering of its equity securities or a merger, through which we would receive amounts in excess of our \$1.5 million note payable plus the associated accrued interest.

*\$100 Million Shelf Registration.* We have registered an aggregate of \$100 million of common stock and preferred stock for issuance in connection with acquisitions, which shares generally will be freely tradeable after their issuance under Rule 145 of the Securities Act unless held by an affiliate of the acquired company, in which case such shares will be subject to the volume and manner of sale restrictions of Rule 144.

*\$125 Million Shelf Registration.* We have registered an aggregate of \$125 million of our 0.75% Convertible Senior Subordinated Notes due 2024 and the common stock issuable upon conversion of the notes. The shares issued upon conversion generally will be freely tradeable after their issuance unless held by an affiliate, in which case such shares will be subject to the volume and manner of sale restrictions of Rule 144.

*Liquidity and Capital Resources.* We believe our existing cash, cash equivalents, and short-term investment balances and anticipated cash flows from operating activities will be sufficient to meet our working capital and other cash requirements over the course of at least the next 12 months. Our future capital requirements will depend on many factors, including our rate of revenue growth or decline, the timing and extent of spending to support product development efforts, costs related to protecting our intellectual property, the expansion of sales and marketing

activities, the timing of introductions of new products and enhancements to existing products, the costs to ensure access to adequate manufacturing capacity, the continuing market acceptance of our product solutions, our common stock repurchase program, and the amount and timing of our investments in, or acquisitions of, other technologies or

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companies. Further equity or debt financing may not be available to us on acceptable terms or at all. If sufficient funds are not available or are not available on acceptable terms, our ability to take advantage of unexpected business opportunities or to respond to competitive pressures could be limited or severely constrained.

**Contractual Obligations and Commercial Commitments**

The following table sets forth a summary of our material contractual obligations and commercial commitments as of September 30, 2006 (in millions):

Contractual Obligations	Total	Payments due by period			
		Less than 1 year	1-3 Years	3-5 Years	More than 5 Years
Convertible senior subordinated notes (1) (2)	\$ 143	\$ 1	\$ 2	\$ 2	\$ 138
Note payable (1)	3	3			
Building leases	2	1	1		
Total	\$ 148	\$ 5	\$ 3	\$ 2	\$ 138

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

(2) Our convertible senior subordinated notes include a provision allowing the noteholders to require us, at the noteholders discretion, to repurchase their notes at a redemption price of 100% of the principal amount of the notes plus accrued and unpaid interest (including contingent interest and additional

interest, if any) on December 1, 2009, December 1, 2014, and December 1, 2019 and in the event of a fundamental change as described in the indenture governing the notes. The early repayment of the notes is not reflected in the above schedule, but if all the noteholders elected to exercise their rights to require us to repurchase their notes on December 1, 2009, then our contractual obligations for the three-to-five year period would be increased by \$123 million and no amounts would be due in more than 5 years.

### **Recent Accounting Pronouncements**

In June 2006, the Financial Accounting Standards Board issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* an interpretation of FASB Statement No. 109, ( FIN 48 ) which clarifies the accounting for uncertainty in income taxes recognized in an entity's financial statements in accordance with SFAS No. 109,

*Accounting for Income Taxes* ( SFAS 109 ). FIN 48 is designed to reduce the disparity in accounting treatment for uncertain tax positions resulting from diverse interpretations of SFAS 109 among companies. FIN 48 prescribes a recognition threshold and measurement attribute for financial statement disclosure of tax positions taken or expected to be taken on a tax return. FIN 48 is effective beginning in our first quarter of fiscal 2008. We are currently evaluating the requirements of FIN 48 and have not yet determined the impact of adoption, if any, on our financial position, results of operations, or cash flows.

In September 2006, the U.S. Securities and Exchange Commission released Staff Accounting Bulletin No. 108, ( SAB 108 ), which provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. SAB 108 provides transition guidance

for correcting errors and requires registrants to quantify misstatements using both the balance-sheet and income-statement approaches and to evaluate whether either approach results in quantifying an error that is material in light of relevant quantitative and qualitative factors. In the year of adoption only, if the effect is determined to be material, SAB 108 allows registrants to record the effect as a cumulative-effect adjustment to beginning-of-year retained earnings. SAB 108 does not change the requirements within SFAS No. 154, Accounting Changes and Error Corrections a replacement of APB No. 20 and FASB Statement No. 3, for the correction of an error on financial statements. Further, SAB 108 does not change the Staff's previous guidance in SAB 99 on evaluating the materiality of misstatements. SAB 108 is effective for our fiscal 2007. We are currently evaluating the requirements of SAB 108 and have not yet determined the impact of adoption, if any, on our financial position, results of operations, or cash flows.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements, ( SFAS 157 ). SFAS 157 defines fair value, establishes a framework for measuring fair value under U.S. generally accepted accounting principles, and expands disclosure about fair value measurements. SFAS 157 applies under other accounting standards that require or permit fair value measurements. Accordingly, SFAS 157 does not require any new fair value measurement. SFAS 157 is effective beginning in our first quarter of fiscal 2009. We are currently evaluating the

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requirements of SFAS 157 and have not yet determined the impact of adoption, if any, on our financial position, results of operations, or cash flows.

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

Our market risk has not changed significantly from the interest rate and foreign currency risks disclosed in Item 7A of our Annual Report on Form 10-K for the fiscal year ended June 30, 2006.

**ITEM 4. CONTROLS AND PROCEDURES**

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

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

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

On March 10, 2006, Elantech Devices Corporation filed a Complaint for Patent Infringement against us in the United States District Court for the Northern District of California, San Jose Division, claiming that we infringed Elantech's U.S. Patent No. 5,825,352 and seeking single and treble damages, attorneys' fees, and a permanent injunction against us infringing or inducing others to infringe the patent. On April 6, 2006, we filed our Answer to the Complaint and Counterclaims against Elantech Devices Corporation, claiming that Elantech has infringed and induced infringement of our U.S. Patent Nos. 5,543,591, 5,880,411, 5,943,052, and 6,380,931 and seeking single and treble damages, attorneys' fees, and a permanent injunction against infringing or inducing others to infringe.

Elantech responded to our counterclaim denying liability and counterclaimed seeking an injunction and damages for alleged violations of California law. We subsequently filed a motion to dismiss the Elantech counterclaims, which was granted on July 7, 2006 with leave to amend the counterclaims after the adjudication of the patent infringement claims. We intend to vigorously defend our patents and pursue our counterclaims.

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

In October 2005, our board of directors authorized an expansion of our stock repurchase program for up to an additional \$40 million of our common stock. The following sets forth purchases of our common stock under the repurchase program for each fiscal month during the three month period ended September 30, 2006:

		Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Program	Maximum Dollar Value of Shares that May Yet Be Purchased Under the Program
June 25, 2006	July 22, 2006			2,306,100	\$ 40,000,000
July 23, 2006	August 19, 2006	215,000	\$ 21.45	2,521,100	\$ 35,388,000
August 20, 2006	September 23, 2006			2,521,100	\$ 35,388,000
Total		215,000	\$ 21.45		

**ITEM 6. EXHIBITS**

- 31.1 Certification of Chief Executive Officer
- 31.2 Certification of Chief Financial Officer
- 32.1 Section 1350 Certification of Chief Executive Officer
- 32.2 Section 1350 Certification of Chief Financial Officer

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**SIGNATURES**

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

**SYNAPTICS INCORPORATED**

Date: October 26, 2006

By: /s/ Francis F. Lee  
Name: Francis F. Lee  
Title: President and Chief Executive  
Officer

By: /s/ Russell J. Knittel  
Name: Russell J. Knittel  
Title: Senior Vice President, Chief  
Financial Officer, and Chief  
Administrative Officer