

HAWTHORN BANCSHARES, INC.
Form 10-Q
August 14, 2015

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

x Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended June 30, 2015

or

Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the transition period from _____ to _____

Commission File Number: **0-23636**

HAWTHORN BANCSHARES, INC.

(Exact name of registrant as specified in its charter)

Missouri **43-1626350**
(State or other jurisdiction of (I.R.S. Employer
incorporation or organization) Identification No.)

132 East High Street, Box 688, Jefferson City, Missouri 65102

(Address of principal executive offices) *(Zip Code)*

(573) 761-6100

(Registrant's telephone number, including area code)

N/A

(Former name, former address and former fiscal year, if changed since last report.)

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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.:

Large accelerated filer <input type="checkbox"/>	Accelerated filer <input type="checkbox"/>
Non-accelerated filer <input checked="" type="checkbox"/> (Do not check if a smaller reporting company)	Smaller reporting company <input type="checkbox"/>

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

Yes No

As of August 14, 2015, the registrant had 5,443,344 shares of common stock, par value \$1.00 per share, outstanding

Part I - Financial Information**Item 1. Financial Statements****HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES****Consolidated Balance Sheets (unaudited)**

<i>(In thousands, except per share data)</i>	June 30, 2015	December 31, 2014
ASSETS		
Cash and due from banks	\$22,413	\$ 22,364
Federal funds sold and other overnight interest-bearing deposits	10,922	20,445
Cash and cash equivalents	33,335	42,809
Investment in available-for-sale securities, at fair value	239,487	198,998
Other investments and securities, at cost	7,916	4,722
Total investment securities	247,403	203,720
Loans	863,654	861,213
Allowances for loan losses	(9,986)	(9,099)
Net loans	853,668	852,114
Premises and equipment - net	37,006	37,498
Mortgage servicing rights	2,727	2,762
Other real estate and repossessed assets - net	12,516	11,885
Accrued interest receivable	4,642	4,816
Cash surrender value - life insurance	2,319	2,284
Other assets	10,747	11,843
Total assets	\$1,204,363	\$ 1,169,731
LIABILITIES AND STOCKHOLDERS' EQUITY		
Deposits		
Non-interest bearing demand	\$206,478	\$ 207,700
Savings, interest checking and money market	465,253	442,059
Time deposits \$100,000 and over	141,776	134,945
Other time deposits	175,359	184,810
Total deposits	988,866	969,514
Federal funds purchased and securities sold under agreements to repurchase	25,842	17,970
Subordinated notes	49,486	49,486
Federal Home Loan Bank advances	47,000	43,000
Accrued interest payable	365	373
Other liabilities	9,015	8,820
Total liabilities	1,120,574	1,089,163
Stockholders' equity:		
Common stock, \$1 par value, authorized 15,000,000 shares; issued 5,395,844 shares, respectively	5,396	5,396
Surplus	38,753	35,901

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Retained earnings	44,711	44,016
Accumulated other comprehensive loss, net of tax	(1,554)	(1,228)
Treasury stock; 161,858 shares, at cost	(3,517)	(3,517)
Total stockholders' equity	83,789	80,568
Total liabilities and stockholders' equity	\$1,204,363	\$ 1,169,731

See accompanying notes to the consolidated financial statements (*unaudited*).

HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES**Consolidated Statements of Income** *(unaudited)*

<i>(In thousands, except per share amounts)</i>	Three Months Ended June 30, 2015		Six Months Ended June 30, 2015	
	2015	2014	2015	2014
INTEREST INCOME				
Interest and fees on loans	\$10,104	\$10,048	\$20,177	\$19,913
Interest on investment securities:				
Taxable	890	874	1,792	1,755
Nontaxable	172	174	355	363
Federal funds sold and other overnight interest-bearing deposits	8	9	22	18
Dividends on other securities	40	20	66	40
Total interest income	11,214	11,125	22,412	22,089
INTEREST EXPENSE				
Interest on deposits:				
Savings, interest checking and money market	247	254	497	521
Time deposit accounts \$100,000 and over	222	244	431	487
Other time deposits	268	357	562	736
Interest on federal funds purchased and securities sold under agreements to repurchase	9	4	16	9
Interest on subordinated notes	320	315	633	627
Interest on Federal Home Loan Bank advances	164	104	311	208
Total interest expense	1,230	1,278	2,450	2,588
Net interest income	9,984	9,847	19,962	19,501
Provision for loan losses	250	0	250	0
Net interest income after provision for loan losses	9,734	9,847	19,712	19,501
NON-INTEREST INCOME				
Service charges and other fees	864	939	1,694	1,830
Bank card income and fees	629	616	1,216	1,159
Trust department income	274	228	478	431
Real estate servicing fees, net	186	22	180	199
Gain on sale of mortgage loans, net	434	257	781	448
Other	74	121	99	202
Total non-interest income	2,461	2,183	4,448	4,269
NON-INTEREST EXPENSE				
Salaries and employee benefits	5,175	4,960	10,478	9,991
Occupancy expense, net	717	672	1,380	1,292
Furniture and equipment expense	484	453	915	896
FDIC insurance assessment	258	242	499	480
Legal, examination, and professional fees	339	282	610	508
Advertising and promotion	270	256	507	546
Postage, printing, and supplies	272	280	543	545
Processing, network, and bank card expense	807	791	1,596	1,579

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Real estate foreclosure expense and (gains), net	158	172	(23)	296
Other	787	703	1,470	1,385
Total non-interest expense	9,267	8,811	17,975	17,518
Income before income taxes	2,928	3,219	6,185	6,252
Income tax expense	1,001	1,121	2,120	2,167
Net income	1,927	2,098	4,065	4,085
Basic earnings per share	\$0.35	\$0.39	\$0.75	\$0.75
Diluted earnings per share	\$0.35	\$0.39	\$0.75	\$0.75

See accompanying notes to the consolidated financial statements (*unaudited*).

HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES**Consolidated Statements of Comprehensive Income** *(unaudited)*

<i>(In thousands)</i>	Three Months		Six Months	
	Ended June 30, 2015	2014	Ended June 30, 2015	2014
Net income	\$1,927	\$2,098	\$4,065	\$4,085
Other comprehensive income, net of tax				
Investment securities available-for-sale:				
Unrealized (loss) gain on investment securities available-for-sale, net of tax	(860)	981	(376)	1,530
Adjustment for gain on sale of investment securities, net of tax	5	0	5	0
Defined benefit pension plans:				
Amortization of prior service cost included in net periodic pension cost, net of tax	22	12	45	24
Total other comprehensive (loss) income	(833)	993	(326)	1,554
Total comprehensive income	\$1,094	\$3,091	\$3,739	\$5,639

See accompanying notes to the consolidated financial statements *(unaudited)*.

HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES**Consolidated Statements of Stockholders' Equity** *(unaudited)*

<i>(In thousands)</i>	Common Stock	Surplus	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total Stock - holders' Equity
Balance, December 31, 2013	\$ 5,195	\$33,385	\$ 40,086	\$ (769	) \$ (3,517	) \$74,380
Net income	0	0	4,085	0	0	4,085
Other comprehensive income	0	0	0	1,554	0	1,554
Stock dividend	0	2,697	(2,697	) 0	0	0
Stock based compensation expense	0	10	0	0	0	10
Cash dividends declared, common stock	0	0	(504	) 0	0	(504
Balance, June 30, 2014	\$ 5,195	\$36,092	\$ 40,970	\$ 785	\$ (3,517	) \$79,525
Balance, December 31, 2014	\$ 5,396	\$35,901	\$ 44,016	\$ (1,228	) \$ (3,517	) \$80,568
Net income	0	0	4,065	0	0	4,065
Other comprehensive loss	0	0	0	(326	) 0	(326
Stock dividend	0	2,847	(2,847	) 0	0	0
Stock based compensation expense	0	5	0	0	0	5
Cash dividends declared, common stock	0	0	(523	) 0	0	(523
Balance, June 30, 2015	\$ 5,396	\$38,753	\$ 44,711	\$ (1,554	) \$ (3,517	) \$83,789

See accompanying notes to the consolidated financial statements *(unaudited)*.

HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES**Consolidated Statements of Cash Flows** *(unaudited)*

<i>(In thousands)</i>	Six Months Ended June 30,	
	2015	2014
Cash flows from operating activities:		
Net income	\$ 4,065	\$ 4,085
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation expense	962	867
Net amortization of investment securities, premiums, and discounts	664	543
Stock based compensation expense	5	10
Change in fair value of mortgage servicing rights	262	247
Gain on sale of investment securities	(8)	0
Gain on sales and dispositions of premises and equipment	(11)	(39)
Gain on sales and dispositions of other real estate and repossessed assets	(144)	(152)
Provision for other real estate owned	(6)	174
Decrease in accrued interest receivable	174	248
Increase in cash surrender value -life insurance	(35)	(38)
Decrease in other assets	1,344	230
Decrease in accrued interest payable	(8)	(33)
Increase in other liabilities		

The following table summarizes cash received and the aggregate intrinsic value for stock options exercised during the six months ended December 31, 2005 and 2004 (in thousands):

	Six Months Ended December 31,	
	2005	2004
Cash received	\$1,481	\$ 5,644
Aggregate intrinsic value	\$3,557	\$24,868

The fair value of each award granted from our stock option plans during the six months ended December 31, 2005 was estimated at the date of grant using the Black-Scholes option pricing model, assuming no expected dividends and the following assumptions:

Expected volatility	73.6%	73.9%
Expected life in years		5.0
Risk-free interest rate	4.1%	4.4%
Fair value per award	\$ 12.38	\$ 13.58

The expected volatility is based on 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 \$28.0 million to be recognized over a weighted average period of three years.

Table of Contents*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 two-year offering period will commence.

The following table summarizes shares purchased, weighted average purchase price, cash received, and the aggregate intrinsic value for ESPP purchases during the six months ended December 31, 2005 and 2004 (in thousands, except for shares purchased and weighted average purchase price):

	Six Months Ended December 31,	
	2005	2004
Shares purchased	49,442	91,961
Weighted average purchase price	\$ 17.47	\$ 6.78
Cash received	\$ 864	\$ 624
Aggregate intrinsic value	\$ 192	\$ 1,153

There were no ESPP shares purchased during the three months ended December 31, 2005 and 2004.

Under the terms of our ESPP, the offering period that commenced on January 1, 2005 was terminated on June 30, 2005 and a new offering period commenced on July 1, 2005. In accordance with Technical Bulletin No. FTB 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. This modification affected 169 employees participating in the ESPP as of June 30, 2005 and resulted in incremental compensation costs, net of estimated forfeitures, which will be recognized on a straight-line basis over the two-year period ending June 30, 2007.

The grant date fair value of each award granted under our ESPP during the six months ended December 31, 2005 was estimated using the Black-Scholes option pricing model, assuming no expected dividends and the following weighted average assumptions:

	Six Months Ended December 31, 2005
Expected volatility	70.9%
Expected life in years	1.2
Risk-free interest rate	3.5%
Fair value per award	\$ 9.55

The expected volatility is based on historical volatility; the expected life is based on the remaining term of the offering period at the date of enrollment to the plan; and the risk free interest rate is based on U. S. Treasury yields or yield curve in effect for the remaining term of the offering period at the date of enrollment in the plan. There were no awards granted under our ESPP during the three months ended December 31, 2005.

Unrecognized share-based compensation costs for awards granted under our ESPP are approximately \$1.5 million to be recognized over a weighted average period of one year.

Table of Contents*Pre-SFAS 123R Pro Forma Accounting Disclosures*

The fair value of each share-based award granted during the three and six months ended December 31, 2004 was estimated at the date of grant using the Black-Scholes option pricing model, assuming no expected dividends and the following weighted average assumptions:

	Three Months Ended December 31, 2004 Employee Stock Purchase Plan	
	Stock Options	Purchase Plan
Expected volatility	62.6%	
Expected life in years	5	
Risk-free interest rate	3.7%	
Fair value per award	\$13.89	
	Six Months Ended December 31, 2004 Employee Stock Purchase Plan	
	Stock Options	Purchase Plan
Expected volatility	63.5%	64.4%
Expected life in years	5	0.5
Risk-free interest rate	3.5%	1.9%
Fair value per award	\$10.79	\$ 2.56

During the three and six months ended December 31, 2004, had compensation expense for stock options been determined based on the fair value of the options at dates of grant consistent with the provisions of SFAS 123, net income and net income per share would have been reduced to the pro forma amounts indicated in the following table (in thousands, except per share amounts):

	Three Months Ended December 31, 2004	Six Months Ended December 31, 2004
Net income as reported	\$ 9,724	\$ 14,155
Add: Total stock-based compensation included in reported net income, net of tax	52	112
Deduct: Total stock-based compensation determined under fair value based method for all awards, net of tax	(1,256)	(2,643)
Net income pro forma	\$ 8,520	\$ 11,624
Net income per share basic:		
As reported	\$ 0.38	\$ 0.56
Pro forma	\$ 0.33	\$ 0.46
Net income per share diluted:		

As reported	\$	0.33	\$	0.50
Pro forma	\$	0.29	\$	0.41

10. 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.

In accordance with SFAS 123R, we established a deferred tax benefit on certain share-based awards associated with our share-based compensation plans, including nonqualified stock options, but under current accounting standards we cannot establish a deferred tax benefit on costs associated with incentive stock options and

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employee stock purchase plan shares (qualified stock options). For qualified stock options, we record tax benefit only in the period when disqualifying dispositions of the underlying stock occur. For the three and six months ended December 31, 2005, the effective tax rate was negatively affected by the impact of accounting required for share-based compensation as determined in accordance with SFAS 123R.

On October 22, 2004, the American Jobs Creation Act of 2004 (the Act) was signed into law. The Act creates a temporary incentive for U.S. corporations to repatriate accumulated income earned abroad by providing an 85% dividends received deduction for certain dividends from controlled foreign corporations, resulting in an approximate 5.25% federal tax rate on the repatriated earnings. To qualify for the deduction, the earnings must be reinvested in the United States pursuant to a domestic reinvestment plan established by our chief executive officer and approved by our board of directors. Certain other criteria in the Act must be satisfied as well. We have until the end of our fiscal year ending June 2006 to make a qualifying repatriation of foreign earnings, and prior to the end of this fiscal year, we will evaluate whether we will repatriate foreign earnings under the provisions of the Act. Our tax rate does not reflect any one-time impact that may result from the repatriation of permanently reinvested offshore earnings under the Act.

11. Segment, Customers, and Geographic Information

We operate in one segment: the development, marketing, and sale of interactive user interface solutions for electronic devices and products. We generate our revenue from two broad product categories: personal computer (PC) applications, primarily notebook computers, and non-PC information appliance applications. PC applications accounted for 91% and 57% of net revenue for the three months ended December 31, 2005 and 2004, respectively and 81% and 61% of net revenue for the six months ended December 31, 2005 and 2004, respectively.

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

	Three Months Ended		Six Months Ended	
	December 31,		December 31,	
	2005	2004	2005	2004
China	\$ 35,109	\$ 42,893	\$ 75,318	\$ 72,521
Taiwan	7,416	6,120	14,660	12,060
Other	6,030	7,530	10,302	10,053
	\$ 48,555	\$ 56,543	\$ 100,280	\$ 94,634

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

	Three Months Ended		Six Months Ended	
	December 31,		December 31,	
	2005	2004	2005	2004
Customer A	10%	37%	18%	37%
Customer B	13%	2%	9%	2%

Major customer accounts receivable as a percentage of total accounts receivable:

	As of	As of
	December	June 30,
	31,	2005
	2005	2005
Customer A	14%	41%
Customer B	12%	2%
Customer C	10%	6%

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12. Comprehensive Income

Our comprehensive income consists of net income, plus the effect of unrealized gains and losses from short-term investments at fair value, which was not material for the three or six months ended December 31, 2005 and 2004. Accordingly, comprehensive income closely approximated net income.

13. Recent Accounting Pronouncements

In May 2005, the Financial Accounting Standards Board issued SFAS No. 154, Accounting Changes and Error Corrections, (SFAS 154). SFAS 154, which replaces APB Opinion No. 20, Accounting Changes, (APB 20) and SFAS No. 3 Reporting Accounting Changes in Interim Financial Statements, applies to all voluntary changes in accounting principle and changes the requirements for accounting for and reporting of a change in accounting principle. APB 20 previously required that most voluntary changes in accounting principle be recognized by including in net income of the period of change a cumulative effect of changing to the new accounting principle while SFAS 154 requires retrospective application to prior periods financial statements of a voluntary change in accounting principle, unless it is impracticable. SFAS 154 enhances the consistency of financial information between periods. SFAS 154 will be effective beginning the first quarter of our fiscal 2007. We do not expect the adoption of SFAS 154 will have a material impact on our financial position, results of operations, or cash flows.

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Forward-Looking Statements and Factors That May Affect Results

You should read the following discussion and analysis in conjunction with our condensed consolidated financial statements and notes in Item 1 and with our audited consolidated financial statements and notes included in our Annual Report on Form 10-K for the year ended June 30, 2005.

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, iAppliance, and other electronic devices markets; competition in the notebook, iAppliance, and other electronic devices markets; revenue from the notebook, iAppliance, and other electronic devices markets; growth rates of these markets; average selling prices; product mix; manufacturing costs; cost-improvement programs; gross margins; customer relationships; research and development expenses; selling, general, and administrative expenses; 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, 2005, including particularly the section captioned "Business 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 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 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 2005, 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 allow 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 and implementing design and process improvements. Our newly introduced products may have lower margins than our more mature products, which have realized greater

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

Our research and development expenses include costs for supplies and materials related to product development, as well as the engineering costs incurred to design 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, share-based compensation costs, provision for income taxes, income taxes payable, intangible assets, and contingencies. We base our estimates on historical experience, applicable laws, and various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our consolidated financial statements. Actual results may differ from these estimates under different assumptions or conditions.

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 collectibility is reasonably assured. We accrue for estimated sales returns and other allowances, based on historical experience, at the time we recognize revenue, which is typically upon shipment. We record contract revenue for research and development as the services are provided under the terms of the contract. We recognize non-refundable contract fees for which no further performance obligations exist and for which there is no continuing involvement by us on the earlier of when the payments are received or when collection is reasonably 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 expectations of future demand and market conditions. Sudden declines in demand, rapid product improvements, or technological changes, or any combination of these factors, can cause us to have excess or obsolete inventories. On an ongoing basis, we review for estimated obsolete or unmarketable inventories and write down our inventories to their net realizable value based upon our forecasts of future demand and market conditions. If actual market conditions are less favorable than our forecasts, additional inventory reserves may be required. The following factors influence our estimates: changes to or cancellations of customer orders, unexpected decline in demand, rapid product improvements and technological advances, and termination or changes by our OEM customers of any product offerings incorporating our product solutions.

Periodically, we purchase inventory from our contract manufacturers when a customer's delivery schedule is delayed or a customer's order is cancelled. In those circumstances in which our customer has cancelled its order and we purchase inventory from our contract manufacturers, we consider a write-down to reduce the carrying value of the inventory purchased to its net realizable value.

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

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Accounting Bulletin No. 107, Share-Based Payment. 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 volatility was used in estimating the fair value of our share-based awards rather than implied volatility, while the expected life 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. The estimated fair value is charged to earnings on a straight-line basis over the vesting period of the underlying awards, which is generally four years for our stock option 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.

Income Taxes

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

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

In accordance with SFAS 123R, we established a deferred tax benefit on certain share-based awards associated with our share-based compensation plans, including nonqualified stock options, but under current accounting standards we cannot establish a deferred tax benefit on costs associated with incentive stock options and employee stock purchase plan shares (qualified stock options). For qualified stock options, we record tax benefit only in the period when disqualifying dispositions of the underlying stock occur. Accordingly, as we cannot record the tax benefit for share-based compensation expense associated with qualified stock options until the occurrence of future disqualifying dispositions of the underlying stock, our future quarterly and annual effective tax rates will be subject to greater volatility and, consequently, our ability to estimate reasonably our future quarterly and annual effective tax rates is greatly diminished.

Table of Contents**Results of Operations**

The following table presents our historical operating results for the periods indicated as a percentage of net revenue.

	Three Months Ended December 31,	
	2005	2004
Net revenue	100.0%	100.0%
Cost of revenue	54.3%	53.3%
Gross margin	45.7%	46.7%
Operating expenses:		
Research and development	17.2%	11.0%
Selling, general, and administrative	14.2%	7.8%
Amortization of deferred stock compensation	0.0%	0.2%
Total operating expenses	31.4%	19.0%
Income from operations	14.3%	27.7%
Interest income	3.9%	0.7%
Interest expense	-1.0%	-0.3%
Income before provision for income taxes	17.2%	28.1%
Provision for income taxes	7.3%	10.9%
Net income	9.9%	17.2%

Net Revenue. Net revenue was \$48.6 million for the three months ended December 31, 2005 compared with \$56.5 million for the three months ended December 31, 2004, a decrease of 14.1%. The decrease in net revenue was primarily attributable to a reduction in overall average selling prices, resulting from changes in product mix and general competitive pricing pressure. Revenue from our dual pointing applications was approximately 15% of net revenue for the three months ended December 31, 2005 compared with approximately 14% for the three months ended December 31, 2004. Our non-PC revenue decreased to 9% of net revenue for the three months ended December 31, 2005 from 43% of net revenue for the three months ended December 31, 2004, primarily due to decreased demand for our capacitive interface solutions for HDD portable digital music players.

Gross Margin. Gross margin as a percentage of net revenue was 45.7% for the three months ended December 31, 2005 compared with 46.7% for the three months ended December 31, 2004. The decline in gross margin as a percentage of net revenue reflects an unfavorable product mix and lower average selling prices, partially offset by lower manufacturing costs, which resulted from the combination of our continuing design and process improvement programs and lower assembly and test costs. Non-cash share-based compensation costs resulted from our adoption of SFAS 123R on a modified prospective basis at the beginning of fiscal year 2006.

Research and Development Expenses. Research and development expenses increased as a percentage of net revenue to 17.2% from 11.0% and increased approximately \$2.1 million, or 33.6%, to \$8.3 million for the three months ended December 31, 2005 compared with \$6.2 million for the three months ended December 31, 2004. A major contributor to the increase in research and development expenses was the inclusion of non-cash share-based compensation costs of \$1.2 million as a result of adopting SFAS 123R on a modified prospective basis at the beginning of fiscal year 2006. Excluding non-cash share-based compensation costs, research and development

expenses increased \$854,000, or 13.7%, because of higher employee compensation costs resulting from additional staffing, increased base compensation related to our annual performance review process, and increased project spending.

Selling, General, and Administrative Expenses. Selling, general, and administrative expenses increased as a percentage of net revenue to 14.2% from 7.8% and increased approximately \$2.5 million, or 57.5%, to \$6.9 million for the three months ended December 31, 2005 compared with \$4.4 million for the three months ended December 31, 2004. The increase in selling, general, and administrative expenses reflects the inclusion of non-cash share-based compensation costs of \$2.0 million as a result of adopting SFAS 123R on a modified prospective basis at the beginning of fiscal year 2006. Excluding non-cash share-based compensation costs, selling, general, and administrative expenses increased \$566,000, or 12.9%, because of higher employee compensation costs resulting from additional staffing, increased base compensation related to our annual performance review process, increased recruiting and hiring costs

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related to our ongoing staffing initiatives, and higher corporate governance costs associated with Sarbanes-Oxley Act compliance.

Amortization of Deferred Stock Compensation. Beginning with fiscal year 2006 we adopted SFAS 123R and, as a result, ceased amortizing deferred stock compensation. Accordingly, no amortization expense for deferred stock compensation was recorded for the three months ended December 31, 2005 while \$85,000 was recorded for the three months ended December 31, 2004.

Interest Income. Interest income was \$1.9 million for the three months ended December 31, 2005 compared with \$397,000 for the three months ended December 31, 2004. The \$1.5 million increase in interest income resulted from a combination of substantially higher average invested cash balances and higher average interest rates. The increase in cash balances was primarily a result of net cash proceeds of \$120.7 million received from the issuance of our convertible senior subordinated notes in December 2004 combined with cash flows from operations during the past twelve months of \$54.3 million, partially offset by \$40 million of cash used for our stock repurchase program.

Interest Expense. Interest expense was \$485,000 for the three months ended December 31, 2005 compared with \$151,000 for the three months ended December 31, 2004. The \$334,000 increase in interest expense resulted primarily from a 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 the amortization of debt issuance costs.

Provision for Income Taxes. The provision for income taxes for the three months ended December 31, 2005 was \$3.5 million compared with \$6.2 million for the three months ended December 31, 2004, which reflected the lower pre-tax profit levels partially offset by a higher effective tax rate. The income tax provision represented estimated federal, foreign, and state taxes for the three months ended December 31, 2005 and 2004. The effective tax rate for the three months ended December 31, 2005 was approximately 42.3% 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 and tax exempt interest income. The effective tax rate for the three months ended December 31, 2004 was approximately 38.9% and diverged from the combined federal and state statutory rate primarily as a result of the impact of higher income from foreign operations, the benefit of research and development tax credits, and tax exempt interest income, partially offset by permanent taxable differences.

In accordance with SFAS 123R, we established a deferred tax benefit on certain share-based awards associated with our share-based compensation plans, including nonqualified stock options, but under current accounting standards we cannot establish a deferred tax benefit on share-based compensation costs associated with incentive stock options and employee stock purchase plan shares (qualified stock options). For qualified stock options, we record tax benefit only in the period when disqualifying dispositions of the underlying stock occur. Tax benefit associated with total share-based compensation was approximately \$724,000 for the three months ended December 31, 2005. Excluding the impact of share-based compensation and the related tax benefit, the effective tax rate for the three months ended December 31, 2005 would have been 36.3%. As we cannot record the tax benefit for share-based compensation expense associated with qualified stock options until the occurrence of future disqualifying dispositions of the underlying stock, our future quarterly and annual effective tax rates will be subject to greater volatility and, consequently, our ability to estimate reasonably our future quarterly and annual effective tax rates is greatly diminished.

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The following table presents our historical operating results for the periods indicated as a percentage of net revenue.

	Six Months Ended December 31,	
	2005	2004
Net revenue	100.0%	100.0%
Cost of revenue	54.3%	53.9%
Gross margin	45.7%	46.1%
Operating expenses:		
Research and development	16.6%	13.0%
Selling, general, and administrative	13.6%	8.6%
Amortization of deferred stock compensation	0.0%	0.2%
Total operating expenses	30.2%	21.8%
Income from operations	15.5%	24.3%
Interest income	3.5%	0.7%
Interest expense	-1.0%	-0.2%
Income before provision for income taxes	18.0%	24.8%
Provision for income taxes	7.7%	9.8%
Net income	10.3%	15.0%

Net Revenue. Net revenue was \$100.3 million for the six months ended December 31, 2005 compared with \$94.6 million for the six months ended December 31, 2004, an increase of 6.0%. The increase in net revenue was primarily attributable to a 26% increase in unit shipments for the six months ended December 31, 2005 compared with the six months ended December 31, 2004, partially offset by a reduction in overall average selling prices, resulting from changes in product mix and general competitive pricing pressure. Revenue from our dual pointing applications was approximately 15% of net revenue for both the six months ended December 31, 2005 and 2004. Our non-PC revenue decreased to 19% of net revenue for the six months ended December 31, 2005 from 39% of net revenue for the six months ended December 31, 2004, primarily due to decreased demand for our capacitive interface solutions for HDD portable digital music players.

Gross Margin. Gross margin as a percentage of net revenue was 45.7% for the six months ended December 31, 2005 compared with 46.1% for the six months ended December 31, 2004. The decline in gross margin as a percentage of net revenue primarily reflects an unfavorable product mix and lower average selling prices, partially offset by lower manufacturing costs, which resulted from the combination of our continuing design and process improvement programs and lower assembly and test costs. Non-cash share-based compensation costs resulted from our adoption of SFAS 123R on a modified prospective basis at the beginning of fiscal year 2006.

Research and Development Expenses. Research and development expenses increased as a percentage of net revenue to 16.6% from 13.0% and increased approximately \$4.3 million, or 35.3%, to \$16.6 million for the six months ended December 31, 2005 compared with \$12.3 million for the six months ended December 31, 2004. A major contributor to the increase in research and development expenses was the inclusion of non-cash share-based compensation costs of \$2.5 million as a result of adopting SFAS 123R on a modified prospective basis at the

beginning of fiscal year 2006. Excluding non-cash share-based compensation costs, research and development expenses increased approximately \$1.8 million, or 14.7%, because of higher employee compensation costs resulting from additional staffing, increased base compensation related to our annual performance review process, and increased project spending.

Selling, General, and Administrative Expenses. Selling, general, and administrative expenses increased as a percentage of net revenue to 13.6% from 8.6% and increased approximately \$5.5 million, or 67.3%, to \$13.6 million for the six months ended December 31, 2005 compared with \$8.2 million for the six months ended December 31, 2004. The increase in selling, general, and administrative expenses reflects the inclusion of non-cash share-based compensation costs of \$3.8 million as a result of adopting SFAS 123R on a modified prospective basis at the beginning of fiscal year 2006. Excluding non-cash share-based compensation costs, selling, general, and administrative expenses increased approximately \$1.7 million, or 20.9%, because of higher employee compensation costs resulting from additional staffing, increased base compensation related to our annual performance review process, increased recruiting

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and hiring costs related to our ongoing staffing initiatives, and higher corporate governance costs associated with Sarbanes-Oxley Act compliance.

Amortization of Deferred Stock Compensation. Beginning with fiscal year 2006 we adopted SFAS 123R and, as a result, ceased amortizing deferred stock compensation. Accordingly, no amortization expense for deferred stock compensation was recorded for the six months ended December 31, 2005 while \$187,000 was recorded for the six months ended December 31, 2004.

Interest Income. Interest income was \$3.5 million for the six months ended December 31, 2005 compared with \$665,000 for the six months ended December 31, 2004. The \$2.8 million increase in interest income resulted from a combination of substantially higher average invested cash balances and higher average interest rates. The increase in cash balances was primarily a result of net cash proceeds of \$120.7 million received from the issuance of our convertible senior subordinated notes in December 2004 combined with cash flows from operations during the past twelve months of \$54.3 million, partially offset by \$40 million of cash used for our stock repurchase program.

Interest Expense. Interest expense was \$969,000 million for the six months ended December 31, 2005 compared with \$177,000 for the six months ended December 31, 2004. The \$792,000 increase in interest expense resulted primarily from a 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 the amortization of debt issuance costs.

Provision for Income Taxes. The provision for income taxes for the six months ended December 31, 2005 was \$7.7 million compared with \$9.3 million for the six months ended December 31, 2004, which reflected lower pre-tax profit levels partially offset by a higher effective tax rate. The income tax provision represented estimated federal, foreign, and state taxes for the six months ended December 31, 2005 and 2004. The effective tax rate for the six months ended December 31, 2005 was approximately 42.9% 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 and tax exempt interest income. The effective tax rate for the six months ended December 31, 2004 was approximately 39.6% and diverged from the combined federal and state statutory rate primarily as a result of permanent taxable differences, partially offset by the benefit of research and development tax credits, and tax exempt interest income.

In accordance with SFAS 123R, we established a deferred tax benefit on share-based compensation costs associated with nonqualified stock options, but under current accounting standards we cannot establish a deferred tax benefit on share-based compensation costs associated with incentive stock options and employee stock purchase plan shares (qualified stock options). For qualified stock options, we record tax benefit only in the period when disqualifying dispositions of the underlying stock occur. Tax benefit associated with total share-based compensation was approximately \$1.4 million for the six months ended December 31, 2005. Excluding the impact of share-based compensation and the related tax benefit, the effective tax rate for the six months ended December 31, 2005 would have been 37.0%. As we cannot record the tax benefit for share-based compensation expense associated with qualified stock options until the occurrence of future disqualifying dispositions of the underlying stock, 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.

Liquidity and Capital Resources

Our cash, cash equivalents, and short-term investments were \$230.2 million as of December 31, 2005 compared with \$228.9 million as of June 30, 2005, an increase of \$1.3 million. The increase in cash, cash equivalents, and short-term investments was primarily attributable to cash generated from operating activities of \$19.1 million, partially offset by \$18.8 million of cash used for the repurchase of approximately 1.2 million shares of our common stock.

Cash Flows from Operating Activities. During the six months ended December 31, 2005, operating activities generated cash of \$19.1 million compared with \$7.4 million of cash generated during the six months ended December 31, 2004. For the six months ended December 31, 2005, the net cash provided by operating activities was primarily attributable to net income of \$10.3 million plus adjustments for non-cash charges, including share-based compensation costs, depreciation, amortization of debt issuance costs, and tax benefit from stock options net of excess

tax benefit from share-based compensation totaling \$8.1 million, partially offset by deferred tax benefit from share-based compensation of \$1.4 million and a net decrease in operating assets and liabilities of \$2.1 million. For the six months

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ended December 31, 2004, the net cash provided by operating activities was primarily attributable to net income of \$14.2 million plus adjustments for non-cash charges, including depreciation and amortization of deferred stock compensation, and amortization of debt issuance costs totaling \$712,000, and tax benefit from stock options totaling \$7.7 million, partially offset by an increase in operating assets and liabilities of \$15.2 million. The increase in operating assets and liabilities for the period ended December 31, 2004 relates primarily to the \$12.8 million increase in accounts receivable and the \$4.4 million increase in inventory levels partially offset by higher accounts payable, all of which reflected our higher operating levels.

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 six months ended December 31, 2005 used net cash of \$45.8 million compared with net cash used of \$386,000 during the six months ended December 31, 2004. During the six months ended December 31, 2005, net cash used in investing activities consisted of purchases of \$131.2 million of short-term investments and \$2.1 million of property and equipment, partially offset by \$87.5 million in proceeds from sales and maturities of short-term investments. Cash used by investing activities during the six months ended December 31, 2004 consisted of cash used for purchases of short-term investments of \$4.2 million and \$768,000 of capital equipment, partially offset by proceeds from sales and maturities of short-term investments of \$4.6 million.

Cash Flows from Financing Activities. Net cash used in financing activities for the six months ended December 31, 2005 was \$15.6 million compared with net cash provided by financing activities of \$126.9 million for the six months ended December 31, 2004. Our financing activities for the six months ended December 31, 2005 consisted primarily of \$18.8 million of cash used for the purchase of 1.2 million shares of treasury stock, partially offset by \$2.3 million in proceeds from common stock issued under our stock option plans and employee stock purchase plan and \$880,000 of excess tax benefit from share-based compensation. Our financing activities for the six months ended December 31, 2004 consisted primarily of the proceeds from the issuance of \$125.0 million of convertible senior subordinated notes and \$6.3 million from common stock issued under our stock option plans and employee stock purchase plan, partially offset by \$4.3 million of debt issuance costs.

Common Stock Repurchase Program. In April 2005, our board of directors authorized a stock repurchase program for up to \$40 million of our common stock on the open market or in privately negotiated transactions, depending upon market conditions and other factors. Common stock repurchased under this program is held as treasury stock, and through September 30, 2005, purchases under this program totaled 2,306,100 shares for an aggregate cost of \$40 million, or an average cost of \$17.34 per share.

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 on the open market or in privately negotiated transactions, depending upon market conditions and other factors through October 2007. Through December 31, 2005, no additional shares have been repurchased under the expanded stock repurchase program.

Bank Credit Facility. We currently maintain a \$15 million working capital line of credit with Silicon Valley Bank. The Silicon Valley Bank revolving line of credit, which expires on November 26, 2006, has an interest rate equal to Silicon Valley Bank's prime lending rate, and provides for a security interest in substantially all of our assets. We had not borrowed any amounts under the line of credit as of December 31, 2005.

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 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.

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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 December 31, 2005, none of the conditions for conversion or redemption of the Notes were satisfied.

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 long-term note payable of \$1.5 million to National Semiconductor Corporation (National) represents limited-recourse debt that matures in August 2007 and is secured solely by a portion of our stockholdings in Foveon, Inc. (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 long-term note payable plus accrued interest expense.

\$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 under Rule 145 of the Securities Act, 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 Outlook. 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 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 companies. We cannot assure you that further equity or debt financing will 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.

Table of Contents**Contractual Obligations and Commercial Commitments**

The following table sets forth a summary of our material contractual obligations and commercial commitments as of December 31, 2005 (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	\$ 125	\$	\$	\$	\$ 125
Note payable	2		2		
Building leases	1	1			
Total	\$ 128	\$ 1	\$ 2	\$	\$ 125

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 \$125 million with a corresponding decrease in amounts due in more than 5 years.

Recent Accounting Pronouncements

In May 2005, the Financial Accounting Standards Board issued SFAS No. 154, Accounting Changes and Error Corrections (SFAS 154). SFAS 154, which replaces Accounting Principles Board Opinion No. 20, Accounting Changes, (APB 20) and SFAS No. 3 Reporting Accounting Changes in Interim Financial Statements, applies to all voluntary changes in accounting principle and changes the requirements for accounting for and reporting of a change in accounting principle. APB 20 previously required that most voluntary changes in accounting principle be recognized by including in net income of the period of change a cumulative effect of changing to the new accounting principle while SFAS 154 requires retrospective application to prior periods' financial statements of a voluntary change in accounting principle, unless it is impracticable. SFAS 154 enhances the consistency of financial information between periods. SFAS 154 will be effective beginning the first quarter of our fiscal 2007. We do not expect the adoption of SFAS 154 will have a material impact on our financial position, results of operations, or cash flows.

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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, 2005.

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 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. There were no purchases under the stock repurchase program during the quarter ended December 31, 2005.

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

Our 2005 Annual Meeting of Stockholders was held on October 18, 2005 for the purpose of electing two directors to serve for three-year terms expiring in 2008 and to ratify the appointment of KPMG LLP, an independent registered public accounting firm, as our independent auditor for the fiscal year ending June 24, 2006.

The following nominees were elected to our Board of Directors to serve for a three-year term expiring 2008 as set forth in the Proxy Statement:

	Nominee	Votes in Favor	Withheld
Francis F. Lee		21,997,976	275,492
Richard L. Sanquini		20,522,105	1,751,363

The following directors terms of office continued after the 2005 Annual Meeting of Stockholders: Federico Faggin, W. Ronald Van Dell, Keith B. Geeslin, and Jeffrey Buchanan.

Ratification of the appointment of KPMG LLP, an independent registered public accounting firm, as our independent auditor for the fiscal year ending June 24, 2006 was voted upon and approved by our stockholders as follows:

	Votes in Favor	Votes Against	Abstain	Broker Non-Votes
22,119,029		142,143	12,296	

ITEM 6. EXHIBITS

- 31.1 Certification of Chief Executive Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a)
- 31.2 Certification of Chief Financial Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a)
- 32.1 Certification of Chief Executive Officer, pursuant to Rule 13a-14(b) or Rule 15d-14(b) and 18 U.S.C Section 1350
- 32.2 Certification of Chief Financial Officer, pursuant to Rule 13a-14(b) or Rule 15d-14(b) and 18 U.S.C Section 1350

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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
(Registrant)

Date: February 6, 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

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