

EMAGIN CORP  
Form 10-Q  
November 19, 2007

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

**Form 10-Q**

(Mark One)

**R QUARTERLY REPORT UNDER SECTION 13 OR 15(D) OF THE  
SECURITIES EXCHANGE ACT OF 1934**

**For the quarterly period ended September 30, 2007  
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 001-15751**

**eMAGIN CORPORATION**

*(Exact name of registrant as specified in its charter)*

**Delaware**

*(State or other jurisdiction of  
incorporation or organization)*

**56-1764501**

*(I.R.S. Employer  
Identification No.)*

**10500 NE 8<sup>th</sup> Street, Suite 1400, Bellevue, Washington 98004**

*(Address of principal executive offices)*

**(425) 749-3600**

*(Registrant's telephone number, including area code)*

**Securities registered pursuant to Section 12(b) of the Act: None**

**Securities registered pursuant to Section 12(g) of the Act: Common Stock, \$.001 Par Value Per Share**

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 R 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 R

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

The number of shares of common stock outstanding as of October 31, 2007 was 12,620,900.

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**eMagin Corporation**  
**Form 10-Q**  
**For the Quarter ended September 30, 2007**

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**CERTIFICATIONS**

**ITEM 1. Condensed Consolidated Financial Statements**

**eMAGIN CORPORATION**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
(In thousands, except share data)

	<b>September 30, 2007 (unaudited)</b>	<b>December 31, 2006</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 792	\$ 1,415
Investments – held to maturity	138	171
Accounts receivable, net	2,698	908
Inventory	1,951	2,485
Prepaid expenses and other current assets	801	656
Total current assets	6,380	5,635
Equipment, furniture and leasehold improvements, net	365	666
Intangible assets, net	52	55
Other assets	231	233
Deferred financing costs, net	40	416
Total assets	\$ 7,068	\$ 7,005
<b>LIABILITIES AND SHAREHOLDERS' CAPITAL DEFICIT</b>		
Current liabilities:		
Accounts payable	\$ 1,188	\$ 1,192
Accrued compensation	1,349	959
Other accrued expenses	881	749
Advance payments	396	444
Deferred revenue	254	126
Current portion of capitalized lease obligations	—	6
Current portion of debt	657	1,217
Derivative liability - warrants	—	1,195
Other current liabilities	68	52
Total current liabilities	4,793	5,940
Long-term debt	5,931	2,229
Total liabilities	10,724	8,169
Commitments and contingencies		
Shareholders' capital deficit:		
Preferred stock, \$.001 par value: authorized 10,000,000 shares; no shares issued and outstanding	—	—

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Series A Senior Secured Convertible Preferred stock, stated value \$1,000 per share, \$.001 per value: 3,198 shares designated, and none issued.

Common stock, \$.001 par value: authorized 200,000,000 shares, issued and outstanding, 12,224,556 shares as of September 30, 2007 and 10,341,029 shares as of December 31, 2006

	12	10
Additional paid-in capital	194,473	179,651
Accumulated deficit	(198,141)	(180,825)
Total shareholders' capital deficit	(3,656)	(1,164)
Total liabilities and shareholders' capital deficit	\$ 7,068	\$ 7,005

See notes to Condensed Consolidated Financial Statements.

**eMAGIN CORPORATION**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
(In thousands, except share and per share data)  
(unaudited)

	<b>Three Months Ended</b>		<b>Nine months</b>	
	<b>September 30,</b>		<b>Ended September 30,</b>	
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
Revenue:				
Product revenue	\$ 4,318	\$ 2,242	\$ 11,985	\$ 5,487
Contract revenue	753	50	927	120
Total revenue, net	5,071	2,292	12,912	5,607
Cost of goods sold	3,059	2,940	9,120	8,934
Gross profit (loss)	2,012	(648)	3,792	(3,327)
Operating expenses:				
Research and development	564	965	2,304	3,507
Selling, general and administrative	1,434	1,838	5,198	6,674
Total operating expenses	1,998	2,803	7,502	10,181
Income (loss) from operations	14	(3,451)	(3,710)	(13,508)
Other income (expense):				
Interest expense	(592)	(509)	(2,766)	(509)
Loss on extinguishment of debt	(10,749)	—	(10,749)	—
Gain (loss) on warrant derivative liability	(1,496)	177	(853)	177
Other income, net	172	14	762	73
Total other (expense) income	(12,665)	(318)	(13,606)	(259)
Net loss	\$ (12,651)	\$ (3,769)	\$ (17,316)	\$ (13,767)
Loss per share, basic and diluted	\$ (1.06)	\$ (0.37)	\$ (1.53)	\$ (1.37)
Weighted average number of shares outstanding:				
Basic and diluted	11,934,705	10,077,260	11,300,757	10,030,988

See notes to Condensed Consolidated Financial Statements.





**eMAGIN CORPORATION**  
**CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' CAPITAL DEFICIT**  
(In thousands)

	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Accumulated Deficit	Total Shareholders' Deficit
Balance, December 31, 2006	10,341	\$ 10	\$ 179,651	\$ (180,825)	\$ (1,164)
Stock-based compensation	—	—	1,172	—	1,172
Debt conversion to equity	797	1	309	—	310
Issuance of common stock for services	1,076	1	952	—	953
Exercise of common stock warrants	10	—	3	—	3
Expiration of derivative liability- warrants	—	—	2,653	—	2,653
Beneficial conversion premium	—	—	5,078	—	5,078
Fair value of warrants issued	—	—	4,655	—	4,655
Net loss	—	—	—	(17,316)	(17,316)
Balance, September 30, 2007 (unaudited)	12,224	\$ 12	\$ 194,473	\$ (198,141)	\$ (3,656)

See notes to Condensed Consolidated Financial Statements.

**eMAGIN CORPORATION**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(In thousands)

	<b>Nine months Ended</b>	
	<b>September 30,</b>	
	<b>2007</b>	<b>2006</b>
	<b>(unaudited)</b>	
Cash flows from operating activities:		
Net loss	\$ (17,316)	\$ (13,767)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	313	792
Amortization of deferred financing fees	266	—
Reduction of provision for sales returns and doubtful accounts	(35)	(18)
Stock-based compensation	1,172	2,270
Issuance of common stock for services	953	375
Amortization of discount on notes payable	1,848	382
Gain on warrant derivative liability	853	(177)
Loss on extinguishment of debt	10749	—
Changes in operating assets and liabilities:		
Accounts receivable	(1,755)	(339)
Inventory	534	899
Prepaid expenses and other current assets	(145)	(8)
Deferred revenue	128	20
Accounts payable, accrued compensation, other accrued expenses, and advanced payments	750	(899)
Other current liabilities	15	101
Net cash used in operating activities	(1,670)	(10,369)
Cash flows from investing activities:		
Purchase of equipment	(9)	(204)
Proceeds from or (purchase of) investments – held to maturity	33	(4)
Purchase of intangibles and other assets	—	(2)
Net cash provided by (used in) investing activities	24	(210)
Cash flows from financing activities:		
Proceeds from exercise of stock options and warrants	3	10
Proceeds from long-term debt and line of credit	1,108	5,379
Payments related to deferred financing costs	(40)	—
Payments of long-term debt and capital leases	(48)	(130)
Net cash provided by financing activities	1,023	5,259
Net decrease in cash and cash equivalents	(623)	(5,320)
Cash and cash equivalents beginning of period	1,415	6,727
Cash and cash equivalents end of period	\$ 792	\$ 1,407
Cash paid for interest	\$ 281	\$ 127
Cash paid for taxes	\$ 67	\$ 35

During the nine months ended September 30, 2007, the Company:

Entered into an intellectual property agreement with Kodak where Kodak was assigned the rights to a specific patent and as part of the consideration waived the royalty payments for the first six months of 2007 and reduced the royalty

payment to 50% for the third quarter. \$723 thousand was recorded as income from the licensing of intangible assets; Issued approximately 797 thousand shares for the conversion of Notes and interest totaling approximately \$310 thousand; and

Entered into amended Note Purchase Agreement with investors and issued warrants that are exercisable at \$1.03 per share into approximately 5.4 million shares of common stock.

See notes to Condensed Consolidated Financial Statements.

**eMAGIN CORPORATION**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

**Note 1: Description of the Business and Summary of Significant Account Policies**

***The Business***

eMagin Corporation is a developer and manufacturer of optical systems and microdisplays for use in the electronics industry. eMagin also develops and markets microdisplay systems and optics technology for commercial, industrial and military applications.

***Basis of Presentation***

In the opinion of management, the accompanying unaudited condensed consolidated financial statements of eMagin Corporation and its subsidiary reflects all adjustments, including normal recurring accruals, necessary for a fair presentation. Certain information and footnote disclosure normally included in annual financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted pursuant to instruction, rules and regulations prescribed by the Securities and Exchange Commission. The Company believes that the disclosures provided herein are adequate to make the information presented not misleading when these unaudited condensed consolidated financial statements are read in conjunction with the audited consolidated financial statements contained in the Company's Annual Report on Form 10-K for the year ended December 31, 2006. The results of operations for the period ended September 30, 2007 are not necessarily indicative of the results to be expected for the full year.

On November 3, 2006, the Company effected a one-for-ten (1-for-10) reverse stock split of its issued and outstanding common stock. All common and per share amounts in the accompanying financial statements have been adjusted to reflect the 1-for-10 reverse stock split.

The condensed consolidated financial statements have been prepared assuming that the Company will continue as a going concern. The Company has had recurring losses from operations which it believes will continue through the foreseeable future. The Company's cash requirements over the next twelve months are greater than the Company's cash, cash equivalents, and investments at September 30, 2007. The Company has a shareholders' deficit at September 30, 2007. These factors raise substantial doubt regarding the Company's ability to continue as a going concern. The condensed consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty. To address the liquidity issue, the Company entered into an asset based loan agreement in August 2007 establishing a \$2.5 million revolving line of credit. See Note 7 for additional information.

***Use of Estimates***

The preparation of financial statements in conformity with generally accepted accounting principles in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements as well as the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. These estimates and assumptions relate to recording net revenue, collectibility of accounts receivable, useful lives and impairment of tangible and intangible assets, accruals, derivative liability, income taxes, inventory realization and other factors. Management has exercised reasonable judgment in deriving these estimates. Consequently, a change in conditions could affect these estimates.

***Revenue Recognition***

Revenue is recognized when products are shipped to customers, net of allowances for anticipated returns. The Company's revenue-earning activities generally involve delivering products, and revenues are considered to be earned when the Company has completed the process by which it is entitled to such revenues. Revenue is recognized when persuasive evidence of an arrangement exists, delivery has occurred, selling price is fixed or determinable and collection is reasonably assured. The Company defers revenue recognition on products sold directly to the consumer with a fifteen day right of return. Revenue is recognized upon the expiration of the right of return.

The Company also earns revenues from certain R&D activities under both firm fixed-price contracts and cost-type contracts, including some cost-plus-fee contracts. Revenues relating to firm fixed-price contracts are generally recognized on the percentage-of-completion method of accounting as costs are incurred (cost-to-cost basis). Revenues on cost-plus-fee contracts include costs incurred plus a portion of estimated fees or profits based on the relationship of costs incurred to total estimated costs. Contract costs include all direct material and labor costs and an allocation of allowable indirect costs as defined by each contract, as periodically adjusted to reflect revised agreed upon rates. These rates are subject to audit by the other party.

### ***Stock-based Compensation***

Effective January 1, 2006, the Company adopted the provisions of SFAS No. 123R, "Share-Based Payment" ("SFAS 123R"), which requires the Company to recognize expense related to the fair value of the Company's share-based compensation issued to employees and directors. SFAS 123R requires companies to estimate the fair value of share-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in the Company's condensed consolidated statement of operations. The Company uses the straight-line method for recognizing compensation expense. An estimate for forfeitures is included in compensation expense for awards under SFAS 123R. See Note 8 for a further discussion on stock-based compensation.

### **Note 2: Recently Issued Accounting Pronouncements**

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements" (SFAS 157"). SFAS 157 provides guidance for using fair value to measure assets and liabilities. It also responds to investors' requests for expanded information about the extent to which companies measure assets and liabilities at fair value, the information used to measure fair value, and the effect of fair value measurements on earnings. SFAS 157 applies whenever other standards require (or permit) assets or liabilities to be measured at fair value, and does not expand the use of fair value in any new circumstances. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and is required to be adopted by the Company in the first quarter of 2008. The Company is evaluating the effect that the adoption of SFAS 157 will have on its consolidated results of operations and statement of financial condition.

In February 2007, the FASB issued Statement No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities: ("SFAS159"). SFAS159 allows entities the option to measure eligible financial instruments at fair value as of specified dates. Such election, which may be applied on an instrument by instrument basis, is typically irrevocable once elected. SFAS 159 is effective for fiscal years beginning after November 15, 2007, and early application is allowed under certain circumstances. The Company is currently evaluating the impact SFAS 159 will have on its consolidated results of operations and statement of financial condition.

### **Note 3: Receivables**

The majority of the Company's commercial accounts receivable are due from Original Equipment Manufacturers ("OEM's"). Credit is extended based on evaluation of a customer's financial condition and, generally, collateral is not required. Accounts receivable are payable in U.S. dollars, are due within 30-90 days and are stated at amounts due from customers, net of an allowance for doubtful accounts. Any account outstanding longer than the contractual payment terms is considered past due.

The Company determines the allowance for doubtful accounts by considering a number of factors, including the length of time the trade accounts receivable are past due, eMagin's previous loss history, the customer's current ability to pay its obligation, and the condition of the general economy and the industry as a whole. The Company will

record a specific reserve for individual accounts when the Company becomes aware of a customer's inability to meet its financial obligations, such as in the case of bankruptcy filings or deterioration in the customer's operating results or financial position. If circumstances related to customers change, the Company would further adjust estimates of the recoverability of receivables.

Receivables consisted of the following (in thousands):

	September 30, 2007 (unaudited)	December 31, 2006
Accounts receivable	\$ 3,106	\$ 1,351
Less allowance for doubtful accounts	(408)	(443)
Net receivables	\$ 2,698	\$ 908

#### Note 4: Research and Development Costs

Research and development costs are expensed as incurred.

#### Note 5: Net Loss per Common Share

In accordance with SFAS No. 128, net loss per common share amounts ("basic EPS") was computed by dividing net loss by the weighted average number of common shares outstanding and excluding any potential dilution. Net loss per common share assuming dilution ("diluted EPS") was computed by reflecting potential dilution from the exercise of stock options and warrants. Common stock equivalent shares are excluded from the computation if their effect is antidilutive. As of September 30, 2007 and 2006, there were stock options, warrants and convertible notes outstanding to acquire 17,440,096 and 7,197,471 shares of our common stock, respectively. These shares were excluded from the computation of diluted loss per share because their effect would be antidilutive.

#### Note 6: Inventories

Inventory is stated at the lower of cost or market. Cost is determined using the first-in first-out method. The Company reviews the value of its inventory and reduces the inventory value to its net realizable value based upon current market prices and contracts for future sales. The components of inventories are as follows (in thousands):

	September 30, 2007 (unaudited)	December 31, 2006
Raw materials	\$ 1,119	\$ 1,146
Work in process	357	558
Finished goods	475	781
Total inventory	\$ 1,951	\$ 2,485

#### Note 7: Debt

Debt is as follows (in thousands):

	September 30, 2007	December 31, 2006
<b>Current portion of long-term debt:</b>		
Capitalized lease obligations	\$ —	\$ 6
Other debt	49	58
Line of credit	608	



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6% Senior Secured Convertible Notes	—	2,880
Less: Unamortized discount on notes payable	—	(1,721)
Current portion of long-term debt, net	657	1,223
<b>Long-term debt:</b>		
Other debt	69	104
6% Senior Secured Convertible Notes	—	2,890
Less: Unamortized discount on notes payable	—	(765)
8% Amended Senior Secured Convertible Notes	5,962	—
Less: Unamortized discount on notes payable	(100)	—
Long-term debt, net	5,931	2,229
Total debt, net	\$ 6,588	\$ 3,452

On July 23, 2007, an investor elected to convert approximately \$252 thousand of the 6% Senior Secured Convertible Note (“Original Note”) representing \$250 thousand of the principal amount of the Note due on July 23, 2007 and approximately \$2 thousand of accrued and unpaid interest. The investor received 720,476 shares of Common Stock at the conversion price of \$0.35. The Company recognized \$250 thousand of interest expense for the three months ended September 30, 2007 of which \$229 thousand was related to the acceleration of the unamortized discount associated with the converted note. The remaining unamortized discount is being amortized to interest expense using the straight-line method as it approximates the effective interest method over the term of the Notes.

On July 23, 2007, the Company entered into Amended Agreements with the note holders of the Original Notes issued July 21, 2006 and March 28, 2007 and agreed to issue each holder an 8% Amended Senior Secured Convertible Note (“Amended Note”) in the principal amount equal to the principal amount outstanding as of July 23, 2007 which was in total approximately \$6.0 million. The significant changes to the Amended Notes include the following:

- The due dates have been changed from July 23, 2007 and January 21, 2008 to December 21, 2008;
  - The annual interest has been changed from 6% to 8%;
- The Amended Notes are convertible into 8,407,612 shares of the Company’s common stock. The conversion price for \$5.8 million of principal is at a conversion price of \$0.75, originally \$2.60 and the conversion price for \$250,000 of principal remains the same at \$0.35;
- The Agreement adjusts the exercise price of the amended Warrants from \$3.60 to \$1.03 per share for 1,553,468 shares of common stock and requires the issuance of warrants for an additional 3,831,859 shares of common stock at \$1.03 per share with an expiration date of July 21, 2011. The warrants are subject to anti-dilution adjustment rights;
- 50% of the Amended Notes can be converted into the Company’s newly designated Series A Senior Secured Convertible Preferred Stock which is convertible into common stock at the same rate as the Amended Notes;
- The liquidated damages of 1% per month will no longer accrue and the deferred balance at July 23, 2007 is forgiven; and
  - There is no minimum cash or cash equivalents balance requirement.

Under the guidance of EITF 96-19, “Debtor’s Accounting for a Modification or Exchange of Debt Instruments”, the Company determined the change in the present value of the expected cash flows between the Amended Notes and the Original Notes issued July 21, 2006 was greater than 10%; therefore (a) for financial reporting purposes, the modifications to the Original Notes issued July 21, 2006 were treated as an extinguishment of debt and (b) on July 23, 2007, the Company recorded a loss on extinguishment of debt of approximately \$10.7 million reflecting the difference between (i) the recorded amount of debt, net of related discounts, of approximately \$4.8 million and (ii) the fair value of the new debt instrument of approximately \$10.7 plus the change in the fair value of the warrants on July 23, 2007, the date of the modification, of approximately \$4.7 million. The Company has also recorded a beneficial conversion of approximately \$5.1 million on the Amended Notes adjusting the Amended Notes to their face value of approximately \$5.8 million. The Original Note issued on March 28, 2007 and amended on July 23, 2007 was not treated as an extinguishment but a modification.

On August 16, 2007, an investor elected to convert approximately \$58 thousand of the Amended Note. The investor received 76,923 shares of Common Stock at the conversion price of \$0.75.

On August 7, 2007, the Company entered into a loan agreement with Moriah Capital, L.P. (“Moriah”) and established a revolving line of credit (the “Loan”) of \$2.5 million. The Company is permitted to borrow an amount not to exceed 90% of its eligible accounts receivable and 50% of its eligible inventory capped at \$600 thousand. As part of the transaction, the Company issued 162,500 shares of unregistered common stock valued at \$195 thousand and paid a servicing fee of \$82,500 to Moriah which will be amortized to interest expense over the life of the agreement. In the three and nine months ended September 30, 2007, approximately \$46 thousand was amortized to interest expense. In conjunction with entering into this loan and issuing unregistered common stock, the Company granted Moriah

registration rights. The Loan can be converted to shares of the Company's common stock pursuant to the terms of the Loan Conversion agreement. The Loan matures on August 8, 2008 however the Company has the option of extending it an additional year.

For the three and nine months ended September 30, 2007, interest expense consisted of interest paid or accrued on outstanding debt of \$195 thousand and \$651 thousand, respectively.

**Note 8: Stock-based Compensation**

Stock based compensation is accounted for in accordance with the provisions of SFAS No. 123R. Under SFAS 123R, the fair value of stock awards is estimated at the date of grant using the Black-Scholes option valuation model. Stock-based compensation expense is reduced for estimated forfeitures and is amortized over the vesting period using the straight-line method.

The following table summarizes the allocation of non-cash stock-based compensation to our expense categories for the three and six month periods ended September 30, 2007 and 2006 (in thousands):

	Three Months Ended		Nine months	
	September 30, 2007	2006	Ended September 30, 2007	2006
Cost of revenue	\$ 43	\$ 112	\$ 173	\$ 370
Research and development	82	119	282	378
Selling, general and administrative	148	459	717	1,522
Total stock compensation expense	\$ 273	\$ 690	\$ 1,172	\$ 2,270

At September 30, 2007, total unrecognized non-cash compensation cost related to stock options was approximately \$2.0 million, net of forfeitures. Total unrecognized compensation cost will be adjusted for future changes in estimated forfeitures and is expected to be recognized over a weighted average period of approximately 2.9 years.

The Company recognizes compensation expense for options granted to non-employees in accordance with the provisions of Emerging Issues Task Force (“EITF”) consensus Issue 96-18, “*Accounting for Equity Instruments that are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling Goods or Services,*” which requires using a fair value options pricing model and re-measuring such stock options to the current fair market value at each reporting period as the underlying options vest and services are rendered.

For the nine month period ended September 30, 2007 and 2006, the following key assumptions were used in the Black-Scholes option pricing model to determine the fair value of stock options granted:

	For the Nine months Ended	
	September 30, 2007	2006
Dividend yield	0%	0%
Risk free interest rates	4.23%	4.59%
Expected volatility	106%	126%
Expected term (in years)	5	5

We have not declared or paid any dividends and do not currently expect to do so in the near future. The risk-free interest rate used in the Black-Scholes option pricing model is based on the implied yield currently available on U.S. Treasury securities with an equivalent term. Expected volatility is based on the weighted average historical volatility of the Company’s common stock for the most recent five year period. The expected term of options represents the period that our stock-based awards are expected to be outstanding and was determined based on historical experience and vesting schedules of similar awards.

**Note 9: Shareholders’ Equity**

The Company has designated but not issued 3,198 shares of the Company’s preferred stock as Series A Senior Secured Convertible Preferred Stock (“the Preferred Stock”) at a stated value of \$1,000 per share. The Preferred Stock is entitled

to cumulative dividends which accrue at a rate of 8% per annum, payable on December 21, 2008. Each share of the Preferred Stock has voting rights equal to (1) in any case in which the Preferred Stock votes together with the Company's Common Stock or any other class or series of stock of the Company, the number of shares of Common Stock issuable upon conversion of such shares of Preferred Stock at such time (determined without regard to the shares of Common Stock so issuable upon such conversion in respect of accrued and unpaid dividends on such share of Preferred Stock) and (2) in any case not covered by the immediately preceding clause one vote per share of Preferred Stock. The Preferred Stock has a mandatory redemption at December 21, 2008.

On July 23, 2007, the Company entered into Agreements with the note holders and agreed to issue each holder an Amended Note in the principal amount equal to the principal amount outstanding as of July 23, 2007 which was in total approximately \$6.0 million. The Amended Notes are convertible into 8,407,612 shares of the Company's common stock. The conversion price for \$5.8 million of principal is at a conversion price of \$0.75 and the conversion price for \$250 thousand of principal remains the same at \$0.35. The Agreement adjusts the exercise price of the amended Warrants from \$3.60 to \$1.03 per share for 1,553,468 shares of common stock and requires the issuance of warrants for an additional 3,831,859 shares of common stock at \$1.03 per share with an expiration date of July 21, 2011. The warrants are subject to anti-dilution adjustment rights. 50% of the Amended Notes can be converted into the Company's newly designated Series A Senior Secured Convertible Preferred Stock which is convertible into common stock at the same rate as the Amended Notes.

As a result of the issuance of the Amended Notes the outstanding 650,000 Series F Common Stock Purchase Warrants that were issued to certain accredited and/or institutional investors pursuant to the Securities Purchase Agreement dated October 25, 2004, were re-priced from \$7.12 to \$4.39 in accordance with the anti-dilution provisions of the original agreement. The repricing of the warrants has no effect on the financial statements.

The Company had recorded the fair value of the warrants associated with the Note as a liability as the warrant agreement required a potential net-cash settlement in the first year of the warrant agreement if the registration statement is not effective as required by EITF 00-19 "Accounting for Derivative Financial Instruments Indexed to and Potentially Settled in, a Company's Own Stock" ("EITF 00-19"). The liability was adjusted to fair value at each reporting period. As of July 23, 2007, the potential net-cash settlement had expired. As a result, the fair value of the warrant liability on July 23, 2007, approximately \$2.7 million, was reversed. For the three and nine months ended September 30, 2007, the Company recorded losses of approximately \$1.5 million and approximately \$0.8 million from the change in the fair value of the warrant derivative liability. The change in the fair value of the warrant liability was recorded in the Consolidated Statement of Operations as other income (expense).

On July 23, 2007, an investor converted \$250 thousand of the principal amount of the Original Note due on July 23, 2007 and approximately \$2 thousand of accrued and unpaid interest totaling \$252 thousand and received 720,476 shares of Common Stock at the conversion price of \$0.35. On August 16, 2007, an investor elected to convert approximately \$58 thousand of the Amended Note. The investor received 76,923 shares of Common Stock at the conversion price of \$0.75.

On August 7, 2007, the Company entered into a loan agreement with Moriah Capital, L.P. ("Moriah") and established a revolving line of credit (the "Loan") of \$2.5 million. As part of the transaction, the Company issued 162,500 shares of unregistered common stock valued at \$195 thousand and paid a servicing fee of \$82,500 to Moriah which will be amortized to interest expense over the life of the agreement. For the three and nine months ended September 30, 2007 approximately \$46 thousand was amortized to interest expense. In conjunction with entering into this loan and issuing unregistered common stock, the Company granted Moriah registration rights. The Loan can be converted to shares of the Company's common stock pursuant to the terms of the Loan Conversion agreement. The Loan matures on August 8, 2008 however the Company has the option of extending it an additional year.

A registration rights agreement was entered into in connection with the Loan which requires the Company to file a registration statement for the resale of the common stock issued. The Company must use its best efforts to have the registration statement declared effective by the end of a specified grace period and also maintain the effectiveness of the registration statement until all shares of common stock have been sold or may be sold without volume restrictions pursuant to Rule 144(k) of the Securities Act. The registration statement has been filed with the Securities and Exchange Commission.

As a result of the issuance of the Loan, the outstanding 650,000 Series F Common Stock Purchase Warrants that were issued to certain accredited and/or institutional investors pursuant to the Securities Purchase Agreement dated October 25, 2004, were re-priced from \$4.39 to \$4.09 in accordance with the anti-dilution provision of the original agreement. The repricing of the warrants has no effect on the financial statements.

For the three and nine months ended September 30, 2007, there were no stock options exercised and the Company received approximately \$3 thousand in proceeds for warrants exercised as compared to the three and nine months ended September 30, 2006 where the Company received approximately \$10 thousand for the exercise of 5 thousand options and no warrants were exercised. For the three and nine months ended September 30, 2007, the Company also issued approximately 163 thousand and 1.1 million shares of common stock, respectively, for payment of approximately \$195 thousand and \$953 thousand, respectively, for services rendered and to be rendered in the future. For the three and nine months ended September 30, 2006, the Company issued approximately 63 thousand and 108 thousand shares of common stock, respectively, for payment of approximately \$209 thousand and \$401 thousand, respectively, for services rendered and to be rendered in the future. As such, the Company recorded the fair value of the services rendered in prepaid expenses and selling, general and administrative expenses in the accompanying unaudited condensed consolidated statement of operations for the three and nine months ended September 30, 2007 and 2006, respectively.

**Note 10: Income Taxes**

The Company adopted the provisions of FIN 48 on January 1, 2007. The Company continues to fully reserve its tax benefits which are offset by a valuation allowance due to the uncertainty that the deferred tax assets will be realized. We will continue to evaluate the realizability of our domestic net deferred tax assets and may record additional benefits in future earnings if we determine the realization of these assets is more likely than not. As at January 1, 2007 and September 30, 2007, the Company did not have any unrecognized tax positions.

The Company files Federal and State corporate tax returns. All tax years since inception are open to tax examination by the taxing authorities for possible adjustments to the net operating losses but not for assessment. The Statute of Limitations for assessment of tax is generally three years for Federal and four years for State tax returns. The years currently open for Federal income tax assessment include calendar years 2003 through 2006 and calendar years 2002 through 2006 for State tax assessment purposes. The Company is not currently under examination by any jurisdictions for any of the open years listed.

The Company is in the process of preparing its Section 382 study to determine the extent to which its utilization of its net operating loss (NOL) carryovers may be limited by the change in ownership rules of the Internal Revenue Code, and has not determined the impact that such study will have on its NOL carryforward.

The implementation of FIN 48 has not resulted in any adjustment to the Company's beginning tax position or tax position for the nine month period ended September 30, 2007.

**Note 11: Commitments and Contingencies**

***Royalty Payments***

The Company, in accordance with a royalty agreement with Eastman Kodak, is obligated to make minimum annual royalty payments of \$125 thousand which commenced on January 1, 2001. Under this agreement, the Company must pay to Eastman Kodak a certain percentage of net sales with respect to certain products, which percentages are defined in the agreement. The percentages are on a sliding scale depending on the amount of sales generated. Any minimum royalties paid will be credited against the amounts due based on the percentage of sales. The royalty agreement terminates upon the expiration of the issued patent which is the last to expire.

Effective May 30, 2007, Kodak and eMagin entered into an intellectual property agreement where eMagin has assigned Kodak the rights, title, and interest to a Company owned patent currently not being used by the Company and in consideration, Kodak has waived the royalties due under existing licensing agreements for the first six months of 2007, and reduced the royalty payments by 50% for the second half of 2007 and for the entire calendar year of 2008. In addition, the minimum royalty payment is delayed until December 1<sup>st</sup> for the years 2007 and 2008. The Company recorded approximately \$163 thousand and \$723 thousand for the three and nine months ended September 30, 2007, respectively, as income from the license of intangible assets.

Royalty expense was approximately \$327 thousand and \$887 thousand, respectively, for the three and nine months ended September 30, 2007 and approximately \$149 thousand and \$340 thousand, respectively, for the three and nine months ended September 30, 2006, respectively.

***Contractual Obligations***

The Company leases office facilities and office, lab and factory equipment under operating leases expiring through 2009. Certain leases provide for payments of monthly operating expenses. The Company currently has lease



commitments for space in Hopewell Junction, New York and Bellevue, Washington. Rent expense was approximately \$332 thousand and \$1.0 million, respectively, for the three and nine months ended September 30, 2007 and 2006.

**Note 12: Legal Proceedings**

In June, 2007, a former employee filed a Charge of Discrimination with the EEOC, alleging that the former employee was subjected to gender discrimination and retaliation in response to her complaint. eMagin filed a position statement with the EEOC on June 11, 2007 denying the allegations and requesting that the EEOC issue a lack of probable cause finding and dismiss the charge. On July 24, 2007 the EEOC reviewed the matter and dismissed the charges. On October 12, 2007 the former employee filed a civil action in the Southern District of New York Court raising allegations identical to those in the EEOC claim. The complaint seeks damages for lost wages, emotional distress and punitive damages and attorneys' fees in unspecified amounts. eMagin will file its response by November 26, 2007. The likelihood of success of this litigation matter has not yet been determined. Accordingly the Company cannot determine at this time if the claim is material.

**Note 13: Subsequent Events (Board approved – need final dates/prices)**

On November 9, 2007, the Board of Directors approved a new plan for compensation of the non-Executive Board of Directors which is effective December 1, 2007. All non-Executive Directors will receive an annual cash retainer of \$10 thousand. The first payment will be December 1, 2007. All subsequent years, 25% of the annual amount will be paid 15 days before the completion of each quarter. The non-Executive Chairman will receive an annual cash retainer of \$60 thousand payable over twelve months commencing January 1, 2008. In addition, each Director will receive a fee for each meeting attended as follows: \$1 thousand for each in-person Board meeting and \$0.5 thousand for each teleconference Board meeting and each Committee meeting, in-person (provided it is held on a separate day from a scheduled in-person Board meeting) and teleconference. Meeting fees will be paid 15 days before the completion of each quarter.

The Non-Executive Directors will receive an annual 25,000 fully vested non-ISO stock options issued at the market price on the date of issuance. The first issuance will be December 1 and all subsequent years, January 1. New Board members will receive 15 thousand non-ISO stock options upon joining. In addition, the non-executive Directors have been granted fully vested stock options equivalent to the number of stock options presently held by each non-Executive Director at a date to be determined. The stock options will be priced at the closing market price on the date granted. The existing stock options will remain at the stated strike price.

## Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

### Statement of Forward-Looking Information

In this quarterly report, references to "eMagin Corporation," "eMagin," "Virtual Vision," "the Company," "we," "us," and "our" refer to eMagin Corporation and its wholly owned subsidiary, Virtual Vision, Inc.

Except for the historical information contained herein, some of the statements in this Report contain forward-looking statements that involve risks and uncertainties. These statements are found in the sections entitled "Management's Discussion and Analysis or Plan of Operations" and "Risk Factors." They include statements concerning: our business strategy; expectations of market and customer response; liquidity and capital expenditures; future sources of revenues; expansion of our proposed product line; and trends in industry activity generally. In some cases, you can identify forward-looking statements by words such as "may," "will," "should," "expect," "plan," "could," "anticipate," "intend," "believe," "estimate," "predict," "potential," "goal," or "continue" or similar terminology. These statements are only predictions and involve known and unknown risks, uncertainties and other factors, including, but not limited to, the risks outlined under "Risk Factors," that may cause our or our industry's actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by such forward-looking statements. For example, assumptions that could cause actual results to vary materially from future results include, but are not limited to: our ability to successfully develop and market our products to customers; our ability to generate customer demand for our products in our target markets; the development of our target markets and market opportunities; our ability to manufacture suitable products at competitive cost; market pricing for our products and for competing products; the extent of increasing competition; technological developments in our target markets and the development of alternate, competing technologies in them; and sales of shares by existing shareholders. Although we believe that the expectations reflected in the forward looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. Unless we are required to do so under federal securities laws or other applicable laws, we do not intend to update or revise any forward-looking statements.

### Overview

We design, develop, manufacture, and market virtual imaging products which utilize OLEDs, or organic light emitting diodes, OLED-on-silicon microdisplays and related information technology solutions. We integrate OLED technology with silicon chips to produce high-resolution microdisplays smaller than one-inch diagonally which, when viewed through a magnifier, create virtual images that appear comparable in size to that of a computer monitor or a large-screen television. Our products enable our original equipment manufacturer, or OEM, customers to develop and market improved or new electronic products. We believe that virtual imaging will become an important way for increasingly mobile people to have quick access to high-resolution data, work, and experience new more immersive forms of communications and entertainment.

Our first commercial product, the SVGA+ (Super Video Graphics Array of 800x600 plus 52 added columns of data) OLED microdisplay, was initially offered for sampling in 2001, and our first SVGA-3D (Super Video Graphics Array plus built-in stereovision capability) OLED microdisplay was shipped in early 2002. We are in the process of completing development of 2 additional OLED microdisplays, namely the SVGA 3DS (SVGA 3D shrink, a smaller format SVGA display with a new cell architecture with embedded features) and an SXGA (1280 x 1024).

In January 2005, we announced the world's first personal display system to combine OLED technology with head-tracking and 3D stereovision, the Z800 3DVisor(tm), which was first shipped in mid-2005. This product received a CES Design and Innovations Award for the electronic gaming category and also received the coveted Best of Innovation Awards for the entire display category. The product was also recognized as a Digital Living Class of

2005 Innovators.

We license our core OLED technology from Eastman Kodak and we have developed our own technology to create high performance OLED-on-silicon microdisplays and related optical systems. We believe our technology licensing agreement with Eastman Kodak, coupled with our own intellectual property portfolio, gives us a leadership position in OLED and OLED-on-silicon microdisplay technology. We believe we are the only company to sell full-color active matrix small molecule OLED-on-silicon microdisplays.

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## **Company History**

From inception through January 1, 2003, we were a developmental stage company. We have transitioned to manufacturing our products and intend to significantly increase our marketing, sales, and research and development efforts, and expand our operating infrastructure. Most of our operating expenses are fixed in the near term. If we are unable to generate significant revenues, our net losses in any given period could be greater than expected.

## **CRITICAL ACCOUNTING POLICIES**

The Securities and Exchange Commission ("SEC") defines "critical accounting policies" as those that require application of management's most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain and may change in subsequent periods. Not all of the accounting policies require management to make difficult, subjective or complex judgments or estimates. However, the following policies could be deemed to be critical within the SEC definition.

### **Revenue Recognition**

Revenue on product sales is recognized when persuasive evidence of an arrangement exists, such as when a purchase order or contract is received from the customer, the price is fixed, title and risk of loss to the goods has changed and there is a reasonable assurance of collection of the sales proceeds. We obtain written purchase authorizations from our customers for a specified amount of product at a specified price and consider delivery to have occurred at the time of shipment. We record a reserve for estimated sales returns, which is reflected as a reduction of revenue at the time of revenue recognition. Products sold directly to consumers have a fifteen day right of return. Revenue on consumer products is deferred until the right of return has expired.

Revenues from research and development activities relating to firm fixed-price contracts are generally recognized on the percentage-of-completion method of accounting as costs are incurred (cost-to-cost basis). Revenues from research and development activities relating to cost-plus-fee contracts include costs incurred plus a portion of estimated fees or profits based on the relationship of costs incurred to total estimated costs. Contract costs include all direct material and labor costs and an allocation of allowable indirect costs as defined by each contract, as periodically adjusted to reflect revised agreed upon rates. These rates are subject to audit by the other party.

### **Use of Estimates**

The preparation of financial statements in conformity with generally accepted accounting principles in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements as well as the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. These estimates and assumptions relate to recording net revenue, collectibility of accounts receivable, useful lives and impairment of tangible and intangible assets, accruals, derivative liability, income taxes, inventory realization and other factors. Management has exercised reasonable judgment in deriving these estimates. Consequently, a change in conditions could affect these estimates.

### **Fair Value of Financial Instruments**

The Company's cash, cash equivalents, investments, accounts receivable and accounts payable are stated at cost which approximates fair value due to the short-term nature of these instruments.

### **Stock-based Compensation**

We maintain several stock equity incentive plans. The 2005 Employee Stock Purchase Plan (the "ESPP") provides our employees with the opportunity to purchase common stock through payroll deductions. Employees purchase stock semi-annually at a price that is 85% of the fair market value at certain plan-defined dates. As of September 30, 2007, the plan had not been implemented.

The 2003 Stock Option Plan (the "2003 Plan") provides for grants of shares of common stock and options to purchase shares of common stock to employees, officers, directors and consultants. Under the 2003 plan, an ISO grant is granted at the market value of our common stock at the date of the grant and a non-ISO is granted at a price not to be less than 85% of the market value of the common stock. These options have a term of up to 10 years and vest over a schedule determined by the Board of Directors, generally over a five year period. The amended 2003 Plan provides for an annual increase of 3% of the diluted shares outstanding on January 1 of each year for a period of 9 years which commenced January 1, 2005.

Effective January 1, 2006, the Company adopted the provisions of SFAS No. 123R, "Share-Based Payment", which requires the Company to recognize expense related to the fair value of the Company's share-based compensation issued to employees and directors. SFAS 123R requires companies to estimate the fair value of share-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in the Company's condensed consolidated statement of operations. The Company uses the straight-line method for recognizing compensation expense. An estimate for forfeitures is included in compensation expense for awards under SFAS 123R.

## **NEW ACCOUNTING PRONOUNCEMENTS**

See Note 2 of the Condensed Consolidated Financial Statements in Item 1 for a description of recent accounting pronouncements, including the expected dates of adoption and estimated effects on results of operations and financial condition.

## **RESULTS OF OPERATIONS**

### **THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2007 COMPARED TO THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2006**

#### **Revenues**

Revenues for the three and nine months ended September 30, 2007 were approximately \$5.1 million and \$12.9 million, respectively, as compared to approximately \$2.3 million and \$5.6 million for the three and nine months ended September 30, 2006, an increase of approximately 121% and 130%, respectively. Higher revenue for the three and nine month periods was primarily due to increased microdisplay demand and increased availability of finished displays due to manufacturing improvements.

#### **Cost of Goods Sold**

Cost of goods sold includes direct and indirect costs associated with production. Cost of goods sold for the three and nine months ended September 30, 2007 was approximately \$3.1 million and \$9.1 million, respectively, as compared to \$2.9 million and \$8.9 million, respectively, for the three and nine months ended September 30, 2006, a slight increase of \$0.2 million.

The gross margin for the three and nine months ended September 30, 2007 was approximately \$2.0 million and \$3.8 million, respectively, as compared to a gross loss of approximately (\$0.6) million and (\$3.3) million, respectively, for the three and nine months ended September 30, 2006. As a percentage of revenue this translates to a gross margin of 40% and 29% for the three and nine months ended September 30, 2007 as compared to a gross loss of (28%) and (59%) for the three and nine months ended September 30, 2006. The gross margin improvement was attributed to fuller utilization of our fixed production overhead due to higher unit volume.

#### **Operating Expenses**

*Research and Development.* Research and development expenses include salaries, development materials and other costs specifically allocated to the development of new microdisplay products, OLED materials and subsystems. Research and development expenses for the three and nine months ended September 30, 2007 were approximately \$0.6 million and \$2.3 million, respectively, as compared to \$1.0 million and \$3.5 million, respectively, for the three and nine months ended September 30, 2006, a decrease of approximately \$0.4 million and \$1.2 million, respectively. The decrease was due to the re-deployment of research and development personnel to production contract services

which are included in cost of goods sold.

*Selling, General and Administrative.* Selling, general and administrative expenses consist principally of salaries and fees for professional services, legal fees incurred in connection with patent filings and related matters, as well as other marketing and administrative expenses. Selling, general and administrative expenses for the three and nine months ended September 30, 2007 were approximately \$1.4 million and \$5.2 million, respectively, as compared to approximately \$1.8 million and \$6.7 million, respectively, for the three and nine months ended September 30, 2006. The decrease of approximately \$0.4 and \$1.5 million, respectively, for the three and nine months ended September 30, 2007 was primarily related to a reduction of marketing, tradeshow and personnel costs as compared to the three and nine months ended September 30, 2006.



*Other Income (Expense), net.* Other income (expense), net consists primarily of interest income earned on investments, interest expense related to the secured debt, loss from the change in the derivative liability, loss on the extinguishment of debt and other income from the licensing of intangible assets. For the three and nine months ended September 30, 2007, interest income was approximately \$9 and \$32 thousand compared to approximately \$14 and \$74 thousand for the three and nine months ended September 30, 2006. The decrease in interest income was primarily a result of lower cash balances available for investment.

For the three and nine months ended September 30, 2007, interest expense was approximately \$592 thousand and \$2.8 million, respectively, as compared to \$509 thousand for the three and nine months ended September 30, 2006. The breakdown of the interest expense for the three and nine month periods in 2007 is as follows: interest expense associated with debt of approximately \$195 thousand and \$652 thousand, respectively; the amortization of the deferred costs associated with the notes payable of approximately \$0 and \$265 thousand, respectively; and the amortization of the debt discount associated with the debt of approximately \$397 thousand and \$1.96 million, respectively.

For the three and nine months ended September 30, 2007, the change in the derivative liability was a loss of approximately \$1.5 million and \$0.9 million, respectively, as compared to \$177 thousand for the three and nine months ended September 30, 2006.

The loss on extinguishment of debt was \$10.7 million for the three and nine months ended September 30, 2007 as compared to \$0 for the three and nine months ended September 30, 2006. See Note 7: Debt for additional information.

Other income for the three and nine months ended September 30, 2007 was approximately \$172 thousand and \$762 thousand, respectively, as compared to approximately \$5 thousand and \$59 thousand, respectively. The increase in other income for the three and six month periods ended September 30, 2007 was income from a gain on the license of intangible assets. See Note 11: Commitments and Contingencies – Royalty Payments for additional information.

### **Liquidity and Capital Resources**

As of September 30, 2007, we had approximately \$0.9 million of cash and investments as compared to \$1.6 million as of December 31, 2006. The decrease of approximately \$0.7 million was due primarily to cash used for operating activities.

Cash flow used in operating activities during the nine months ended September 30, 2007 was approximately \$1.7 million as compared to cash used of approximately \$10.4 million during the nine months ended September 30, 2006. The decrease was mainly attributable to a reduction in net losses.

Cash provided by investing activities during the nine months ended September 30, 2007 was approximately \$24 thousand as compared to approximately \$210 thousand used in investing activities during the nine months ended September 30, 2006. The decrease in the cash used in investing activities was attributable to lower equipment purchases.

Cash provided by financing activities during the nine months ended September 30, 2007 was approximately \$1.0 million and was comprised of approximately \$3 thousand of proceeds from exercise of warrants, approximately \$460 thousand in net proceeds from debt issuance, and approximately \$608 from the line of credit and offset by payments on debt of \$88 thousand. The cash provided by financing activities during the nine months ended September 30, 2006 primarily consisted of \$5.3 million, net, from the sale of senior secured debentures.

Our condensed consolidated financial statements as of September 30, 2007 have been prepared under the assumption that we will continue as a going concern for the year ending December 31, 2007. Our independent registered public accounting firm had issued a report dated March 27, 2007 in connection with the audit of the financial statements for the year ended December 31, 2006, that included an explanatory paragraph expressing substantial doubt as to our ability to continue as a going concern. Our ability to continue as a going concern ultimately is dependent on our ability to generate a profit which is likely dependant upon our ability to obtain additional equity or debt financing, attain further operating efficiencies and, ultimately, to achieve profitable operations. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

As we have reported, our business experienced significant revenue growth during the first nine months of 2007. This trend, if it continues, may result in higher accounts receivable levels and may require increased production and/or higher inventory levels both of which require additional working capital. We anticipate that our cash requirements to fund operating or investing cash requirements over the next twelve months will be greater than our current cash on hand.

To address these liquidity issues we have finalized an agreement with our note holders that defers the note re-payments until December 21, 2008. See Note 7: Debt for additional information. We have entered into an intellectual property agreement with Kodak and assigned Kodak the rights, title and interest to a Company owned patent not being used by the Company and in consideration, Kodak has waived the royalties due under existing licensing agreements for the first six months of 2007, and reduced the royalty payments by 50% for the second half of 2007 and for the entire year of 2008. In addition, the minimum royalty payment is deferred until December 1<sup>st</sup> for the years 2007 and 2008. We have entered into an asset based loan agreement establishing a \$2.5 million revolving line of credit. However to fund operating or investing cash requirements, we still may need to raise additional funds in the next twelve months.

### **Off-Balance Sheet Arrangements**

We do not have any off balance sheet arrangements that are reasonably likely to have a current or future effect on our financial condition, revenues, results of operations, liquidity or capital expenditures.

### **ITEM 3. Quantitative and Qualitative Disclosures About Market Risk**

#### ***Market Rate Risk***

We are exposed to market risk related to changes in interest rates and foreign currency exchanges rates.

#### ***Interest Rate Risk***

We hold our assets in cash and cash equivalents. We do not hold derivative financial instruments or equity securities.

#### ***Foreign Currency Exchange Rate Risk***

Our revenue and expenses are denominated in U.S. dollars. We have conducted some transactions in foreign currencies and expect to continue to do so; we do not anticipate that foreign exchange gains or losses will be significant. We have not engaged in foreign currency hedging to date.

Our international business is subject to risks typical of international activity, including, but not limited to, differing economic conditions; change in political climates; differing tax structures; and other regulations and restrictions. Accordingly, our future results could be impacted by changes in these or other factors.

### **ITEM 4. Controls and Procedures**

a) *Evaluation of Disclosure Controls and Procedures.* Based on an evaluation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, as amended) required by paragraph (b) of Rule 13a-15 or Rule 15d-15, as of September 30, 2007, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures were effective in ensuring that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Commission's rules and forms. Our Chief

Executive Officer and Chief Financial Officer also concluded that, as of September 30, 2007, our disclosure controls and procedures were effective in ensuring that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, to allow timely decisions regarding required disclosure.

(b) *Changes in Internal Controls.* During the quarter ended September 30, 2007, there were no changes in our internal control over financial reporting identified in connection with the evaluation required by paragraph (d) of Rule 13a-15 or Rule 15d-15 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## PART II - OTHER INFORMATION

### ITEM 1. Legal Proceedings

In June, 2007, a former employee filed a Charge of Discrimination with the EEOC, alleging that the former employee was subjected to gender discrimination and retaliation in response to her complaint. eMagin filed a position statement with the EEOC on June 11, 2007 denying the allegations and requesting that the EEOC issue a lack of probable cause finding and dismiss the charge. On July 24, 2007 the EEOC reviewed the matter and dismissed the charges. On October 12, 2007, the former employee filed a civil action in the Southern District of New York Court raising allegations identical to those in the EEOC claim. The complaint seeks damages for lost wages, emotional distress and punitive damages and attorneys' fees in unspecified amounts. eMagin will file its response by November 26, 2007. The likelihood of success of this litigation matter has not yet been determined. Accordingly the Company cannot determine at this time if the claim is material.

### ITEM 1A. Risk Factors

You should carefully consider the following risk factors and the other information included herein as well as the information included in other reports and filings made with the SEC before investing in our common stock. If any of the following risks actually occurs, our business, financial condition or results of operations could be harmed. The trading price of our common stock could decline due to any of these risks, and you may lose part or all of your investment.

#### RISKS RELATED TO OUR FINANCIAL RESULTS

*We have a history of losses since our inception and may incur losses for the foreseeable future.*

Our accumulated losses are approximately \$198 million as of September 30, 2007. We have not yet achieved profitability and we can give no assurances that we will achieve profitability within the foreseeable future as we fund operating and capital expenditures in areas such as establishment and expansion of markets, sales and marketing, operating equipment and research and development. We cannot assure investors that we will ever achieve or sustain profitability or that our operating losses will not increase in the future.

*We may not be able to execute our business plan and may not generate cash from operations.*

As we have reported, our business is currently experiencing significant revenue growth during the nine months ended September 30, 2007. We anticipate that our cash requirements to fund these requirements as well as other operating or investing cash requirements over the next twelve months may be greater than our current cash on hand and borrowing availability under our revolving credit facility. In the event that cash flow from operations is less than anticipated and we are unable to secure additional funding to cover our expenses, in order to preserve cash, we would be required to reduce expenditures and effect reductions in our corporate infrastructure, either of which could have a material adverse effect on our ability to continue our current level of operations. No assurance can be given that additional financing will be available, or if available, will be on acceptable terms.

*Our independent registered public accounting firm has expressed doubt about our ability to continue as a going concern, which may hinder our ability to obtain future financing.*

Our condensed consolidated financial statements as of September 30, 2007 have been prepared under the assumption that we will continue as a going concern for the year ending December 31, 2007. Our independent registered public accounting firm had issued a report dated March 27, 2007 in connection with the audit of the financial statements for

the year ended December 31, 2006, that included an explanatory paragraph expressing substantial doubt as to our ability to continue as a going concern. Our ability to continue as a going concern ultimately is dependent on our ability to generate a profit which is likely dependant upon our ability to obtain additional equity or debt financing, attain further operating efficiencies and, ultimately, to achieve profitable operations. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

### ***RISKS RELATED TO MANUFACTURING***

***The manufacture of OLED-on-silicon is new and OLED microdisplays have not been produced in significant quantities.***

If we are unable to produce our products in sufficient quantity, we will be unable to maintain and attract new customers. In addition, we cannot assure you that once we commence volume production we will attain yields at high throughput that will result in profitable gross margins or that we will not experience manufacturing problems which could result in delays in delivery of orders or product introductions.

***We are dependent on a single manufacturing line.***

We currently manufacture our products on a single manufacturing line. If we experience any significant disruption in the operation of our manufacturing facility or a serious failure of a critical piece of equipment, we may be unable to supply microdisplays to our customers. For this reason, some OEMs may also be reluctant to commit a broad line of products to our microdisplays without a second production facility in place. However, we try to maintain product inventory to fill the requirements under such circumstances. Interruptions in our manufacturing could be caused by manufacturing equipment problems, the introduction of new equipment into the manufacturing process or delays in the delivery of new manufacturing equipment. Lead-time for delivery of manufacturing equipment can be extensive. No assurance can be given that we will not lose potential sales or be unable to meet production orders due to production interruptions in our manufacturing line. In order to meet the requirements of certain OEMs for multiple manufacturing sites, we will have to expend capital to secure additional sites and may not be able to manage multiple sites successfully.

***We could experience manufacturing interruptions, delays, or inefficiencies if we are unable to timely and reliably procure components from single-sourced suppliers.***

We maintain several single-source supplier relationships, either because alternative sources are not available or the relationship is advantageous due to performance, quality, support, delivery, capacity, or price considerations. If the supply of a critical single-source material or component is delayed or curtailed, we may not be able to ship the related product in desired quantities and in a timely manner. Even where alternative sources of supply are available, qualification of the alternative suppliers and establishment of reliable supplies could result in delays and a possible loss of sales, which could harm operating results.

***We expect to depend on semiconductor contract manufacturers to supply our silicon integrated circuits and other suppliers of key components, materials and services.***

We do not manufacture the silicon integrated circuits on which we incorporate our OLED technology. Instead, we expect to provide the design layouts to semiconductor contract manufacturers who will manufacture the integrated circuits on silicon wafers. We also expect to depend on suppliers of a variety of other components and services, including circuit boards, graphic integrated circuits, passive components, materials and chemicals, and equipment support. Our inability to obtain sufficient quantities of high quality silicon integrated circuits or other necessary components, materials or services on a timely basis could result in manufacturing delays, increased costs and ultimately in reduced or delayed sales or lost orders which could materially and adversely affect our operating results.

### **RISKS RELATED TO OUR INTELLECTUAL PROPERTY**

***We rely on our license agreement with Eastman Kodak for the development of our products.***



We rely on our license agreement with Eastman Kodak for the development of our products, and the termination of this license, Eastman Kodak's licensing of its OLED technology to others for microdisplay applications, or the sublicensing by Eastman Kodak of our OLED technology to third parties, could have a material adverse impact on our business.

Our principal products under development utilize OLED technology that we license from Eastman Kodak. We rely upon Eastman Kodak to protect and enforce key patents held by Eastman Kodak, relating to OLED display technology. Eastman Kodak's patents expire at various times in the future. Our license with Eastman Kodak could terminate if we fail to perform any material term or covenant under the license agreement. Since our license from Eastman Kodak is non-exclusive, Eastman Kodak could also elect to become a competitor itself or to license OLED technology for microdisplay applications to others who have the potential to compete with us. The occurrence of any of these events could have a material adverse impact on our business.

*We may not be successful in protecting our intellectual property and proprietary rights.*

We rely on a combination of patents, trade secret protection, licensing agreements and other arrangements to establish and protect our proprietary technologies. If we fail to successfully enforce our intellectual property rights, our competitive position could suffer, which could harm our operating results. Patents may not be issued for our current patent applications, third parties may challenge, invalidate or circumvent any patent issued to us, unauthorized parties could obtain and use information that we regard as proprietary despite our efforts to protect our proprietary rights, rights granted under patents issued to us may not afford us any competitive advantage, others may independently develop similar technology or design around our patents, our technology may be available to licensees of Eastman Kodak, and protection of our intellectual property rights may be limited in certain foreign countries. We may be required to expend significant resources to monitor and police our intellectual property rights. Any future infringement or other claims or prosecutions related to our intellectual property could have a material adverse effect on our business. Any such claims, with or without merit, could be time consuming to defend, result in costly litigation, divert management's attention and resources, or require us to enter into royalty or licensing agreements. Such royalty or licensing agreements, if required, may not be available on terms acceptable to us, if at all. Protection of intellectual property has historically been a large yearly expense for eMagin. We have not been in a financial position to properly protect all of our intellectual property, and may not be in a position to properly protect our position or stay ahead of competition in new research and the protecting of the resulting intellectual property.

#### **RISKS RELATED TO THE MICRODISPLAY INDUSTRY**

*The commercial success of the microdisplay industry depends on the widespread market acceptance of microdisplay systems products.*

The market for microdisplays is emerging. Our success will depend on consumer acceptance of microdisplays as well as the success of the commercialization of the microdisplay market. As an OEM supplier, our customer's products must also be well accepted. At present, it is difficult to assess or predict with any assurance the potential size, timing and viability of market opportunities for our technology in this market. The viewfinder microdisplay market sector is well established with entrenched competitors with whom we must compete.

*The microdisplay systems business is intensely competitive.*

We do business in intensely competitive markets that are characterized by rapid technological change, changes in market requirements and competition from both other suppliers and our potential OEM customers. Such markets are typically characterized by price erosion. This intense competition could result in pricing pressures, lower sales, reduced margins, and lower market share. Our ability to compete successfully will depend on a number of factors, both within and outside our control. We expect these factors to include the following:

- our success in designing, manufacturing and delivering expected new products, including those implementing new technologies on a timely basis;
  - our ability to address the needs of our customers and the quality of our customer services;
  - the quality, performance, reliability, features, ease of use and pricing of our products;
    - successful expansion of our manufacturing capabilities;
  - our efficiency of production, and ability to manufacture and ship products on time;
- the rate at which original equipment manufacturing customers incorporate our product solutions into their own products;
  - the market acceptance of our customers' products; and
  - product or technology introductions by our competitors.

Our competitive position could be damaged if one or more potential OEM customers decide to manufacture their own microdisplays, using OLED or alternate technologies. In addition, our customers may be reluctant to rely on a relatively small company such as eMagin for a critical component. We cannot assure you that we will be able to compete successfully against current and future competition, and the failure to do so would have a materially adverse effect upon our business, operating results and financial condition.

***The display industry is cyclical.***

The display industry is characterized by fabrication facilities that require large capital expenditures and long lead times for supplies and the subsequent processing time, leading to frequent mismatches between supply and demand. The OLED microdisplay sector may experience overcapacity if and when all of the facilities presently in the planning stage come on line leading to a difficult market in which to sell our products.

***Competing products may get to market sooner than ours.***

Our competitors are investing substantial resources in the development and manufacture of microdisplay systems using alternative technologies such as reflective liquid crystal displays (LCDs), LCD-on-Silicon ("LCOS") microdisplays, active matrix electroluminescence and scanning image systems, and transmissive active matrix LCDs. Our competitive position could be damaged if one or more of our competitors' products get to the market sooner than our products. We cannot assure you that our product will get to market ahead of our competitors or that we will be able to compete successfully against current and future competition. The failure to do so would have a materially adverse effect upon our business, operating results and financial condition.

***Our competitors have many advantages over us.***

As the microdisplay market develops, we expect to experience intense competition from numerous domestic and foreign companies including well-established corporations possessing worldwide manufacturing and production facilities, greater name recognition, larger retail bases and significantly greater financial, technical, and marketing resources than us, as well as from emerging companies attempting to obtain a share of the various markets in which our microdisplay products have the potential to compete. We cannot assure you that we will be able to compete successfully against current and future competition, and the failure to do so would have a materially adverse effect upon our business, operating results and financial condition.

***Our products are subject to lengthy OEM development periods.***

We plan to sell most of our microdisplays to OEMs who will incorporate them into products they sell. OEMs determine during their product development phase whether they will incorporate our products. The time elapsed between initial sampling of our products by OEMs, the custom design of our products to meet specific OEM product requirements, and the ultimate incorporation of our products into OEM consumer products is significant. If our products fail to meet our OEM customers' cost, performance or technical requirements or if unexpected technical challenges arise in the integration of our products into OEM consumer products, our operating results could be significantly and adversely affected. Long delays in achieving customer qualification and incorporation of our products could adversely affect our business.

***Our products will likely experience rapidly declining unit prices.***

In the markets in which we expect to compete, prices of established products tend to decline significantly over time. In order to maintain our profit margins over the long term, we believe that we will need to continuously develop product enhancements and new technologies that will either slow price declines of our products or reduce the cost of producing and delivering our products. While we anticipate many opportunities to reduce production costs over time, there can be no assurance that these cost reduction plans will be successful nor is there any assurance that our costs can be reduced as quickly as any reduction in unit prices. We may also attempt to offset the anticipated decrease in our average selling price by introducing new products, increasing our sales volumes or adjusting our product mix. If we fail to do so, our results of operations would be materially and adversely affected.

**RISKS RELATED TO OUR BUSINESS**

*Our success depends on attracting and retaining highly skilled and qualified technical and consulting personnel.*

We must hire highly skilled technical personnel as employees and as independent contractors in order to develop our products. The competition for skilled technical employees is intense and we may not be able to retain or recruit such personnel. We must compete with companies that possess greater financial and other resources than we do, and that may be more attractive to potential employees and contractors. To be competitive, we may have to increase the compensation, bonuses, stock options and other fringe benefits offered to employees in order to attract and retain such personnel. The costs of retaining or attracting new personnel may have a materially adverse affect on our business and our operating results. In addition, difficulties in hiring and retaining technical personnel could delay the implementation of our business plan.

***Our success depends in a large part on the continuing service of key personnel.***

Changes in management could have an adverse effect on our business. We are dependent upon the active participation of several key management personnel and will also need to recruit additional management in order to expand according to our business plan. The failure to attract and retain additional management or personnel could have a material adverse effect on our operating results and financial performance.

***Our business depends on new products and technologies.***

The market for our products is characterized by rapid changes in product, design and manufacturing process technologies. Our success depends to a large extent on our ability to develop and manufacture new products and technologies to match the varying requirements of different customers in order to establish a competitive position and become profitable. Furthermore, we must adopt our products and processes to technological changes and emerging industry standards and practices on a cost-effective and timely basis. Our failure to accomplish any of the above could harm our business and operating results.

***We generally do not have long-term contracts with our customers.***

Our business has primarily operated on the basis of short-term purchase orders. We are now receiving longer term purchase agreements, such as those which comprise our approximately \$7.4 million backlog, and procurement contracts, but we cannot guarantee that we will continue to do so. Our current purchase agreements can be cancelled or revised without penalty, depending on the circumstances. We plan production on the basis of internally generated forecasts of demand, which makes it difficult to accurately forecast revenues. If we fail to accurately forecast operating results, our business may suffer and the value of your investment in eMagin may decline.

***Our business strategy may fail if we cannot continue to form strategic relationships with companies that manufacture and use products that could incorporate our OLED-on-silicon technology.***

Our prospects will be significantly affected by our ability to develop strategic alliances with OEMs for incorporation of our OLED-on-silicon technology into their products. While we intend to continue to establish strategic relationships with manufacturers of electronic consumer products, personal computers, chipmakers, lens makers, equipment makers, material suppliers and/or systems assemblers, there is no assurance that we will be able to continue to establish and maintain strategic relationships on commercially acceptable terms, or that the alliances we do enter in to will realize their objectives. Failure to do so would have a material adverse effect on our business.

***Our business depends to some extent on international transactions.***

We purchase needed materials from companies located abroad and may be adversely affected by political and currency risk, as well as the additional costs of doing business with a foreign entity. Some customers in other countries have longer receivable periods or warranty periods. In addition, many of the OEMs that are the most likely long-term purchasers of our microdisplays are located abroad exposing us to additional political and currency risk. We may find it necessary to locate manufacturing facilities abroad to be closer to our customers which could expose us to various risks, including management of a multi-national organization, the complexities of complying with foreign laws and customs, political instability and the complexities of taxation in multiple jurisdictions.

***Our business may expose us to product liability claims.***

Our business may expose us to potential product liability claims. Although no such claims have been brought against us to date, and to our knowledge no such claim is threatened or likely, we may face liability to product users for damages resulting from the faulty design or manufacture of our products. While we plan to maintain product liability insurance coverage, there can be no assurance that product liability claims will not exceed coverage limits, fall outside the scope of such coverage, or that such insurance will continue to be available at commercially reasonable rates, if at all.

*Our business is subject to environmental regulations and possible liability arising from potential employee claims of exposure to harmful substances used in the development and manufacture of our products.*

We are subject to various governmental regulations related to toxic, volatile, experimental and other hazardous chemicals used in our design and manufacturing process. Our failure to comply with these regulations could result in the imposition of fines or in the suspension or cessation of our operations. Compliance with these regulations could require us to acquire costly equipment or to incur other significant expenses. We develop, evaluate and utilize new chemical compounds in the manufacture of our products. While we attempt to ensure that our employees are protected from exposure to hazardous materials, we cannot assure you that potentially harmful exposure will not occur or that we will not be liable to employees as a result.

### **RISKS RELATED TO OUR STOCK**

*The substantial number of shares that are or will be eligible for sale could cause our common stock price to decline even if eMagin is successful.*

Sales of significant amounts of common stock in the public market, or the perception that such sales may occur, could materially affect the market price of our common stock. These sales might also make it more difficult for us to sell equity or equity-related securities in the future at a time and price that we deem appropriate. As of September 30, 2007, we have outstanding (i) options to purchase 768,898 shares, (ii) warrants to purchase 8,340,509 shares of common stock and (iii) notes to convert to 8,330,689 shares.

*We have a staggered board of directors and other anti-takeover provisions, which could inhibit potential investors or delay or prevent a change of control that may favor you.*

Our Board of Directors is divided into three classes and our Board members are elected for terms that are staggered. This could discourage the efforts by others to obtain control of eMagin. Some of the provisions of our certificate of incorporation, our bylaws and Delaware law could, together or separately, discourage potential acquisition proposals or delay or prevent a change in control. In particular, our board of directors is authorized to issue up to 10,000,000 shares of preferred stock (less any outstanding shares of preferred stock) with rights and privileges that might be senior to our common stock, without the consent of the holders of the common stock.

### **ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds.**

On March 28, 2007, the Company entered into a Note Purchase Agreement for the sale of \$500 thousand of senior secured debentures (the "Note") and warrants to purchase approximately 1.0 million shares of common stock, par value \$.001 per share. The investor purchased the Note with a conversion price of \$0.35 per share that may convert into approximately 1.4 million shares of common stock and issued warrants exercisable at \$0.48 per share for approximately 1.0 million shares of common stock expiring in July 2011. On April 9, 2007, the Company closed the transaction and received approximately \$460 thousand, net of offering costs of approximately \$40 thousand which are being amortized over the life of the Note. On July 23, 2007, the investor converted \$250,000 of the principal amount of the Note which was due on July 23, 2007 and \$2,166.50 of accrued and unpaid interest totaling \$252,166.50 and received 720,476 shares of Common Stock at the conversion price of \$0.35.

On July 23, 2007, we entered into Amendment Agreements (the "Agreements") with the holders of the Notes issued July 21, 2006 and March 28, 2007 (each a "Holder" and collectively, the "Holders") and agreed to issue each Holder an amended and restated Note (the "Amended Notes") in the principal amount equal to the principal amount outstanding as of July 23, 2007.





The changes to the Amended Notes include the following:

- The due date for the outstanding Notes (totaling after conversions an aggregate of \$6,020,000) has been extended to December 21, 2008;
- The Amended Notes are convertible into (i) 8,407,612 shares of the Company's common stock. The conversion price for \$5,770,000 of principal was revised from \$2.60 to \$0.75 per share. The conversion price of \$0.35 per share for \$250,000 of principal was unchanged;
- \$3,010,000 of the Notes can convert into (ii) 3,010 shares of the Company's newly formed Series A Convertible Preferred Stock (the "Preferred") at a conversion price of \$1,000 per share. The Preferred is convertible into common stock at the same price allowable by the Amended Notes, subject to adjustment as provided for in the Certificate of Designations;
- The Amended Notes adjust the exercise price from \$3.60 to \$1.03 per share for 1,553,468 Warrants and require the issuance of 3,831,859 Warrants exercisable at \$1.03 per share pursuant to which the holders may acquire common stock, until July 21, 2011; and
- As of July 23, 2007 the interest rate was raised from 6% to 8%.

On August 7, 2007, the Company entered into a loan agreement with Moriah Capital, L.P. ("Moriah") and established a revolving line of credit (the "Loan") of \$2.5 million. As part of the transaction, the Company issued 162,500 shares of common stock, par value of \$.001 per share, with an aggregate market value of \$195,000.

**ITEM 3. Defaults Upon Senior Securities**

None.

**ITEM 4. Submission of Matters to a Vote of Security Holders**

None.

**ITEM 5. Other Information**

None.

**ITEM 6. Exhibits**

<u>EXHIBIT NUMBER</u>	<u>DESCRIPTION</u>
31.1	Certification by Chief Executive Officer pursuant to Sarbanes Oxley Section 302*
31.2	Certification by Chief Financial Officer pursuant to Sarbanes Oxley Section 302*
32.1	Certification by Chief Executive Officer pursuant to 18 U.S.C. Section 1350*
32.2	Certification by Chief Financial Officer pursuant to 18 U.S.C. Section 1350*

\*Filed herewith.

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**SIGNATURES**

In accordance with Section 13 or 15(d) of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized on this 19th day of November 2007.

**eMAGIN CORPORATION**

By: /s/ K.C. Park  
K.C. Park  
*Interim Chief Executive Officer*  
*Principal Executive Officer*

By: /s/ John Atherly  
John Atherly  
*Chief Financial Officer*  
*Principal Accounting and Financial Officer*