EMAGIN CORP
Form 10-Q
August 14, 2006
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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 June 30, 2006

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	**56-1764501**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*

10500 NE 8th 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

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

The number of shares of common stock outstanding as of July 31, 2006 was 100,522,492.

eMagin Corporation
Form 10-Q
For the Quarter ended June 30, 2006

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ITEM 1. Condensed Consolidated Financial Statements

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

	June 30, 2006 (unaudited)	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 255	$ 6,727
Investments - held to maturity	124	120
Accounts receivable, net	954	762
Inventory	3,614	3,839
Prepaid expenses and other current assets	832	1,045
Total current assets	5,779	12,493
Equipment, furniture and leasehold improvements, net	983	1,299
Intangible assets, net	56	57
Other assets	233	233
Total assets	$ 7,051	$ 14,082
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 2,686	$ 562
Accrued compensation	1,018	1,010
Other accrued expenses	875	1,894
Deferred revenue	98	96
Current portion of capitalized lease obligations	9	16
Other current liabilities	148	47
Total current liabilities	4,834	3,625
Capitalized lease obligations	4	6
Long-term debt	37	50
Total liabilities	4,875	3,681
Commitments and contingencies		
Shareholders' equity:		
Preferred stock, $.001 par value: authorized 10,000,000 shares; no shares issued and outstanding	—	—
Common stock, $.001 par value: authorized 200,000,000 shares, issued and outstanding, 100,422,492 shares as of June 30, 2006 and 99,972,458 shares as of December 31, 2005	100	100
Additional paid-in capital	177,633	175,860
Accumulated deficit	(175,557)	(165,559)

Total shareholders’ equity		2,176		10,401
Total liabilities and shareholders’ equity	$	7,051	$	14,082

See notes to Condensed Consolidated Financial Statements.

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

	Three Months Ended June 30, 2006	Three Months Ended June 30, 2005	Six Months Ended June 30, 2006	Six Months Ended June 30, 2005
Revenue:				
Product revenue	$ 1,674	$ 616	$ 3,245	$ 1,307
Contract revenue	---	36	70	36
Total revenue, net	1,674	652	3,315	1,343
Cost of goods sold	2,965	2,389	5,994	4,346
Gross loss	(1,291)	(1,737)	(2,679)	(3,003)
Operating expenses:				
Research and development	1,304	1,130	2,542	2,016
Selling, general and administrative	2,248	1,760	4,836	3,095
Total operating expenses	3,552	2890	7,378	5,111
Loss from operations	(4,843)	(4,627)	(10,057)	(8,114)
Other income (expense):				
Interest expense	---	(1)	---	(2)
Other income, net	5	130	59	149
Total other income, net	5	129	59	147
Net loss	$ (4,838)	$ (4,498)	$ (9,998)	$ (7,967)
Loss per share, basic and diluted	$ (0.05)	$ (0.05)	$ (0.10)	$ (0.10)
Weighted average number of shares outstanding:				
Basic and diluted	100,114,000	82,445,000	100,076,000	81,955,000

See notes to Condensed Consolidated Financial Statements.

eMAGIN CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
(In thousands)

	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Accumulated Deficit	Total Shareholders' Equity
Balance, December 31, 2005	99,972	$ 100	$ 175,860	$ (165,559)	$ 10,401
Stock-based compensation	-----	-----	1,581	-----	1,581
Issuance of common stock for services	450	-----	192	-----	192
Net loss	-----	-----	-----	(9,998)	(9,998)
Balance, June 30, 2006, (unaudited)	100,422	$ 100	$ 177,633	$ (175,557)	$ 2,176

See notes to Condensed Consolidated Financial Statements.

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

	Six months ended June 30, 2006		Six months ended June 30, 2005	
	(unaudited)			
Cash flows from operating activities:				
Net loss	$	(9,998)	$	(7,967)
Adjustments to reconcile net loss to net cash used in operating activities:				
Depreciation and amortization		513		378
Reduction in provision for sales returns and doubtful accounts		(13)		(101)
Stock-based compensation		1,581		---
Issuance of common stock for services		192		240
Changes in operating assets and liabilities:				
Accounts receivable		(180)		150
Inventory		226		(1,489)
Prepaid expenses and other current assets		213		(389)
Deferred revenue		2		---
Accounts payable, accrued compensation, and other accrued expenses		1,106		540
Other current liabilities		101		10
Net cash used in operating activities		(6,257)		(8,628)
Cash flows from investing activities:				
Purchase of equipment		(194)		(494)
Purchase of investments - held to maturity		(4)		---
Purchase of intangibles and other assets		(2)		35
Net cash used by investing activities		(200)		(459)
Cash flows from financing activities:				
Proceeds from exercise of stock options and warrants		---		1,564
Payments of long-term debt and capital leases		(15)		(7)
Net cash (used) provided by financing activities		(15)		1,557
Net (decrease) in cash and cash equivalents		(6,472)		(7,530)
Cash and cash equivalents beginning of period		6,727		13,457
Cash and cash equivalents end of period	$	255	$	5,927
Cash paid for interest	$	---	$	8
Cash paid for taxes	$	35	$	---

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, 2005.

Certain prior-period balances have been reclassified to conform to the current period presentation. These reclassifications had no impact on revenue, net loss, assets or liabilities in either period presented. The results of operations for the period ended June 30, 2006 are not necessarily indicative of the results to be expected for the full year.

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 2006. These factors raise substantial doubt regarding the Company’s ability to continue as a going concern without continuing to obtain additional funding. If management is unsuccessful in its efforts to obtain additional funding, the Company will reduce its operating plan which will have an impact on its ability to achieve profitability. The condensed consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

Use of Estimates

In accordance with accounting principles generally accepted in the United States, management utilizes certain estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. On an on-going basis, management evaluates its estimates and judgments. Management bases its estimates and judgments on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results could differ from those 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, the 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

The Company maintains several stock equity incentive plans. The 2005 Employee Stock Purchase Plan (the "ESPP") provides the Company's 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 June 30, 2006, the number of shares of common stock available for issuance was 1,500,000. As of June 30, 2006, 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 the Company's 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 at the date of grant. These options have a term of up to 10 years and vest over a schedule determined by the Board of Directors, generally five years. 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 nine (9) years which commenced January 1, 2005.

On January 1, 2006, the Company adopted the provisions of Financial Accounting Standards Board ("FASB") Statement No. 123(R), "*Share-Based Payment*", ("SFAS No. 123R"), which requires the Company to recognize expense related to the fair value of the Company's share-based compensation. Prior to January 1, 2006, the Company accounted for share-based compensation under the recognition and measurement provisions of Accounting Principles Board Opinion No. 25 ("APB No. 25"), "*Accounting for Stock Issued to Employees",* and related interpretations, as permitted by FASB Statement No. 123, "Accounting for Stock-Based Compensation" ("SFAS No. 123"). In accordance with APB No. 25, no compensation cost was required to be recognized for options granted that had an exercise price equal to the market value of the underlying common stock on the date of grant.

The Company adopted SFAS No. 123R using the modified prospective transition method and consequently has not retroactively adjusted results for prior periods. Under this transition method, compensation cost associated with stock options includes: a) compensation cost for all share-based compensation granted prior to, but not vested as of January 1, 2006, based on the grant-date fair value estimated in accordance with the original provisions of SFAS No.123 and b) compensation cost for all share-based compensation granted beginning January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS No.123R. The Company uses the straight-line method for recognizing compensation expense. Compensation expense for awards under SFAS 123R includes an estimate for forfeitures.

See Note 7 for further information regarding the Company's stock-based compensation assumptions and expenses, including the impact of adoption on the Company's condensed Consolidated Financial Statements and pro forma disclosures for prior periods as if we had recorded stock-based compensation expense.

Note 2: Receivables

The majority of the Company's commercial accounts receivable is 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):

	June 30, 2006 (unaudited)	December 31, 2005
Accounts receivable	$ 1,429	$ 1,249
Less allowance for doubtful accounts	(475)	(487)
Net receivables	$ 954	$ 762

Note 3: Research and Development Costs

Research and development costs are expensed as incurred.

Note 4: 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 June 30, 2006 and 2005, there were stock options and warrants outstanding to acquire 36,081,749 and 34,132,127 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 5: 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):

	June 30, 2006 (unaudited)	December 31, 2005
Raw materials	$ 2,066	$ 2,353
Work in process	250	107
Finished goods	1,298	1,379
Total Inventory	$ 3,614	$ 3,839

Note 6: Debt

Debt is as follows (in thousands):

	June 30, 2006 (unaudited)	December 31, 2005
Current portion of capitalized lease obligations	$ 9	$ 16
Long-term capitalized lease obligations	4	6
Long-term debt	37	50
Total debt	$ 50	$ 72

Note 7: Stock-based Compensation

On January 1, 2006, the Company adopted the provisions of SFAS No. 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. Prior to January 1, 2006, the Company accounted for share-based compensation under the recognition and measurement provisions of APB No. 25 and related interpretations, as permitted by SFAS No. 123. We adopted SFAS No. 123R using the modified prospective transition method. Accordingly, periods prior to adoption have not been restated. Compensation cost recognized for the three and six months ended June 30, 2006 includes a) compensation cost for all share-based compensation granted prior to, but not vested as of January 1, 2006, based on the grant-date fair value estimated in accordance with the original provisions of SFAS No.123 and b) compensation cost for all share-based compensation granted beginning January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS No.123R. The compensation cost was recognized using the straight-line attribution 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 June 30, 2006 (in thousands):

	Three Months Ended June 30, 2006	Six Months Ended June 30, 2006
Cost of revenue	$ 123	$ 258
Research and development	131	259
Selling, general and administrative	536	1,064
Total stock compensation expense	$ 790	$ 1,581

For the three and six months ended June 30, 2006, stock compensation was approximately $0.8 million and $1.6 million, respectively. At June 30, 2006, total unrecognized non-cash compensation costs related to stock options was approximately $6.1 million, net of estimated 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 5.2 years.

The Company recognizes compensation expense for options granted to non-employees in accordance with the provision 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.

In determining the fair value of stock options granted during the six month periods ended June 30, 2006 and 2005, the following key assumptions were used in the Black-Scholes option pricing model:

	For the Six Months Ended June 30,	
	2006	**2005**
Dividend yield	0%	0%
Risk free interest rates	5.10%	3.98%
Expected volatility	123%	69%
Expected term (in years)	5 years	7 years

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 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.

The following table shows the proforma effect on our net loss and net loss per share had compensation expense been determined based on the fair value at the award grant date in accordance with SFAS No. 123 for the three and six months ended June 30, 2005 (in thousands, except per share data):

	Three Months Ended June 30, 2005	Six Months Ended June 30, 2005
Net loss, as reported	$ (4,498)	$ (7,967)
Deduct: Stock-based employee compensation expense determined under fair value method	(527)	(2,055)
Pro forma net loss	$ (5,025)	$ (10,022)
Net loss per share:		
Basic and diluted, as reported	$ (0.05)	$ (0.10)
Basic and diluted, pro forma	$ (0.06)	$ (0.12)

A summary of the Company's stock option activity for the six months ended June 30, 2006 is presented in the following tables:

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (In Years)	Aggregate Intrinsic Value
Outstanding at January 1, 2006	18,052,636	$ 1.09		
Options granted	1,080,000	0.55		
Options exercised	----	----		
Options cancelled	(2,405,358)	1.07		
Outstanding at June 30, 2006	16,727,278	$ 1.04	4.26	$ 95,000
Vested or expected to vest at June 30, 2006 (1)	16,058,187	$ 1.02	3.71	$ 95,000
Exercisable at June 30, 2006	9,392,781	$ 1.04	3.31	$ 95,000

	Options Outstanding			Options Exercisable	
	Number Outstanding	Weighted Average Remaining Contractual Life (In Years)	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercisable Price
$0.21 - $0.85	7,492,258	4.05	$0.50	4,516,036	$0.45
$1.00 - $1.50	4,395,914	5.38	1.14	1,505,021	1.13
	4,839,106	3.57	1.80	3,371,724	1.80

$1.52 - $6.30					
	16,727,278	4.26	$1.04	9,392,781	$1.04

(1) The expected to vest options are the result of applying the pre-vesting forfeiture rate assumptions to total outstanding options.

The aggregate intrinsic value in the table above represents the difference between the exercise price of the underlying options and the quoted price of the Company's common stock for the 1,192,015 options that were in-the-money at June 30, 2006. The Company's closing stock price was $0.29 as of June 30, 2006. The Company issues new shares of common stock upon exercise of stock options.

Note 8: Shareholders' Equity

For the three and six months ended June 30, 2006, there were no warrants and stock options exercised as compared to the three and six months ended June 30, 2005 where the Company received approximately $318,000 and $1.6 million, respectively, in proceeds from the exercise of approximately 600,000 and 3.0 million warrants and options, respectively. For the three and six months ended June 30, 2006, the Company also issued approximately 373,000 and 450,000 shares of common stock, respectively, in lieu of payment of approximately $142,000 and $192,000, respectively, for services rendered and to be rendered in the future. For the three and six months ended June 30, 2005, the Company also issued approximately 284,000 and 296,000 shares of common stock, respectively, in lieu of payment of approximately $244,000 and $257,000, respectively, for services rendered and to be rendered in the future.

Note 9: 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 $125,000 which commenced on January 1, 2001. Under this agreement, the Company must pay to Eastman Kodak a certain percentage of net sales of 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 last-to-expire issued patent.

The Company paid $125,000 for the minimum amount due for 2006 and 2005. The amount was recorded in prepaid expenses and will be amortized as the Company records the royalty expense as defined in the agreement. Royalty expense was approximately $106,000 and $191,000, respectively, for the three and six months ended June 30, 2006 and approximately $42,000 and $65,000, respectively, for the three and six months ended June 30, 2005.

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 $332,000 and $679,000 for the three and six months ended June 30, 2006, respectively, and approximately $241,000 and $475,000 for the three and six months ended June 30, 2005, respectively.

Note 10: Legal Proceedings

On December 6, 2005, New York State Urban Development Corporation commenced action in the Supreme Court of the State of New York, County of New York against the Company, asserting breach of contract and seeking to recover a $150,000 grant which was made to the Company based on goals set forth in the agreement for recruitment of employees. The Company has received an extension of time to answer the Complaint and is in on-going negotiations with New York State Urban Development Corporation in order to resolve this matter. See Note 11 for further information.

Note 11: Subsequent Events

On July 13, 2006, the Company agreed to a settlement with the New York State Urban Development Corporation to repay $112,200 of a $150,000 grant made to the Company based on goals set forth in an agreement for recruitment of employees. The repayment will be made through monthly payments of $3,117 per month commencing August 1, 2006 and ending on July 1, 2009.

On July 21, 2006, the Company entered into several Note Purchase Agreements for the sale of approximately $6.5 million of senior secured debentures and warrants. The investors purchased $5.97 million principal amount of notes with conversion prices of $0.26 per share that may convert into approximately 23.0 million shares of common stock and 5 year warrants exercisable at $0.36 per share for approximately 16.1 million shares of common stock. An additional $0.5 million will be invested through the exercise of a warrant to purchase approximately 1.92 million shares of common stock at $0.26 per share prior to December 14, 2006, or at the request of the Company, by the purchase of additional notes and warrants. If the notes are not converted, 50% of the principal amount will be due July 21, 2007 and the remaining 50% due January 21, 2008. Commencing September 1, 2006, 6% interest is payable in quarterly installments on outstanding notes.

On July 21, 2006, certain employees and Directors of the Company agreed to forfeit approximately 4.7 million shares of existing stock options in return for re-pricing 8.7 million existing options at $0.26 per share. Option grants that have not been re-priced will remain unchanged. The Company offered the re-pricing to employees and Directors in lieu of making j new grants. The unvested options which were re-priced will continue to vest on original vesting schedules, but in no event prior to January 19, 2007. Previously vested options which were re-priced will now vest on January 19, 2007. Re-priced grants will be forfeited if the individual leaves voluntarily. The Company is currently evaluating the impact. of this re-pricing on its result of operations. Any additional compensation charges will be recognized over the shorter of the six months ended January 19, 2007 for previously vested options and over the remaining vesting period for unvested options.

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 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.

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 selling price is fixed, title 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. Revenue is recognized at shipment and we record a reserve for estimated sales returns, which is reflected as a reduction of revenue at the time of revenue recognition. We defer revenue 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.

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

In accordance with accounting principles generally accepted in the United States, management utilizes 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, income taxes, inventory realization, stock-based compensation expense and other factors. Management believes it 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 appropriates 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 June 30, 2006, the number of shares of common stock available for issuance was 1,500,000. As of June 30, 2006, the plan had not been implemented.

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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.

On January 1, 2006, we adopted the provisions of Financial Accounting Standards Board ("FASB") Statement No. 123(R), "*Share-Based Payment*", and ("SFAS No. 123R"), which requires us to recognize expense related to the fair value of our share-based compensation issued to employees and directors. Prior to the January 1, 2006, we accounted for share-based compensation under the recognition and measurement provisions of Accounting Principles Board Opinion No. 25 ("APB No. 25"), "*Accounting for Stock Issued to Employees",* and related interpretations, as permitted by FASB Statement No. 123, "Accounting for Stock-Based Compensation" ("SFAS No. 123"). In accordance with APB No. 25, no compensation cost was required to be recognized for options granted that had an exercise price equal to the market value of the underlying common stock on the date of grant.

We adopted SFAS No. 123R using the modified prospective transition method and consequently have not retroactively adjusted results for prior periods. Under this transition method, compensation cost associated with stock options includes: a) compensation cost for all share-based compensation granted prior to, but not vested as of January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS No.123 and b) compensation cost for all share-based compensation granted beginning January 1, 2006, based on the grant-date fair value estimated in accordance with the original provisions of SFAS No.123R. We use the straight-line method for recognizing compensation expense. Compensation expense for awards under SFAS 123R includes an estimate for forfeitures.

NEW ACCOUNTING PRONOUNCEMENT

The Financial Accounting Standards Board ("FASB") has issued interpretation No. 48, "Accounting for Uncertainty in Income Taxes—An Interpretation of FASB Statement No. 109" ("FIN 48"), regarding accounting for, and disclosure of, uncertain tax positions. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, "Accounting for Income Taxes." FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. We do not anticipate that the adoption of this statement will have a material effect on our financial position or results of operation.

RESULTS OF OPERATIONS

THREE AND SIX MONTHS ENDED JUNE 30, 2006 COMPARED TO THREE AND SIX MONTHS ENDED JUNE 30, 2005

Revenues

Revenues for the three and six months ended June 30, 2006 were approximately $1.7 million and $3.3 million, respectively, as compared to approximately $0.7 million and $1.3 million, respectively, for the three and six months ended June 30, 2005, an increase of approximately 157% and 147%, respectively. The increase in revenue was due to increased unit shipments of our microdisplays due to increased, reliable manufacturing output and a broadening of our product revenue through sales of the Z800 3DVisor.

Cost of Goods Sold

Cost of goods sold includes direct and indirect costs associated with production. Cost of goods sold for the three and six months ended June 30, 2006 was approximately $3.0 million and $6.0 million, respectively, as compared to approximately $2.4 million and $4.3 million, respectively, for the three and six months ended June 30, 2005, an increase of approximately $0.6 million and $1.7 million, respectively. The gross loss for the three and six months ended June 30, 2006 was approximately ($1.3) million and ($2.7) million, respectively, as compared to approximately ($1.7) million and $(3.0) million, respectively, for the three and six months ended June 30, 2005. This translates to a gross loss of (77%) and (81%), respectively, for the three and six months ended June 30, 2006 as compared to a gross loss of (266%) and (224%), respectively, for the three and six months ended June 30, 2005. The increase to cost of goods sold for the three and six months 2006 was attributed to higher staffing levels and materials usage to support increased production as well as approximately $123,000 and $258,000 for the three and six month periods of non cash stock compensation expense reflected in accordance with SFAS No. 123R in 2006.

Operating Expenses

Research and Development. Research and development expenses included salaries, development materials and other costs specifically allocated to the development of new microdisplay products, OLED materials and subsystems. Gross research and development expenses for the three and six months ended June 30, 2006 were approximately $1.3 million and $2.5 million, respectively, as compared to approximately $1.1 million and $2.0 million, respectively, for the three and six months ended June 30, 2005, increases of approximately $175,000 and $526,000, respectively. The increases were due to increased personnel costs related to additional headcount and stock-based compensation expense of approximately $131,000 and $259,000, respectively, for the three and six months ended June 30, 2006 reflected in accordance with SFAS No. 123R in 2006.

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 six months ended June 30, 2006 were approximately $2.2 million and $4.8 million, respectively, as compared to approximately $1.8 million and $3.1 million, respectively, for the three and six months ended June 30, 2005. The increases of approximately $0.4 million and $1.7 million, respectively, were primarily due to an increase in advertising expenses related to our Z800 3DVisor, trade show participation and increased personnel costs related to additional headcount as well as stock-based compensation expense of approximately $536,000 and $1,065,000, respectively, for the three and six months ended June 30, 2006 reflected in accordance with SFAS No. 123R in 2006.

Other Income, net. Other income, net consists primarily of interest income earned on investments. For the three and six months ended June 30, 2006 interest income was $5,000 and $59,000, respectively, as compared to $130,000 and $149,000, respectively, for the three and six months ended June 30, 2005. The decrease in net other income was primarily a result of lower cash balances available for investment.

Liquidity and Capital Resources

As of June 30, 2006, we had approximately $0.9 million of working capital as compared to approximately $8.9 million as of December 31, 2005. This decrease of approximately $8.0 million was due primarily to uses of working capital to fund operations.

Cash flow used in operating activities during the first six months of 2006 was approximately $6.3 million as compared to cash used of approximately $8.6 million during the first six months of 2005. This decrease was primarily attributable to approximately $1.5 million used to increase inventory during the first six months of 2005 and not repeated in 2006 as well as increases in liabilities in 2006 which lowered the use of cash during the period. In June of 2006 we took steps to reduce our use of cash for operating activities by approximately $4 million annually by reducing our headcount by 28 employees and lowering discretionary spending.

Cash used in investing activities during the first half of 2006 was approximately $0.2 million as compared to approximately $0.5 million during the first half of 2005. The reduction of cash used in investing activities was primarily due to lower purchases of equipment.

Cash used in financing activities during the first half of 2006 was $15,000 as compared to cash provided from financing activities of approximately $1.6 million during the first half of 2005. We received approximately $1.6 million of proceeds from the exercise of employee stock options and warrants during the first half of 2005.

Our condensed consolidated financial statements as of June 30, 2006 have been prepared under the assumption that we will continue as a going concern for the year ending December 31, 2006. Our independent registered public accounting firm have issued their report dated March 15, 2006 that included an explanatory paragraph expressing substantial doubt in our ability to continue as a going concern without additional capital becoming available. Our ability to continue as a going concern is dependent 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.

Our business is currently experiencing significant revenue growth during the first half of 2006 which if it continues may result in higher accounts receivable levels and higher inventory levels. To fund these requirements as well as other operating or investing cash requirements over the next 12 months, we anticipate that our cash requirements will be greater than our current cash on hand. On July 21, 2006, we entered into several Note Purchase agreements for the sale of approximately $6.5 million of senior secured debentures and warrants. We purchased $5.97 million principal amount of notes and an additional $0.5 million will be purchased prior to December 14, 2006. Please see Note 11: Subsequent Events in Notes to Condensed Consolidated Financial Statements for additional information. However based on growth expectations, we anticipate that additional capital will be required. We do not have commitments for such financing and no assurance can be given that additional financing will be available, or if available, will be on acceptable terms. If we are unable to obtain sufficient funds during the next 12 months we will further reduce the size of our organization which could have a material adverse impact on our business prospects.

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.* As of the end of the period covered by this report, we conducted an evaluation, under the supervision and with the participation of our chief executive officer and chief financial officer of our disclosure controls and procedures (as defined in Rule 13a-15(e) and Rule 15d-15(e) of the Exchange Act). Based upon this evaluation, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures are effective to ensure 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.

(b) *Changes in Internal Controls.* There was no change in our internal controls or in other factors that could affect these controls during our last fiscal quarter 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

On December 6, 2005, New York State Urban Development Corporation commenced action in the Supreme Court of the State of New York, County of New York against eMagin, asserting breach of contract and seeking to recover a $150,000 grant which was made to eMagin based on goals set forth in the agreement for recruitment of employees. On July 13, 2006, the Company agreed to a settlement with the New York State Urban Development Corporation to repay $112,200 of a $150,000 grant made to the Company based on goals set forth in an agreement for recruitment of employees. The repayment will be made through monthly payments of $3,117 per month commenting August 1, 2006 and ending on July 1, 2009.

ITEM 1A. Risk Factors

In evaluating our business, prospective investors and shareholders should carefully consider the risks factors, any of which could have a material adverse impact on our business, operating results and financial condition and result in a complete loss 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.

Accumulated losses excluding non-cash transactions as of June 30, 2006 were $74 million and acquisition related non-cash transactions were $102 million, which resulted in an accumulated net loss of $176 million. 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.

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. To the extent that operating expenses increase or we need additional funds to make acquisitions, develop new technologies or acquire strategic assets, the need for additional funding may be accelerated and there can be no assurances that any such additional funding can be obtained on terms acceptable to us, if at all. If we were not able to generate sufficient capital, either from operations or through additional debt or equity financing, to fund our current operations, we would be forced to significantly reduce or delay our plans for continued research and development and expansion. This could significantly reduce the value of our securities.

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

Our consolidated financial statements as of June 30, 2006 have been prepared under the assumption that we will continue as a going concern for the year ending December 31, 2006. Our independent registered public accounting firm have issued their report dated March 15, 2006 that included an explanatory paragraph expressing substantial doubt in our ability to continue as a going concern without additional capital becoming available. 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.

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 produce our products 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 and those under development utilize OLED technology that we license from Eastman Kodak. We rely upon Eastman Kodak to protect and enforce key patents, 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 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;

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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, including Gary W. Jones, our chief executive officer. We 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 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 our company 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 the company 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 June 30, 2006, we have outstanding (i) options to purchase 16,727,278 shares and (ii) warrants to purchase 19,354,471 shares of common stock.

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 the company. 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

None.

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

EXHIBIT NUMBER	DESCRIPTION
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.

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 14th day of August, 2006.

eMAGIN CORPORATION

By: /s/ Gary W. Jones

Gary W. Jones
Chief Executive Officer
Principal Executive Officer

By: /s/ John Atherly

John Atherly
Chief Financial Officer
Principal Accounting and Financial Officer