

EMAGIN CORP  
Form 10-Q  
November 12, 2010

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

Form 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2010  
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.)

3006 Northup Way, Suite 103, Bellevue, Washington 98004  
(Address of principal executive offices)

(425) 284-5200  
(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  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T

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(§232.405 of this chapter) during the preceding 12 months ). Yes " No "

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

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

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, 2010 was 20,310,569.

eMagin Corporation  
Form 10-Q  
For the Quarter ended September 30, 2010

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## ITEM 1. Condensed Consolidated Financial Statements

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

|  | September<br>30, 2010<br>(unaudited) | December<br>31, 2009 |
|--|--------------------------------------|----------------------|
| <b>ASSETS</b>  |                                      |                      |
| Current assets:                                      |                                      |                      |
| Cash and cash equivalents                            | \$ 6,714                             | \$ 5,295             |
| Short-term investments – held to maturity            | 2,600                                | 100                  |
| Accounts receivable, net                             | 5,231                                | 4,563                |
| Inventory  | 1,671                                | 2,179                |
| Prepaid expenses and other current assets            | 599                                  | 687                  |
| Total current assets                                 | 16,815                               | 12,824               |
| Long-term investments – held to maturity             | 1,000                                | —                    |
| Equipment, furniture and leasehold improvements, net | 3,232                                | 1,021                |
| Intangible assets, net                               | 41                                   | 43                   |
| Other assets   | 92                                   | 92                   |
| Total assets   | \$ 21,180                            | \$ 13,980            |

**LIABILITIES AND SHAREHOLDERS' EQUITY**

|                           |        |          |
|---------------------------|--------|----------|
| Current liabilities:      |        |          |
| Accounts payable          | \$ 988 | \$ 1,122 |
| Accrued compensation      | 1,807  | 956      |
| Other accrued expenses    | 977    | 791      |
| Advance payments          | 125    | 211      |
| Deferred revenue          | 154    | 238      |
| Other current liabilities | 734    | 891      |
| Total current liabilities | 4,785  | 4,209    |

Commitments and contingencies (Note 12)

Shareholders' equity:

Preferred stock, \$.001 par value: authorized 10,000,000 shares:

Series B Convertible Preferred stock, (liquidation preference of \$5,679,000 at September 30, 2010) stated value \$1,000 per share, \$.001 par value: 10,000 shares designated and 5,679 issued and outstanding as of September 30, 2010 and 5,739 as of December 31, 2009

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|  |           |           |
|--|-----------|-----------|
| Common stock, \$.001 par value: authorized 200,000,000 shares, issued and outstanding, 19,938,992 shares as of September 30, 2010 and 16,967,244 as of December 31, 2009 |           |           |
| Additional paid-in capital   | 208,665   | 206,664   |
| Accumulated deficit  | (192,290) | (196,910) |
| Total shareholders' equity   | 16,395    | 9,771     |
| Total liabilities and shareholders' equity   | \$ 21,180 | \$ 13,980 |

See notes to Condensed Consolidated Financial Statements.

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

|  | Three Months Ended<br>September 30, |          | Nine Months Ended<br>September 30, |           |
|--|-------------------------------------|----------|------------------------------------|-----------|
|  | 2010                                | 2009     | 2010                               | 2009      |
| Revenue:                                       |                                     |          |                                    |           |
| Product revenue                                | \$ 6,936                            | \$ 5,260 | \$ 17,826                          | \$ 14,560 |
| Contract revenue                               | 1,320                               | 847      | 4,669                              | 2,543     |
| Total revenue, net                             | 8,256                               | 6,107    | 22,495                             | 17,103    |
| Cost of goods sold:                            |                                     |          |                                    |           |
| Product revenue                                | 2,105                               | 1,996    | 6,590                              | 5,817     |
| Contract revenue                               | 683                                 | 611      | 2,380                              | 1,528     |
| Total cost of goods sold                       | 2,788                               | 2,607    | 8,970                              | 7,345     |
| Gross profit                                   | 5,468                               | 3,500    | 13,525                             | 9,758     |
| Operating expenses:                            |                                     |          |                                    |           |
| Research and development                       | 511                                 | 463      | 1,888                              | 1,376     |
| Selling, general and administrative            | 2,054                               | 1,772    | 6,873                              | 5,083     |
| Total operating expenses                       | 2,565                               | 2,235    | 8,761                              | 6,459     |
| Income from operations                         | 2,903                               | 1,265    | 4,764                              | 3,299     |
| Other income (expense):                        |                                     |          |                                    |           |
| Interest expense                               | (21)                                | (76)     | (79)                               | (417)     |
| Other income, net                              | 2                                   | 1        | 10                                 | 41        |
| Total other expense, net                       | (19)                                | (75)     | (69)                               | (376)     |
| Income before provision for income taxes       | 2,884                               | 1,190    | 4,695                              | 2,923     |
| Provision for income taxes                     | 56                                  | —        | 75                                 | —         |
| Net income                                     | \$ 2,828                            | \$ 1,190 | \$ 4,620                           | \$ 2,923  |
| Income per share, basic                        |                                     |          |                                    |           |
| Income per share, basic                        | \$ 0.14                             | \$ 0.07  | \$ 0.25                            | \$ 0.18   |
| Income per share, diluted                      | \$ 0.09                             | \$ 0.04  | \$ 0.15                            | \$ 0.12   |
| Weighted average number of shares outstanding: |                                     |          |                                    |           |

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|         |            |            |            |            |
|---------|------------|------------|------------|------------|
| Basic   | 19,883,029 | 16,513,101 | 18,781,185 | 16,133,646 |
| Diluted | 31,816,477 | 26,592,267 | 30,680,340 | 24,471,486 |

See notes to Condensed Consolidated Financial Statements.



eMAGIN CORPORATION  
CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY  
(In thousands, except for share data)  
(unaudited)

|   | Preferred Stock |        | Common Stock |        | Additional<br>Paid-in<br>Capital | Accumulated<br>Deficit | Total<br>Shareholders'<br>Equity |
|---|-----------------|--------|--------------|--------|----------------------------------|------------------------|----------------------------------|
|   | Shares          | Amount | Shares       | Amount |                                  |                        |                                  |
| Balance,<br>December 31,<br>2009                                | 5,739           | \$ —   | 16,967,244   | \$ 17  | \$ 206,664                       | \$ (196,910)           | \$ 9,771                         |
| Cashless exercise<br>of common stock<br>warrants                |                 |        | 2,601,591    | 2      | (2)                              |                        |                                  |
| Conversion of<br>Series B Preferred<br>Stock to common<br>stock | (60)            | —      | 80,000       | —      | —                                |                        |                                  |
| Issuance of<br>common stock for<br>services                     |                 |        | 15,363       | —      | 55                               |                        | 55                               |
| Exercise of<br>common stock<br>warrants                         |                 |        | 100,000      | 1      | 249                              |                        | 250                              |
| Exercise of<br>common stock<br>options                          |                 |        | 174,794      | —      | 322                              |                        | 322                              |
| Stock-based<br>compensation                                     |                 |        |              |        | 1,377                            |                        | 1,377                            |
| Net income  |                 |        |              |        |                                  | 4,620                  | 4,620                            |
| Balance,<br>September 30,<br>2010                               | 5,679           | \$ —   | 19,938,992   | \$ 20  | \$ 208,665                       | \$ (192,290)           | \$ 16,395                        |

See notes to Condensed Consolidated Financial Statements.



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

|  | Nine Months Ended<br>September 30,<br>2010                  2009<br>(unaudited) |          |
|--|---|----------|
| Cash flows from operating activities:  |   |          |
| Net income   | \$ 4,620  | \$ 2,923 |
| Adjustments to reconcile net income to net cash provided by operating activities:                          |   |          |
| Depreciation and amortization  | 52  | 65       |
| Amortization of deferred financing and waiver fees   | —   | 362      |
| (Reduction of) provision for sales returns and doubtful accounts   | (260)   | (423)    |
| Stock-based compensation   | 1,377   | 926      |
| Amortization of common stock issued for services   | 61  | 178      |
| Changes in operating assets and liabilities:   |   |          |
| Accounts receivable  | (468)   | (45)     |
| Inventory  | 508   | 309      |
| Prepaid expenses and other current assets  | 72  | (54)     |
| Deferred revenue   | (84)  | 56       |
| Accounts payable, accrued compensation, other accrued expenses, and advance payments                       | 827   | (725)    |
| Other current liabilities  | (97)  | (121)    |
| Net cash provided by operating activities  | 6,608   | 3,451    |
| Cash flows from investing activities:  |   |          |
| Purchase of equipment  | (2,261)   | (492)    |
| Purchase of investments – held to maturity   | (3,500)   | —        |
| Net cash used in investing activities  | (5,761)   | (492)    |
| Cash flows from financing activities:  |   |          |
| Payments of debt   | —   | (1,654)  |
| Proceeds from exercise of stock options and warrants   | 572   | —        |
| Net cash provided by (used in) financing activities  | 572   | (1,654)  |
| Net increase in cash and cash equivalents  | 1,419   | 1,305    |
| Cash and cash equivalents, beginning of period   | 5,295   | 2,404    |
| Cash and cash equivalents, end of period   | \$ 6,714  | \$ 3,709 |
|  |   |          |
| Cash paid for interest   | \$ 76   | \$ 67    |
| Cash paid for taxes  | \$ 125  | \$ 46    |
| Supplemental information of non-cash operating and financing activities:                                   |   |          |
| Common stock issued for services charged to prepaid expenses   | \$ —  | \$ 126   |
| Issuance of 2,601,591 shares of common stock for cashless exercise of 3,778,811 warrants in 2010           | \$ —  | \$ —     |
| Conversion of 60 shares of Series B Convertible Preferred Stock into 80,000 shares of common stock in 2010 | \$ —  | \$ —     |

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 Accounting Policies

The Business

eMagin Corporation (the “Company”) designs, develops, manufactures, and markets OLED (organic light emitting diode) on silicon microdisplays and virtual imaging products which utilize OLED microdisplays. The Company’s products are sold mainly in North America, Asia, and Europe.

Basis of Presentation

In the opinion of management, the accompanying unaudited condensed consolidated financial statements of eMagin Corporation and its subsidiary reflect 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 instructions, 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, 2009. The results of operations for the period ended September 30, 2010 are not necessarily indicative of the results to be expected for the full year.

Use of Estimates

In accordance with accounting principles generally accepted in the United States of America, 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 and Cost Recognition

Revenue is recognized when persuasive evidence of an arrangement exists, delivery has occurred, selling price is fixed or determinable and collection is reasonably assured. Product revenue is generally recognized when products are shipped to customers. The Company defers revenue recognition on products sold directly to the consumer with a maximum thirty 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 (contract revenues) under both firm fixed-price contracts and cost-type contracts. Revenues relating to firm fixed-price contracts and cost-type contracts are generally recognized on the percentage-of-completion method of accounting as costs are incurred (cost-to-cost basis). 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.

Product warranty

The Company offers a one-year product replacement warranty. In general, the standard policy is to repair or replace the defective products. The Company accrues for estimated returns of defective products at the time revenue is recognized based on historical activity as well as for specific known product issues. The determination of these accruals requires the Company to make estimates of the frequency and extent of warranty activity and estimate future costs to replace the products under warranty. If the actual warranty activity and/or repair and replacement costs differ significantly from these estimates, adjustments to cost of revenue may be required in future periods.

Research and Development Costs

Research and development costs are expensed as incurred.

Note 2: Recently Issued Accounting Pronouncements

In April 2010, the FASB amended the authoritative guidance on the milestone method of revenue recognition. The amendment defines a milestone and determines when it may be appropriate to apply the milestone method of revenue recognition for research or development transactions. Consideration that is contingent on achievement of a milestone in its entirety may be recognized as revenue in the period in which the milestone is achieved only if the milestone is judged to meet certain criteria to be considered substantive. This new guidance permits prospective adoption for milestones achieved in fiscal years and interim periods within those years, beginning on or after June 15, 2010. Early adoption is permitted. As the Company plans to implement the guidance prospectively, the effect of this guidance will be limited to future transactions. The Company does not expect adoption of this standard to have a material impact on its financial position or results of operations as it has no material research and development arrangements which are accounted for under the milestone method.

Note 3: Fair Value Measurement

Authoritative accounting guidance defines fair value, establishes a framework for measuring fair value and establishes a fair value hierarchy which prioritizes the inputs to valuation techniques. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between participants at the measurement date. The fair value hierarchy ranks the quality and reliability of the information used to determine fair values. Financial assets and liabilities carried at fair value will be classified and disclosed in one of the following three categories:

Level 1 – valued based on quoted prices at the measurement date for identical assets or liabilities trading in active markets.

Level 2 – quoted prices in active markets for similar assets and liabilities and inputs that are observable for the asset or liability.

Level 3 – valuations derived from valuation techniques in which one or more significant inputs are not readily observable.

As of September 30, 2010, the certificates of deposit comprising short-term and long-term investments – held to maturity of \$3.6 million are classified as Level 1.

Note 4: 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, historical experience, the customer's current ability to pay its obligations, 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<br>30,<br>2010<br>(unaudited) | December<br>31, 2009 |
|--------------------------------------|---|----------------------|
| Accounts receivable                  | \$ 5,615                                | \$ 5,147             |
| Less allowance for doubtful accounts | (384)                                   | (584)                |
| Net receivables                      | \$ 5,231                                | \$ 4,563             |



## Note 5: Net Income per Common Share

The net income per common share ("basic EPS") is computed by dividing net income by the weighted average number of common shares outstanding and excluding any potential dilution. Net income per common share assuming dilution ("diluted EPS") is computed by reflecting potential dilution from the exercise of stock options, warrants, convertible preferred stock and redeemable stock.

## Note 5: Net Income per Common Share (continued)

The following table presents a reconciliation of the numerator and denominator of the basic and diluted EPS calculations (in thousands, except share and per share data):

|  | Three Months Ended<br>September 30, |            | Nine Months Ended<br>September 30, |            |
|--|-------------------------------------|------------|------------------------------------|------------|
|  | 2010                                | 2009       | 2010                               | 2009       |
| Numerator:   |                                     |            |                                    |            |
| Net income   | \$ 2,828                            | \$ 1,190   | \$ 4,620                           | \$ 2,923   |
| Denominator:   |                                     |            |                                    |            |
| Weighted average shares outstanding for basic earnings per share   | 19,883,029                          | 16,513,101 | 18,781,185                         | 16,133,646 |
| Effective of dilutive shares:                                      |                                     |            |                                    |            |
| Dilution from stock options and warrants                           | 4,361,448                           | 2,427,166  | 4,327,155                          | 685,840    |
| Convertible preferred stock  | 7,572,000                           | 7,652,000  | 7,572,000                          | 7,652,000  |
| Dilutive potential common shares                                   | 11,933,448                          | 10,079,166 | 11,899,155                         | 8,337,840  |
| Weighted average shares outstanding for diluted earnings per share | 31,816,477                          | 26,592,267 | 30,680,340                         | 24,471,486 |

For the three and nine months ended September 30, 2010, the Company has excluded stock options and warrants to acquire 1,271,817 and 1,282,817 shares, respectively, of the Company's common stock since their effect would be anti-dilutive. For the three and nine months ended September 30, 2010 and 2009, the convertible preferred stock is included in the calculation of diluted earnings per share as all shares are assumed converted. For the three and nine months ended September 30, 2009, the Company has excluded stock options and warrants to acquire 3,498,592 and 10,226,638 shares, respectively, of the Company's common stock since their effect would be anti-dilutive.

## Note 6: Inventory

Inventory is stated at the lower of cost or market. Cost is determined using the first-in first-out method. Cost includes materials, labor, and manufacturing overhead related to the purchase and production of inventories. The Company regularly reviews inventory quantities on hand, future purchase commitments with the Company's suppliers, and the estimated utility of the inventory. If the Company review indicates a reduction in utility below carrying value, the inventory is reduced to a new cost basis.

The components of inventories are as follows (in thousands):

| September<br>30, | December<br>31, 2009 |
|------------------|----------------------|
|------------------|----------------------|

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|                 | 2010<br>(unaudited) |          |
|-----------------|---------------------|----------|
| Raw materials   | \$ 752              | \$ 806   |
| Work in process | 436                 | 709      |
| Finished goods  | 483                 | 664      |
| Total inventory | \$ 1,671            | \$ 2,179 |

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## Note 7: Prepaid Expenses and Other Current Assets

Prepaid expenses and other current assets consist of the following (in thousands):

|   | September<br>30,<br>2010<br>(unaudited) | December<br>31, 2009 |
|---|---|----------------------|
| Vendor prepayments                              | \$ 32                                   | \$ 266               |
| Other prepaid expenses *                        | 567                                     | 421                  |
| Total prepaid expenses and other current assets | \$ 599                                  | \$ 687               |

\*No individual amounts greater than 5% of current assets.

## Note 8: Debt

Effective September 1, 2010, the Company renewed its credit facility with Access Business Finance, LLC (“Access”) under which the Company may borrow up to a maximum of \$3 million based on a borrowing base equivalent of 75% of eligible accounts receivable. The interest on the line of credit is equal to the Prime Rate plus 4.00% but may not be less than 7.25% with a minimum monthly interest payment of \$5,000. The term of the agreement with Access is for one year and automatically renews for successive one year terms unless, at least 60 days prior to the end of the current term, the Company gives Access prior written notice of its intent not to renew or if Access, at least ten days prior to the end of the current term, gives the Company written notice of its intent not to renew. The Company’s obligations under the agreement are secured by its assets. The Company paid \$30,000 in annual loan fees to Access which were charged to prepaid expenses and amortized over the one year term. As of September 30, 2010, \$2,500 had been amortized to interest expense. As of September 30, 2010, the Company had not borrowed on its line of credit.

## Note 9: Stock-based Compensation

The Company uses the fair value method of accounting for share-based compensation arrangements. The fair value of stock options 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 nine month periods ended September 30, 2010 and 2009 (in thousands):

|                                     | Three Months Ended<br>September 30, |        | Nine Months Ended<br>September 30, |        |
|-------------------------------------|-------------------------------------|--------|------------------------------------|--------|
|                                     | 2010                                | 2009   | 2010                               | 2009   |
| Cost of revenue                     | \$ 28                               | \$ 25  | \$ 155                             | \$ 111 |
| Research and development            | 23                                  | 39     | 151                                | 165    |
| Selling, general and administrative | 376                                 | 317    | 1,071                              | 650    |
| Total stock compensation expense    | \$ 427                              | \$ 381 | \$ 1,377                           | \$ 926 |

At September 30, 2010, total unrecognized compensation costs related to stock options was approximately \$0.4 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 1.3 years.

Options granted to non-employees are measured at the grant date using a fair value options pricing model and remeasured to the current fair market value at each reporting period as the underlying options vest and services are rendered. There were no options granted to consultants in the three and nine months ended September 30, 2010. For the nine months ended September 30, 2009, there were 60,000 options granted to consultants. In May 2009, there were 60,000 options granted to consultants, of which the unvested options were remeasured to the current fair market value at September 30, 2010. The following assumptions were used in the Black-Scholes option pricing model to determine the fair value of stock options granted: dividend yield – 0%; risk free interest rates – 0.64% to 1.70%; expected volatility – 68.4% to 84.1%; and expected term – 3 years.

During the three and nine month periods ended September 30, 2010, there were 236,200 and 853,085 stock options, respectively, granted to employees and directors. During the nine month period ended September 30, 2009, there were 411,600 and 1,278,841 stock options granted to employees and directors. 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<br>Ended September 30, |                  |
|--------------------------|--|------------------|
|                          | 2010                                       | 2009             |
| Dividend yield           | 0%   | 0%               |
| Risk free interest rates | 1.31 to<br>2.57%                           | 2.02 to<br>2.51% |
| Expected volatility      | 80.6 to<br>86.9%                           | 80.3 to<br>86.4% |
| Expected term (in years) | 3.5 to 5.5                                 | 4.0 to 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.

For the nine month period ended September 30, 2010, 10,500 options were granted to employees from the 2008 Plan with a fair value of approximately \$12 thousand and 842,585 options were granted to employees and directors from the 2003 Plan with a fair value of approximately \$1.4 million. The weighted average fair value per share for options granted in the first nine months of 2010 was \$1.67.

A summary of the Company's stock option activity for the nine months ended September 30, 2010 is presented in the following tables:

|  | Number of<br>Shares | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Remaining<br>Contractual<br>Life (In<br>Years) | Aggregate<br>Intrinsic<br>Value |
|--|---------------------|--|---|---------------------------------|
| Outstanding at December 31, 2009                     | 2,817,574           | \$ 1.33                                  |   |                                 |
| Options granted                                      | 853,085             | 2.59                                     |   |                                 |
| Options exercised                                    | (174,794)           | 1.84                                     |   |                                 |
| Options forfeited                                    | —                   |  |   |                                 |
| Options cancelled                                    | (71,919)            | 3.11                                     |   |                                 |
| Outstanding at September 30, 2010                    | 3,432,946           | \$ 1.58                                  | 6.18  | \$ 5,806,112                    |
| Vested or expected to vest at September 30, 2010 (1) | 3,388,476           | \$ 1.72                                  | 6.18  | \$ 5,149,400                    |
| Exercisable at September 30, 2010                    | 2,917,243           | \$ 1.52                                  | 6.25  | \$ 5,149,400                    |

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

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|            | Options Outstanding |             |          | Options Exercisable |             |  |
|------------|---------------------|-------------|----------|---------------------|-------------|--|
|            | Number              | Weighted    | Weighted | Number              | Weighted    |  |
|            | Outstanding         | Average     | Average  | Exercisable         | Average     |  |
|            |                     | Remaining   | Exercise |                     | Exercisable |  |
|            |                     | Contractual | Price    |                     | Price       |  |
|            |                     | Life        |          |                     |             |  |
|            |                     | (In Years)  |          |                     |             |  |
| 0.34 -     |                     |             |          |                     |             |  |
| \$ \$0.98  | 1,160,340           | 5.67        | \$ 0.82  | 1,146,212           | \$ 0.82     |  |
| 1.00 -     |                     |             |          |                     |             |  |
| \$ \$1.51  | 1,185,938           | 6.42        | 1.20     | 1,030,400           | 1.22        |  |
| 1.80 -     |                     |             |          |                     |             |  |
| \$ \$1.94  | 411,341             | 6.32        | 1.94     | 194,519             | 1.94        |  |
| 2.60 -     |                     |             |          |                     |             |  |
| \$ \$3.92  | 639,327             | 6.74        | 3.05     | 519,912             | 3.04        |  |
| 5.80 -     |                     |             |          |                     |             |  |
| \$ \$22.50 | 27,000              | 1.51        | 11.00    | 26,200              | 10.97       |  |
|            | 3,432,946           | 6.18        | \$ 1.58  | 2,917,243           | \$ 1.52     |  |

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. There were 3,206,745 options in-the-money at September 30, 2010. The Company's closing stock price was \$3.19 as of September 30, 2010. The Company issues new shares of common stock upon exercise of stock options.

Note 10: Shareholders' Equity

Preferred Stock - Series B Convertible Preferred Stock ("the Preferred Stock – Series B")

The Company has designated 10,000 shares of the Company's preferred stock as Series B Convertible Preferred Stock ("the Preferred -Series B") at a stated value of \$1,000 per share. The Preferred Stock – Series B is convertible into common stock at a conversion price of \$0.75 per share. The Preferred Stock – Series B does not pay interest. The holders of the Preferred Stock – Series B are not entitled to receive dividends unless the Company's Board of Directors declares a dividend for holders of the Company's common stock and then the dividend shall be equal to the amount that such holder would have been entitled to receive if the holder converted its Preferred Stock – Series B into shares of the Company's common stock. Each share of Preferred Stock – Series B has voting rights equal to (i) the number of shares of Common Stock issuable upon conversion of such shares of Preferred Stock – Series B 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) when the Preferred Stock – Series B votes together with the Company's Common Stock or any other class or series of stock of the Company and (ii) one vote per share of Preferred Stock when such vote is not covered by the immediately preceding clause. In the event of a liquidation, dissolution, or winding up of the Company, the Preferred Stock – Series B is entitled to receive liquidation preference before the Common Stock. The Company may at its option redeem the Preferred Stock – Series B by providing the required notice to the holders of the Preferred Stock – Series B and paying an amount equal to \$1,000 multiplied by the number of shares for all of such holder's shares of outstanding Preferred Stock – Series B to be redeemed.

For the nine months ended September, 2010, there were 60 shares of Preferred Stock - Series B that were converted into 80,000 shares of common stock. As of September 30, 2010, there were 5,679 shares of Preferred Stock – Series B issued and outstanding.

Common Stock

For the three months ended September 30, 2010, the Company received approximately \$201 thousand for 101,230 stock options exercised and for the nine months ended September 30, 2010, \$322 thousand for 174,794 stock options exercised. For the three and nine months ended September 30, 2009, there were no stock options exercised. For the three months ended September 30, 2010, there were no warrants exercised. For the nine months ended September 30, 2010, there were 3,778,811 warrants exercised on a cashless basis resulting in 2,601,591 shares of common stock issued. For the nine months ended September 30, 2010, the Company received approximately \$250 thousand for 100,000 warrants exercised. For the three and nine months ended September 30, 2009, there were 2.9 million warrants exercised on a cashless basis resulting in 726,910 shares of common stock issued.

For the three months ended September 30, 2010, no shares of common stock were issued for payment of services rendered and for the nine months ended September 30, 2010, 15,363 shares of common stock were issued for payment of \$55 thousand for services rendered. For the three and nine months ended September 30, 2009, the Company issued approximately 42,857 and 498,533 shares of common stock, respectively, for payment of approximately \$45 thousand and \$304 thousand, respectively, for services rendered and to be rendered in the future. The Company recorded the fair value of the services rendered in selling, general and administrative expenses in the accompanying unaudited condensed consolidated financial statements for the nine months ended September 30, 2010 and the three and nine months ended September 30, 2009.

Note 11: Income Taxes

The Company's tax provision was \$56,000 and \$75,000, respectively, for the three and nine months ended September 30, 2010 which represents alternative minimum tax expense.

The Company accounts for income taxes under an asset and liability approach that requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been recognized in the Company's financial statements or tax returns. The effect on deferred tax assets and liabilities of changes in tax rates will be recognized as income or expense in the period that the change occurs. A valuation allowance for deferred tax assets is recorded when it is more likely than not that some or all of the benefit from the deferred tax asset will not be realized. Changes in circumstances, assumptions and clarification of uncertain tax regimes may require changes to any valuation allowances associated with the Company's deferred tax assets. Historically, the Company has incurred significant losses, however recently the Company has had a number of consecutive quarters of net income. Notwithstanding this positive trend, management does not believe that it is more likely than not that the benefits of the net operating losses carryforwards and other deferred tax assets will be realized. Accordingly, the Company has recognized the benefits of the deferred tax assets only to the extent of current taxable income.

Due to the Company's operating loss carryforwards, all tax years remain open to examination by the major taxing jurisdictions to which the Company is subject. In the event that the Company is assessed interest or penalties at some point in the future, it will be classified in the financial statements as tax expense.



Note 12: Commitments and Contingencies

Royalty Payments

The Company signed a license agreement on March 29, 1999 with Eastman Kodak (“Kodak”), under which it was obligated to make royalty payments. Under this agreement, the Company must pay to Kodak a minimum royalty plus 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. The Company was notified that Kodak sold substantially all rights and obligations under the Company’s license agreement to Global OLED Technology, owned by LG Electronics, as of December 30, 2009.

In late 2008, the Company began evaluating the status of its manufacturing process and the use of the IP associated with its license agreement. After this analysis and after making a few changes to its manufacturing process, the Company determined it was no longer using the IP covered under the license agreement. As the Company has determined it is no longer using the IP covered under the license agreement in its manufacturing process, the Company believes that it is no longer required to pay the minimum annual royalty payment of \$125,000 and as such has not paid or accrued this amount in 2010. Going forward, the Company will continue to recognize the reduced royalty liability on sales of product produced prior to the manufacturing process change. There can be no assurance that the licensor will not challenge the Company’s position.

As of September 30, 2010, the Company had approximately \$49 thousand of inventory manufactured using the IP which if sold would result in royalty due of approximately \$13 thousand. For the three and nine months ended September 30, 2010, the Company recorded approximately \$1 thousand and \$9 thousand, respectively, as royalty expense in its consolidated statements of operations and the associated liability on its consolidated balance sheets as the Company believes this is the amount due under the agreement which is based on applying the royalty formula to only the sold displays produced prior to the manufacturing process changes. Royalty expense was approximately \$250 thousand for the nine months ended September 30, 2009.

Contractual Obligations

The Company leases office facilities and office, lab and factory equipment under operating leases. 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.

The Company’s manufacturing facilities are leased from IBM in Hopewell Junction, New York. eMagin leases approximately 37,000 square feet to house its equipment for OLED microdisplay fabrication and for research and development, an assembly area and administrative offices. The lease expires May 31, 2014 and contains an option of extending the lease for five years. The corporate headquarters are located in Bellevue, Washington where eMagin leases approximately 5,100 square feet. The lease expires on August 31, 2014. Rent expense was approximately \$283 thousand and \$850 thousand, respectively, for the three and nine months ended September 30, 2010 and \$336 thousand and \$1.1 million, respectively, for the three and nine months ended September 30, 2009.

Note 13: Legal Proceedings

On March 17, 2010, Gary Jones, a former executive at the Company, filed a complaint for damages in the Superior Court of the State of Washington for King County (the "Complaint") against the Company and the Company's Chief Financial Officer. The Complaint alleges unspecified damages for failure to pay contractual payments and wages under Washington law ("the Washington Wage Claim") and includes, among other claims, breach of contract, breach of the duty of good faith and fair dealing, promissory estoppel and misrepresentation.

On May 21, 2010, the court granted eMagin's motion to dismiss regarding the claim for misrepresentation and the Washington Wage Claim. The Chief Financial Officer's motion to dismiss was also granted relating to the following claims against him: the Washington Wage Claims, breach of contract, breach of promises of specific treatment in specific circumstances, breach of the duty of good faith and fair dealing, and promissory estoppel. With respect to the undismissed claims, the litigation is ongoing. The Company denies the allegations raised in the Complaint and intends to vigorously defend itself. There can be no assurance of the outcome of this matter.

#### Note 14: Employment Agreements

Pursuant to the Employment Agreement between the Company and Susan Jones (as previously amended and extended, the "Employment Agreement"), the term of Ms. Jones' contract with the Company ended May 12, 2010 and her employment with the Company ceased at that time. Under the terms of the Employment Agreement between Susan Jones and the Company, Ms. Jones was entitled to a payment of eighteen months salary totaling approximately \$473 thousand which payment was made as of June 30, 2010, incentive payments of 1% of revenue paid quarterly for a period of eighteen months, continuation of health insurance for twenty four months and a moving allowance for personal effects of \$7.5 thousand. In addition, 12,696 unvested options immediately vested and became exercisable upon termination. As a result, the Company took a one time non-cash compensation charge of \$28 thousand in the second quarter of 2010.

The Company accounted for the incentive payments under guidance that benefits provided in accordance with an agreement be recorded as a liability when it is probable that the employee is entitled to the benefits and the amount can be reasonably estimated. The Company estimated that \$440 thousand is a reasonable estimate of the eighteen months of incentive payments and approximately \$21 thousand is a reasonable estimate for the continuation of health insurance for twenty four months. In the second quarter of 2010, the Company recorded a liability of approximately \$469 thousand which included the incentive payments, health insurance coverage, and the moving allowance in the condensed consolidated balance sheets and the associated expense as a sales, general and administrative expense in the condensed consolidated statements of operations. At September 30, 2010, the Company reviewed the estimates and assessed there was no material change.

## 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 "Business," "Management's Discussion and Analysis of Financial Condition and Results of Operation," 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 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 and manufacture miniature displays, which we refer to as OLED-on-silicon-microdisplays, and microdisplay modules for virtual imaging, primarily for incorporation into the products of other manufacturers. Microdisplays are typically smaller than many postage stamps, but when viewed through a magnifier they can contain all of the information appearing on a high-resolution personal computer screen. Our microdisplays use organic light emitting diodes, or OLEDs, which emit light themselves when a current is passed through the device. Our technology permits OLEDs to be coated onto silicon chips to produce high resolution OLED-on-silicon microdisplays.

We believe that our OLED-on-silicon microdisplays offer a number of advantages in near to the eye applications over other current microdisplay technologies, including lower power requirements, less weight, fast video speed without flicker, and wider viewing angles. In addition, many computer and video electronic system functions can be built directly into the OLED-on-silicon microdisplay, resulting in compact systems with lower expected overall system costs relative to alternate microdisplay technologies.

We have developed a strong portfolio of our own patents, manufacturing know-how and technology to create high performance OLED-on-silicon microdisplays and related optical systems. We believe our technology and intellectual property portfolio, gives us a leadership position in OLED and OLED-on-silicon microdisplay technology. We believe that we are the only company to demonstrate publicly and market full-color small molecule OLED-on-silicon microdisplays.

## Company History

As of January 1, 2003, we were no longer classified as a development stage company. We transitioned to manufacturing our product and have significantly increased our marketing, sales, and research and development efforts, and expanded our operating infrastructure. Currently, most of our operating expenses are labor related and semi-fixed.

## 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 and Cost 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. Products sold directly to consumers have a thirty 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 and cost-type contracts are generally recognized on the percentage-of-completion method of accounting as costs are incurred (cost-to-cost basis). 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.

### Product Warranty

We offer a one-year product replacement warranty. In general, our standard policy is to repair or replace the defective products. We accrue for estimated returns of defective products at the time revenue is recognized based on historical activity as well as for specific known product issues. The determination of these accruals requires us to make estimates of the frequency and extent of warranty activity and estimate future costs to replace the products under warranty. If the actual warranty activity and/or repair and replacement costs differ significantly from these estimates, adjustments to cost of revenue may be required in future periods.

### 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, 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

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

## Stock-based Compensation

eMagin maintains 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, 2010, the number of shares of common stock available for issuance was 300,000. As of September 30, 2010, 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 in common stock available for issuance by 3% of the diluted shares outstanding on January 1 of each year for a period of 9 years which commenced January 1, 2005. For the three and nine months ended September 30, 2010, there were 236,200 and 842,585 options, respectively, granted from this plan.

The 2008 Incentive Stock Plan (“the 2008 Plan”) adopted and approved by the Board of Directors on November 5, 2008 provides for the issuance of shares of common stock and options to purchase shares of common stock to employees, officers, directors and consultants. The 2008 Plan has an aggregate of 2,000,000 shares. For the nine months ended September 30, 2010, 10,500 options were granted from this plan.

We account for the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors by estimating the fair value of stock awards 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. See Note 9 of the Condensed Consolidated Financial Statements – Stock Compensation for a further discussion on stock-based compensation.

## 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 MONTHS AND NINE MONTHS ENDED SEPTEMBER 30, 2010 COMPARED TO THREE MONTHS AND NINE MONTHS ENDED SEPTEMBER 30, 2009

## Revenues

Revenues for the three and nine months ended September 30, 2010 were approximately \$8.3 million and \$22.5 million, respectively, as compared to approximately \$6.1 million and \$17.1 million, respectively, for the three and nine months ended September 30, 2009, an increase of approximately 36% and 32%, respectively.

For the three and nine months ended September 30, 2010, product revenue increased approximately \$1.7 million or 32% and \$3.3 million or 23%, respectively, as compared to the three and nine months ended September 30, 2009 which was primarily a result of an increase in customer demand for our OLED microdisplays. For the three and nine months ended September 30, 2010, contract revenue increased approximately \$0.5 million or 56% and \$2.1 million or 84%, respectively, as compared to the three and nine months ended September 30, 2009 which was a result of an increase in the number of active projects in the first nine months of 2010 as compared to the first nine months of 2009.

## Cost of Goods Sold

Cost of goods sold is comprised of costs of product revenue and contract revenue. Cost of product revenue includes materials, labor and manufacturing overhead related to our products. Cost of contract revenue includes direct and allocated indirect costs associated with performing on contracts. Cost of goods sold for the three and nine months ended September 30, 2010 was approximately \$2.8 million and \$9.0 million, respectively, as compared to approximately \$2.6 million and \$7.3 million for the three and nine months ended September 30, 2009, an increase of approximately \$0.2 million and \$1.7 million, respectively, for the three and nine months ended September, 2010.

Cost of goods sold as a percentage of revenues was 34% and 40%, respectively, for the three and nine months ended September 30, 2010 as compared to 43% for both the three and nine months ended September 30, 2009.

The following table outlines product, contract and total gross profit and related gross margins for both the three and nine months ended September 30, 2010 and 2009 (dollars in thousands):

|                               | Three months ended    |                       | Nine months ended     |                       |
|-------------------------------|-----------------------|-----------------------|-----------------------|-----------------------|
|                               | September 30,<br>2010 | September 30,<br>2009 | September 30,<br>2010 | September 30,<br>2009 |
|                               | (unaudited)           |                       | (unaudited)           |                       |
| Product revenue gross profit  | \$4,831               | \$3,264               | \$11,236              | \$8,743               |
| Product revenue gross margin  | 70                    | % 62                  | % 63                  | % 60                  |
| Contract revenue gross profit | \$637                 | \$236                 | \$2,289               | \$1,015               |

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|                               |         |   |         |   |          |   |         |   |
|-------------------------------|---------|---|---------|---|----------|---|---------|---|
| Contract revenue gross margin | 48      | % | 28      | % | 49       | % | 40      | % |
| Total gross profit            | \$5,468 |   | \$3,500 |   | \$13,525 |   | \$9,758 |   |
| Total gross margin            | 66      | % | 57      | % | 60       | % | 57      | % |

The gross profit for the three and nine months ended September 30, 2010 was approximately \$5.5 million and \$13.5 million as compared to approximately \$3.5 million and \$9.8 million for the three and nine months ended September 30, 2009, an increase of \$2.0 million and \$3.7 million, respectively. Gross margin was 66 % for the three months ended September 2010 up from 57% for the three months ended September 30, 2009. Gross margin was 60 % for the nine months ended September 2010 up from 57% for the nine months ended September 30, 2009.

The product gross profit for the three and nine months ended September 30, 2010 was approximately \$4.8 million and \$11.2 million as compared to approximately \$3.3 million and \$8.7 million for the three and nine months ended September, 2009, an increase of \$1.5 million and \$2.5 million, respectively. Product gross margin was 70% for the three months ended September 30, 2010 up from 62% for the three months ended September 30, 2009. Product gross margin was 63% for the nine months ended September 30, 2010 up from 60% for the nine months ended September 30, 2009. The increase in product gross profit and gross margin was due to higher sales volumes and improved product mix resulting in a higher average selling price in conjunction with lower display costs which were a result of the of increased production volume and improved manufacturing utilization. The higher average selling price was a result of the mix of products sold which included custom displays with a higher sales price.



The contract gross profit for the three and nine months ended September 30, 2010 was approximately \$0.6 million and \$2.3 million as compared to \$0.2 million and \$1.0 million for the three and nine months ended September 30, 2009, an increase of \$0.4 million and \$1.3 million, respectively. Contract gross margin was 48% for the three months ended September 30, 2010 up from 28% for the three months ended September 30, 2009. Contract gross margin was 49% for the nine months ended September 30, 2010 up from 40% for the nine months ended September 30, 2009. The contract gross margin is dependent upon the mix of costs, internal versus external third party costs, with external third party costs causing a lower gross margin and reducing the contract gross profit.

#### 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 months ended September 30, 2010 and 2009 were both approximately \$0.5 million. Research and development expenses for the nine months ended September 30, 2010 were approximately \$1.9 million as compared to \$1.4 million for the nine months ended September 30, 2009, an increase of approximately \$0.5 million. The increase for the nine months ended September 30, 2010 was primarily related to an increase in internal research and development of \$0.4 million and personnel expense of \$0.1 million.

**Selling, General and Administrative.** Selling, general and administrative expenses consist principally of salaries, including severance, and fees for professional services, legal fees in connection with litigation, as well as other marketing and administrative expenses. Selling, general and administrative expenses for the three and nine months ended September 30, 2010 were approximately \$2.1 million and \$6.9 million as compared to approximately \$1.8 million and \$5.1 million for the nine months ended September 30, 2009. The increase of approximately \$0.3 million for the three months ended September 30, 2010 was primarily related to increased personnel costs including non-cash compensation. The increase of approximately \$1.8 million for the nine months ended September 30, 2010 was primarily related to severance expense of \$1.0 million, personnel costs including non-cash compensation of \$0.8 million, and legal fees of \$0.4 million offset by a decrease in professional services of \$0.2 million and recruiting expenses of \$0.2 million.

**Other Income (Expense), net.** Other income (expense), net consists primarily of interest income earned on investments, interest expense related to the secured debt, and income from the licensing of intangible assets.

For the three and nine months ended September 30, 2010, interest expense was approximately \$21 thousand and \$79 thousand, respectively, as compared to approximately \$76 thousand and \$417 thousand, respectively, for the three and nine months ended September 30, 2009. For the three and nine months ended September 30, 2010, the majority of the interest expense was associated with debt. The breakdown of the interest expense for the three and nine month period in 2009 is as follows: interest expense associated with debt of approximately \$7 thousand and \$48 thousand, respectively, and the amortization of the deferred costs associated with the debt was \$62 thousand and \$362 thousand, respectively. The decrease in interest expense for the three and nine months ended September 30, 2010 as compared to the three and nine months ended September 30, 2009 was primarily a result of the Company not having any outstanding debt.

Other income for the three and nine months ended September 30, 2010 was approximately \$2 thousand and \$10 thousand as compared to \$1 thousand and \$41 thousand for the three and nine months ended September 30, 2009. The other income for the three and nine months ended September 30, 2010 was interest income of approximately \$2 thousand and \$4 thousand, respectively, and \$0 and \$6 thousand, respectively, from equipment salvage. The other income for the three and nine months ended September 30, 2009 was interest income of approximately \$1 thousand

and \$3 thousand, respectively, and \$0 and \$38 thousand, respectively, for a settlement of a liability.

#### Net Income

Net income totaled \$2.8 million and \$4.6 million, respectively, for the three and nine months ended September 30, 2010 as compared to \$4.6 million and \$2.9 million, respectively, for the three and nine months ended September 30, 2009. Net income for the nine months ended September 30, 2010 would have been \$5.6 million excluding the \$1.0 million one time severance charge.

#### Liquidity and Capital Resources

As of September 30, 2010, we had approximately \$10.3 million of cash, cash equivalents, and investments in certificates of deposit (“CDs”). As of September 30, 2010, we had approximately \$6.7 million of cash and cash equivalents as compared to \$5.3 million as of December 31, 2009. The change in cash of \$1.4 million was primarily due to cash provided by operations of approximately \$6.6 million and financing activities of approximately \$0.6 million offset by cash used for investing activities of approximately \$5.8 million.

Cash flow provided by operating activities during the nine months ended September 30, 2010 was approximately \$6.6 million, attributable to our net income of approximately \$4.6 million, non-cash expenses of \$1.2 million and approximately \$0.8 million from the change in operating assets and liabilities. Cash flow provided by operating activities during the nine months ended September 30, 2009 was approximately \$3.5 million, attributable to our net income of approximately \$2.9 million, non-cash expenses of \$1.1 million and approximately \$0.6 million from the change in operating assets and liabilities.

Cash used in investing activities during the nine months ended September 30, 2010 was approximately \$5.8 million to purchase equipment of \$2.3 million and purchase certificates of deposit (“CDs”) of \$3.5 million. Cash used in investing activities during the nine months ended September 30, 2009 was approximately \$0.5 million to purchase equipment.

Cash provided by financing activities during the nine months ended September 30, 2010 was approximately \$0.6 million from the exercise of stock options and warrants. Cash used by financing activities during the nine months ended September 30, 2009 was approximately \$1.7 million to pay down the line of credit.

Our business continues to experience revenue growth. This trend, if it continues, may result in higher accounts receivable levels and may require increased production and/or higher inventory levels. We believe our current liquidity position, where we have approximately \$10.3 million of cash, cash equivalents, and investments – held to maturity on hand as of September 30, 2010, together with our available line of credit and the prospects for continued generation of cash from operations are adequate for our business needs over the next twelve months. We anticipate that we will not require additional funds over the next twelve months other than perhaps discretionary capital spending. If unanticipated events arise during the next twelve months, we may need additional funds. If additional funds are required and if we are unable to obtain sufficient funds we may have to reduce the size of our organization and/or be forced to reduce and/or curtail our production and operations, all of 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

Not applicable.

#### ITEM 4. Controls and Procedures

##### (a) Evaluation of Disclosure Controls and Procedures.

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15 under the Securities Exchange Act of 1934 (the “Exchange Act”)) as of the end of the period covered by this Quarterly Report on Form 10-Q. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives. In addition, the design of disclosure controls and procedures must reflect the fact that there are resource constraints and that management is required to apply its judgment in evaluating the benefits of possible controls and procedures relative to their costs.

Based on our evaluation, our Chief Executive Officer and Chief Financial Officer concluded that, as of the end of the period covered by this report, our disclosure controls and procedures are designed at a reasonable assurance level and are effective to provide reasonable assurance that information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in Securities and Exchange Commission rules and forms, and that such information is accumulated and communicated to

our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

(b) Limitations on the Effectiveness of Internal Controls.

Our disclosure controls and procedures are designed to provide reasonable, not absolute, assurance that the objectives of our disclosure control system are met. Because of inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues, if any, within a company have been detected. Our Chief Executive Officer and Chief Financial Officer have concluded, based on their evaluation as of the end of the period covered by this report, that our disclosure controls and procedures were sufficiently effective to provide reasonable assurance that the objectives of our disclosure control system were met.

(c) Changes in Internal Controls.

There were no changes in our internal controls over financial reporting during the fiscal quarter ended September 30, 2010 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## PART II - OTHER INFORMATION

### ITEM 1. Legal Proceedings

On March 17, 2010, Gary Jones, a former executive at the Company filed a complaint for damages in the Superior Court of the State of Washington for King County (the "Complaint") against the Company and the Company's Chief Financial Officer. The Complaint alleges unspecified damages for failure to pay contractual payments and wages under Washington law ("the Washington Wage Claim") and includes, among other claims, breach of contract, breach of the duty of good faith and fair dealing, promissory estoppel and misrepresentation.

On May 21, 2010, the court granted eMagin's motion to dismiss regarding the claim for misrepresentation and the Washington Wage Claim. The Chief Financial Officer's motion to dismiss was also granted relating to the following claims against him: the Washington Wage Claims, breach of contract, breach of promises of specific treatment in specific circumstances, breach of the duty of good faith and fair dealing, and promissory estoppel. With respect to the undismissed claims, the litigation is ongoing. The Company denies the allegations raised in the Complaint and intends to vigorously defend itself. There can be no assurance of the outcome of this matter.

### ITEM 1A. Risk Factors

In addition to other information set forth in this Report, you should carefully consider the risk factors previously disclosed in "Item 1A to Part 1" of our Annual Report on Form 10-K for the year ended December 31, 2009. There were no material changes from the risk factors during the nine months ended September 30, 2010.

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

Pursuant to various cashless warrant exercises, the Company issued 2,601,591 shares of common stock in the nine months ended September 30, 2010. In addition, the Company received proceeds of \$250 thousand from a warrant exercise and issued 100,000 shares of common stock in the nine months ended September 30, 2010. In connection with the foregoing, the Company relied upon the exemption from securities registration afforded by Rule 506 of Regulation D as promulgated by the SEC under the Securities Act of 1933, as amended (the "Securities Act") and/or Section 4(2) of the Securities Act. No advertising or general solicitation was employed in offering the securities.

### ITEM 3. Defaults Upon Senior Securities

None.

### ITEM 4. (Removed and Reserved)

None.

### ITEM 5. Other Information

None.

### ITEM 6. Exhibits

31.1 Certification by Chief Executive Officer pursuant to Sarbanes Oxley Section 302 (1)

31.2 Certification by Chief Financial Officer pursuant to Sarbanes Oxley Section 302 (1)

32.1 Certification by Chief Executive Officer pursuant to 18 U.S.C. Section 1350 (1)

32.2 Certification by Chief Financial Officer pursuant to 18 U.S.C. Section 1350 (1)

(1) Filed herewith.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized on this 12th day of November 2010.

eMAGIN CORPORATION

By: /s/ Andrew G. Sculley  
Andrew G. Sculley  
Chief Executive Officer  
Principal Executive Officer

By: /s/ Paul Campbell  
Paul Campbell  
Chief Financial Officer  
Principal Accounting and Financial  
Officer