EMAGIN CORP
Form 10-Q
November 10, 2011

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

Form 10-Q

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

For the quarterly period ended September 30, 2011
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.)

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 R No ¨

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

(§232.405 of this chapter) during the preceding 12 months). Yes þ 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 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 October 31, 2011 was 23,302,686.

eMagin Corporation
Form 10-Q
For the Quarter ended September 30, 2011

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ITEM 1. Condensed Consolidated Financial Statements

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

	September 30, 2011 (unaudited)	December 31, 2010
ASSETS		
Current assets:		
Cash and cash equivalents	$ 6,498	$ 7,796
Short-term investments	6,245	3,100
Accounts receivable, net	5,893	5,150
Inventory	2,119	1,905
Prepaid expenses and other current assets	857	777
Total current assets	21,612	18,728
Long-term investments	1,000	1,500
Equipment, furniture and leasehold improvements, net	4,522	3,287
Intangible assets, net	36	39
Other assets	92	92
Deferred tax asset	9,056	9,056
Total assets	$ 36,318	$ 32,702
LIABILITIES AND SHAREHOLDERS’ EQUITY		
Current liabilities:		
Accounts payable	$ 1,021	$ 1,100
Accrued compensation	1,631	1,975
Other accrued expenses	1,636	1,781
Advance payments	122	101
Deferred revenue	55	26
Warrant liability	—	7,694
Other current liabilities	235	170
Total current liabilities	4,700	12,847
Warrant liability	—	5,158
Total liabilities	4,700	18,005
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 $5,659,000) stated value $1,000 per share, $.001 par value: 10,000 shares designated and 5,659 issued and outstanding as of September 30, 2011 and 5,679 issued and	—	—

outstanding as of December 31, 2010				
Common stock, $.001 par value: authorized 200,000,000 shares, issued and outstanding, 23,293,586 shares as of September 30, 2011 and 21,210,445 as of December 31, 2010		23		21
Additional paid-in capital		219,465		206,298
Accumulated deficit		(187,870)		(191,622)
Total shareholders' equity		31,618		14,697
Total liabilities and shareholders' equity	$	36,318	$	32,702

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 September 30, 2011	Three Months Ended September 30, 2010	Nine Months Ended September 30, 2011	Nine Months Ended September 30, 2010
Revenue:				
Product	$ 6,306	$ 6,936	$ 16,564	$ 17,826
Contract	1,957	1,320	4,589	4,669
Total revenue, net	8,263	8,256	21,153	22,495
Cost of goods sold:				
Product	2,902	2,105	8,554	6,590
Contract	1,002	683	2,368	2,380
Total cost of goods sold	3,904	2,788	10,922	8,970
Gross profit	4,359	5,468	10,231	13,525
Operating expenses:				
Research and development	765	511	2,071	1,888
Selling, general and administrative	1,992	2,054	6,361	6,873
Total operating expenses	2,757	2,565	8,432	8,761
Income from operations	1,602	2,903	1,799	4,764
Other income (expense):				
Interest expense	(26)	(21)	(85)	(79)
Interest income	3	2	32	10
Change in fair value of warrant liability	3,028	723	2,548	(9,620)
Total other income (expense), net	3,005	704	2,495	(9,689)
Income (loss) before provision for income taxes	4,607	3,607	4,294	(4,925)
Provision for income taxes	488	56	542	75
Net income (loss)	$ 4,119	$ 3,551	$ 3,752	$ (5,000)
Income (loss) per share, basic	$ 0.13	$ 0.13	$ 0.13	$ (0.27)
Income (loss) per share, diluted	$ 0.03	$ 0.08	$ 0.02	$ (0.27)
Weighted average number of shares outstanding:				

Basic	23,084,229	19,883,029	22,153,525	18,781,185
Diluted	25,322,920	24,244,477	25,642,105	18,781,185

See notes to Condensed Consolidated Financial Statements.

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

	Preferred Stock		Common Stock				
	Shares	Amount	Shares	Amount	Additional Paid-in Capital	Accumulated Deficit	Total Shareholders' Equity
Balance, December 31, 2010	5,679	$ —	21,210,445	$ 21	$ 206,298	$ (191,622)	$ 14,697
Fair value of warrants reclassified from liability to equity	—	—	—	—	10,304	—	10,304
Cashless exercise of common stock warrants	—	—	476,663	—	—	—	—
Cashless exercise of common stock options	—	—	49,685	—	—	—	—
Conversion of Series B Preferred Stock to common stock	(20)	—	26,666	—	—	—	—
Exercise of common stock warrants	—	—	1,072,116	1	561	—	562
Exercise of common stock options	—	—	458,011	1	525	—	526
Stock-based compensation	—	—	—	—	1,777	—	1,777
Net income	—	—	—	—	—	3,752	3,752
Balance, September 30, 2011	5,659	$ —	23,293,586	$ 23	$ 219,465	$ (187,870)	$ 31,618

See notes to Condensed Consolidated Financial Statements.

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

	Nine Months Ended September 30, 2011	Nine Months Ended September 30, 2010
	(unaudited)	
Cash flows from operating activities:		
Net income (loss)	$3,752	$(5,000)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	118	52
Reduction of provision for sales returns and doubtful accounts	(98)	(260)
Stock-based compensation	1,777	1,377
Amortization of common stock issued for services	—	61
Change in the fair value of warrant liability	(2,548)	9,620
Changes in operating assets and liabilities:		
Accounts receivable	(645)	(468)
Inventory	(214)	508
Prepaid expenses and other current assets	(80)	72
Deferred revenue	29	(84)
Accounts payable, accrued compensation, other accrued expenses, advance payments, and other current liabilities	(482)	730
Net cash provided by operating activities	1,609	6,608
Cash flows from investing activities:		
Purchase of equipment	(1,350)	(2,261)
Purchase of investments – held to maturity	(2,645)	(3,500)
Net cash used in investing activities	(3,995)	(5,761
Cash flows from financing activities:		
Proceeds from exercise of stock options	526	322
Proceeds from exercise of stock warrants	562	250
Net cash provided by financing activities	1,088	572
Net increase (decrease) in cash and cash equivalents	(1,298)	1,419
Cash and cash equivalents, beginning of period	7,796	5,295
Cash and cash equivalents, end of period	$6,498	$6,714
Cash paid for interest	$42	$76
Cash paid for taxes	$15	$125
Issuance of 476,663 and 2,601,591 shares of common stock for cashless exercise of 581,895 and 3,778,811 warrants in 2011 and 2010, respectively.	$—	$—
Conversion of 20 and 60 shares of Series B Convertible Preferred Stock for 26,666 and 80,000 shares of common stock in 2011 and 2010, respectively.	$—	$—
Issuance of 49,685 shares of common stock for cashless exercise of 60,000 stock options in 2011.	$—	$—

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/A for the year ended December 31, 2010. The results of operations for the period ended September 30, 2011 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 related to, among others, allowance for doubtful accounts, warranty reserves, inventory reserves, stock-based compensation expense, deferred tax asset valuation allowances, litigation, fair value of financial instruments and other loss contingencies. 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 research and development ("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 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.

Cash and cash equivalents

All highly liquid instruments with an original maturity of three months or less at the date of purchase are considered to be cash equivalents.

Investments

Investments are certificates of deposit in financial institutions carried at cost on the accompanying balance sheet.

Concentration of credit risk

eMagin's products are sold mainly throughout North America, Asia, and Europe. Sales to the Company's recurring customers are generally made on open account while sales to occasional customers are typically made on a prepaid basis. eMagin performs periodic credit evaluations on its recurring customers and generally does not require collateral. An allowance for doubtful accounts is maintained for credit losses.

Financial instruments which potentially subject the Company to concentrations of credit risk consist of cash and cash equivalents and short-term and long-term investments. The Company's cash and cash equivalents are deposited with financial institutions which, at times, may exceed federally insured limits. The Company has Certificates of Deposits ("CDs"), classified as short and long-term investments, which are federally insured. To date, the Company has not experienced any loss associated with this risk.

Warrant liability

eMagin accounts for its warrants that contain anti-dilution provisions for the holder as a liability. The fair value of the warrant liability is estimated each period using the Monte Carlo Simulation approach using the following assumptions: risk-free interest rate, expected volatility, expected life, and expected dividend yield. The changes in the fair value of the warrant liability from period to period are recorded in other income and expense on the condensed consolidated statements of operations.

Note 2: Recently Issued Accounting Pronouncements

In June 2011, the Financial Accounting Standards Board ("FASB") issued an accounting standard update relating to the presentation of other comprehensive income. The accounting update eliminates the option to present components of other comprehensive income as part of the statement of stockholders' equity. Instead, companies must report comprehensive income in either a single continuous statement of comprehensive income (which would contain the current income statement presentation followed by the components of other comprehensive income and a total amount for comprehensive income), or in two separate but consecutive statements. This guidance is effective for the Company's fiscal year beginning January 1, 2012. The Company does not expect the guidance to impact its consolidated financial statements.

In May 2011, the FASB issued an accounting standard update related to fair value measurements and disclosures to improve the comparability of fair value measurements presented and disclosed in financial statements prepared in accordance with United States GAAP and International Financial Reporting Standards. This guidance includes amendments that clarify the intent about the application of existing fair value measurement requirements, while other amendments change a principle or requirement for measuring fair value or for disclosing information about fair value measurements. Specifically, the guidance requires additional disclosures for fair value measurements that are based on significant unobservable inputs. The updated guidance is to be applied prospectively and is effective for the Company's interim and annual periods beginning January 1, 2012. The adoption of this guidance is not expected to have a material impact on the Company's consolidated financial statements.

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.

Warrant Liability

As of September 30, 2011, the Company and Stillwater Holdings LLC (“the Holder”) signed an agreement to amend the warrant issued to the Holder on December 22, 2008 to purchase 1,875,467 shares of the Company’s common stock. There are 1,000,000 shares remaining as the Holder exercised 875,467 shares in April 2010. The Amendment changes the expiration date from December 22, 2013 to June 22, 2014 and deletes Section 9(c), Dilution Issuances, removing the anti-dilution feature. The warrant was reclassified from a warrant liability to equity as of September 30, 2011.

The table below provides a reconciliation of the beginning and ending balances for the warrant liability measured at fair value using significant unobservable inputs (Level 3) (in thousands).

Balance as of January 1, 2011	$12,852
Change in fair value of warrants	(2,548)
Fair value of warrants exercised	(8,490)
Fair value of warrant modified	(1,814)
Balance as of September 30, 2011	$—

For the three and nine months ended September 30, 2011, the change in fair value of the warrant liability of $3.0 million and $2.5 million, respectively, was recorded as other income in the accompanying unaudited condensed consolidated statements of operations.

The Company estimated the fair value of the warrant liability utilizing the Monte Carlo Simulation method. The following assumptions were used in the Monte Carlo Simulation model to determine the fair value of the warrant liability:

	September 30, 2011 (at modification)	December 31, 2010
Risk-free interest rate	0.42 %	0.19% - 1.02 %
Expected volatility	81.0 %	71.9% - 79.2 %
Expected life (in years)	2.75	0.50 – 3.0
Expected dividend yield	0 %	0 %

Note 4: Receivables

The majority of the Company’s commercial accounts receivable are due from Original Equipment Manufacturers ("OEM’s”). Credit is extended based on an 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 allowance for doubtful accounts reflects an estimate of probable losses inherent in the accounts receivable balance. 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, deterioration in the customer's operating results or financial position, or deterioration in the customer’s credit history. If circumstances related to customers change, the Company would further adjust estimates of the recoverability of receivables. Account balances are charged off against the allowance after all reasonable means of collection have been exhausted and the potential for recovery is considered remote.

Receivables consisted of the following (in thousands):

	September 30, 2011 (unaudited)	December 31, 2010
Accounts receivable	$ 6,169	$ 5,524
Less allowance for doubtful accounts	(276)	(374)
Net receivables	$ 5,893	$ 5,150

Note 5: Net Income (Loss) per Common Share

Basic income (loss) per share (“Basic EPS”) is computed by dividing net income (loss) by the weighted average number of common shares outstanding during the reporting period. Diluted income (loss) per share (“Diluted EPS”) is computed by dividing the net income (loss) by the weighted average number of common shares outstanding during the reporting period while also giving effect to all potentially dilutive common shares that were outstanding during the reporting period.

Entities that have issued securities other than common stock that participate in dividends with the common stock ("participating securities") are required to apply the two-class method to compute EPS. The two-class method is an earnings allocation method under which basic and diluted EPS is calculated for each class of common stock and participating security as if all such earnings had been distributed during the period. On December 22, 2008, the Company issued Preferred Stock – Series B which participates in dividends with the Company's common stock and is therefore considered to be a participating security. Thus, the Company calculates basic and diluted EPS using the two-class method. The Company does not intend to pay dividends on its common or preferred stock.

The following table sets forth the computation of basic and diluted earnings per share (in thousands, except share and per share data):

	Three Months Ended September 30, 2011 (unaudited)			Three Months Ended September 30, 2010 (unaudited)		
	Income	Average Shares	Per Share Amount	Income	Average Shares	Per Share Amount
Basic EPS						
Net income	$4,119			$3,551		
Income allocated to participating securities	$1,015			$979		
Income allocated to common shares	$3,104	23,084,229	$0.13	$2,572	19,883,029	$0.13
Diluted EPS						
Less: Change in fair value of warrant liability allocated to common shares	2,268			524		
Diluted potential common shares		2,238,691			4,361,448	
Income allocated to common shares	$836	25,322,920	$0.03	$2,048	24,244,477	$0.08

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	Nine Months Ended September 30, 2011 (unaudited)			Nine Months Ended September 30, 2010 (unaudited)		
	Income	Average Shares	Per Share Amount	Income	Average Shares	Per Share Amount
Basic EPS						
Net income (loss)	$3,752			$(5,000)		
Income (loss) allocated to participating securities	$954			$—		
Income (loss) allocated to common shares	$2,798	22,153,525	$0.13	$(5,000)	18,781,185	$(0.27)
Diluted EPS						
Less: Change in fair value of warrant liability allocated to common shares	$2,247			—		
Diluted potential common shares		3,488,580			—	
Income (loss) allocated to common shares	$551	25,642,105	$0.02	$(5,000)	18,781,185	$(0.27)

For the three and nine months ended September 30, 2011, there were stock options outstanding to acquire 1,545,086 and 1,463,086 shares of the Company's common stock which were excluded from the computation of its diluted earnings per share as their effect would be antidilutive.

For the three months ended September 30, 2010, the Company has excluded stock options and warrants to acquire 1,271,817 shares of the Company's common stock since their effect would be anti-dilutive. For the nine months ended September 30, 2010, the Company has excluded options, warrants and convertible preferred stock to acquire 16,020,727 of its 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 30, 2011 (unaudited)	December 31, 2010
Raw materials	$ 1,350	$ 748
Work in process	410	681
Finished goods	359	476

Total inventory	$	2,119	$	1,905

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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 30, 2011 (unaudited)	December 31, 2010
Vendor prepayments	$ 81	$ 83
Other prepaid expenses *	776	694
Total prepaid expenses and other current assets	$ 857	$ 777

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

Note 8: Debt

Effective September 1, 2011, the Company renewed its line of credit of $3 million with Access. The terms of the line of credit were amended as follows: the minimum monthly interest payment has decreased from $5,000 to $1,000; the interest rate has increased from Prime plus 4% but not less than 7.25% to Prime plus 5% but not less than 8.25%; the collateral management fee has decreased from .4% to 0%; the early termination fee has decreased from $18,000 to $6,000; and the borrowing minimum monthly fee has decreased from $6,000 to $2,000. The term of the agreement is for one year and automatically renews for successive one year terms unless either party provides written notice of its intent to not renew. The renewal date is September 1, 2012.

The Company paid $30,000 in loan fees to Access which were charged to prepaid expense and will be amortized over the life of the Agreement. As of September 30, 2011, $2,500 has been amortized to interest expense. The Company's obligations under the agreement are secured by its assets. For the three and nine months ended September 30, 2011, 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 month periods ended September 30, 2011 and 2010 (in thousands):

	Three Months Ended September 30, (unaudited)		Nine Months Ended September 30, (unaudited)	
	2011	2010	2011	2010
Cost of revenue	$ 62	$ 28	$ 148	$ 155
Research and development	130	23	279	151
Selling, general and administrative	224	376	1,350	1,071
Total stock compensation expense	$ 416	$ 427	$ 1,777	$ 1,377

At September 30, 2011, total unrecognized compensation costs related to stock options was approximately $3.8 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 2.7 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 when classified as liabilities. There were 12,500 options granted to consultants in the nine months ended September 30, 2011 which were fully vested upon grant. The following assumptions were used in the Black-Scholes option pricing model to determine the fair value of stock options granted to non-employees: dividend yield – 0%; risk free interest rate – 2.32%; expected volatility – 85.7%; and expected term – 5 years.

During the nine month period ended September 30, 2011, there were 1,392,108 stock options granted to employees and directors. During the nine month period ended September 30, 2010, there were 853,085 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 Ended September 30, 2011	2010
Dividend yield	0 %	0 %
Risk free interest rates	1.04-2.37 %	1.31 to 2.57 %
Expected volatility	67.1 to 85.7 %	80.6 to 86.9 %
Expected term (in years)	3.5 to 5.5	3.5 to 5.5

The Company has not declared or paid any dividends and does 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 months ended September 30, 2011, 200,000 options were granted to employees from the 2008 Incentive Stock Plan ("2008 Plan") with a fair value of approximately $0.8 million and 1,192,108 options were granted to employees and directors from the 2003 Stock Option Plan ("2003 Plan") with a fair value of approximately $4.8 million. The weighted average fair value per share for options granted in the first nine months of 2011 was $3.95.

A summary of the Company's stock option activity for the nine months ended September 30, 2011 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 December 31, 2010	3,152,114	$ 1.71		
Options granted	1,404,608	7.49		
Options exercised	(507,696)	1.14		
Options forfeited	(12,630)	13.15		
Options cancelled	(42,154)	3.98		
Outstanding at September 30, 2011	3,994,242	$ 3.76	5.66	$ 2,851,148
Vested or expected to vest at September 30, 2011 (1)	3,914,896	$ 3.69	5.67	$ 2,678,730
Exercisable at September 30, 2011	2,659,287	$ 2.04	6.03	$ 2,806,795

(1) The expected to vest options are the result of applying the pre-vesting forfeiture rate assumptions to total unvested 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. There were 2,055,015 options in-the-money at September 30, 2011. The Company's closing stock price was $2.63 as of September 30, 2011. 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 declare 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.

The Preferred Stock –Series B votes with holders of Common Stock upon the election of directors and upon any other matter submitted to a vote of shareholders, except those matters required by law to be submitted to a vote of holders of Preferred Stock of the Company or Series B Convertible Preferred Stock voting separately as a class or series, and except as provided in the Certificate of Designations of Series B Convertible Preferred Stock. Fractional votes shall not, however, be permitted. The holder of 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 30, 2011, there were 20 shares of Preferred Stock - Series B that were converted into 26,666 shares of common stock. As of September 30, 2011, there were 5,659 shares of Preferred Stock – Series B issued and outstanding.

Common Stock

The Company received approximately $12 thousand and $526 thousand for the exercise of 10,000 and 458,011 stock options in the three and nine months ended September 30, 2011, respectively. 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 nine months ended September 30, 2011, there were 60,000 options exercised on a cashless basis resulting in 49,685 shares of common stock issued.

There were 186,666 and 581,995 warrants exercised on a cashless basis resulting in 154,728 and 476,663 shares of common stock issued in the three and nine months ended September 30, 2011, respectively. For the three and nine months ended September 30, 2011, the Company received proceeds of approximately $480 thousand and $562 thousand from the exercise of warrants and issued 1,000,000 and 1,072,116 shares of common stock, respectively. 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 three and nine months ended September 30, 2011, no shares of common stock were issued for payment for services rendered and to be rendered in the future. For the nine months ended September 30, 2010, 15,363 shares of common stock were issued for payment of $55 thousand for services rendered and the Company recorded the fair value of the services rendered in selling, general and administrative expenses in the accompanying unaudited condensed consolidated financial statements.

On August 24, 2011, eMagin's Board of Directors approved a stock repurchase plan. The Company has been authorized to repurchase common stock not to exceed $2.5 million in total value. The common stock repurchased will be considered authorized but un-issued shares. As of September 30, 2011, the Company had not repurchased any common stock.

Note 11: Income Taxes

For the three and nine months ended September 30, 2011, the Company recorded income tax expense of approximately $488 thousand and $542 thousand, respectively, based upon the projected effective income tax rate for the year. For the three and nine months ended September 30, 2010, the Company recorded income tax expense of approximately $56 thousand and $75 thousand, respectively.

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.

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 is 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 ("GOT") as of December 30, 2009.

In late 2008, the Company began evaluating the status of its manufacturing process and the use of the intellectual property ("IP") associated with its license agreement. After this analysis and after making a few changes to its manufacturing process, by the end of 2008 the Company had stopped using the IP covered under the license agreement. The last royalty payment under the license agreement was made in November 2009. The Company determined that it is no longer required to pay the minimum royalty payment and as such has not paid or accrued this amount in 2010 or to date in 2011.

In April 2011, the Company received a request for royalty payments from a representative of GOT. The Company responded stating that the licenses were no longer in force and that the request for royalties was untimely. Although GOT does not agree, both parties have expressed an interest in resolving the disagreement amicably. Communications to date have been very preliminary regarding its resolution. The Company estimates that the range of loss contingency is between $0 and $250 thousand.

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, Bellevue, Washington, and Santa Clara, California.

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 with the option of extending the lease for five years. The corporate headquarters are located in Bellevue, Washington where eMagin leases approximately 6,300 square feet. The lease expires on August 31, 2014. In addition, the Company leases approximately 2,400 square feet of office space for design and product development in Santa Clara, California and the lease expires on October 31, 2012.

Rent expense was approximately $302 thousand and $889 thousand, respectively, for the three and nine months ended September 30, 2011 and approximately $283 thousand and $850 thousand, respectively, for the three and nine months ended September 30, 2010.

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.

On March 21, 2011, the Company executed a Settlement Agreement and Full and Complete Mutual Release (the "Settlement Agreement") among the Company, Mr. Jones and the Company's Chief Financial Officer, which had previously been executed by Mr. Jones and the Chief Financial Officer, and became effective on March 29, 2011 (the "Effective Date"). On April 5, 2011, pursuant to the Settlement Agreement, the Company made the following payments in the aggregate amount of $650 thousand: (i) payment to Mr. Jones in the gross amount of $478 thousand for payment amounts set forth in the Executive Separation and Consulting Agreement (“ECSA”) and Expense Reimbursement and Compensation Schedule (“ERCS”) entered into by Mr. Jones and the Company in January 2007; (ii) payment to Mr. Jones in the amount of approximately $27 thousand for a negotiated interest amount pursuant to the ECSA and ERCS; and (iii) approximately $145 thousand in attorney’s fees paid to Mr. Jones’ attorneys (collectively, the “Settlement Payments”). The settlement offer was recorded as a liability on the Company’s Consolidated Balance Sheet and included in selling, general, and administrative expense on the Company’s Consolidated Statements of Operations as of December 31, 2010. In addition to the Settlement Payments, the defendants agreed to provide a full and complete release to Mr. Jones.

The Settlement Agreement contains mutual releases among the Company, its Chief Financial Officer and Mr. Jones, and pursuant to the Settlement Agreement, Mr. Jones agreed to dismiss the Complaint against the Company and its Chief Financial Officer with prejudice. On April 7, 2011 the Complaint was dismissed with prejudice by the Superior Court of the State of Washington for King County.

Employment Agreements

Effective as of June 1, 2011, the Company and Andrew G. Sculley entered into an executive employment agreement (the "Employment Agreement") pursuant to which Mr. Sculley will continue serving as the Company's President and Chief Executive Officer until December 31, 2013 unless the contract is terminated sooner pursuant to its terms. Under the Employment Agreement, Mr. Sculley is paid an annual base salary of $384,000. Pursuant to the Employment Agreement, the Company shall use reasonable efforts to submit a proposal to its shareholders at its next annual meeting relating to the approval of a new incentive stock plan ("Plan"). Provided that the Plan is approved by the Company's shareholders holding the required number of shares of the Company's voting securities (the "Approval"), within ten days of such Approval, the Company and Mr. Sculley shall enter into an agreement, which agreement shall entitle Mr. Sculley to receive a mix of stock options (the "Options") and/or restricted shares of the Company's Common Stock, valued at $400,000 (based on a Black Scholes valuation method for the Options and the market price on the day of the grant for the restricted stock). Within ten days of the annual meeting, provided that the Approval was obtained, the Compensation Committee or Board shall meet to determine the appropriate mix of Options and restricted shares to be awarded. The Options shall entitle Mr. Sculley to purchase shares of the Company's common stock at an exercise price equal to the closing price on the date the Options are granted, which options shall vest as follows: (i) 1/3 shall vest on the 1st annual anniversary of the Employment Agreement, (ii) 1/3 shall vest on the 2nd annual anniversary of the Employment Agreement and (iii) 1/3 shall vest on December 31, 2012. On September 27, 2011, the Company and Mr. Sculley amended the Employment Agreement to correct and change the date from December 31, 2012 to December 31, 2013 for the vesting of the final 1/3 of his options ('iii" above). The restricted shares, if any, shall have such vesting terms as may be determined by the Compensation Committee in their discretion prior to the grant.

Pursuant to the Employment Agreement, Mr. Sculley's employment may be terminated by the Company with or without cause and he may terminate his employment for Good Reason (as defined in the Employment Agreement) and such other reasons set forth in the Employment Agreement. If Mr. Sculley's employment agreement is terminated without cause or if he terminates it for Good Reason, then Mr. Sculley, at the Company's sole discretion, shall be entitled to the lesser of (i) the total amount of his base salary that remains unpaid under the Employment Agreement, which shall be paid monthly or (ii) monthly salary payments for twelve (12) months, based on his monthly rate of base salary at the date of such termination, provided, however in lieu of the aforementioned monthly payments, the Company may in its sole discretion pay such payments in a lump-sum. Mr. Sculley shall also be entitled to receive (i) payment for accrued and unpaid vacation pay and (ii) all bonuses that have accrued during the term of the Employment Agreement, but have not been paid. Additionally, any non-vested options held by Mr. Sculley shall vest immediately. If the Employment Agreement is terminated with cause or if Mr. Sculley terminates it without Good Reason then Mr. Sculley shall cease to accrue salary, personal time off, benefits and other compensation on the date of such termination.

On March 15, 2011, the Company signed an executive employment agreement (the "Employment Agreement") with Jerry Carollo to serve as the Company's Senior Vice President Business Development effective March 21, 2011. Pursuant to the Employment Agreement, Mr. Carollo is paid a base salary of $270,000 and was granted 100,000 options which are exercisable at $6.89 per share, the market price on the date of the grant, of which one third will vest annually on the subsequent three anniversary dates. If Mr. Carollo voluntarily terminates his employment with the Company, other than for Good Reason as defined in the Employment Agreement, he shall cease to accrue salary, personal time off, benefits and other compensation on the date of voluntary termination. The Company may terminate Mr. Carollo's employment with or without cause. If the Company terminates without cause, Mr. Carollo will be entitled to the lesser of (i) the total amount of base salary that remains unpaid under the Employment Agreement which shall be paid monthly or (ii) monthly salary payments for twelve (12) months, based on his monthly rate of base salary at the date of such termination, or in lieu of the aforementioned monthly payments, the Company may in its sole discretion pay such payments in a lump- sum. Mr. Carollo shall also be entitled to receive (i) payment for accrued and unpaid vacation pay and (ii) all bonuses that have accrued during the term of the Employment Agreement, but not been paid. All non-vested options shall vest immediately.

On January 19, 2011, the Company signed an executive employment agreement (the "Employment Agreement") with Susan R. Taylor to serve as the Company's Corporate Secretary, Senior Vice President and General Counsel effective February 1, 2011. Pursuant to the Employment Agreement, Ms. Taylor is paid a base salary of $175,000 and was granted 225,000 options which are exercisable at $6.82 per share, the market price on the date of the grant, of which one third will vest annually on the subsequent three anniversary dates. If Ms. Taylor voluntarily terminates her employment with the Company, other than for Good Reason as defined in the Employment Agreement, she shall cease to accrue salary, personal time off, benefits and other compensation on the date of voluntary termination. The Company may terminate Ms. Taylor's employment with or without cause. If the Company terminates without cause, Ms. Taylor will be entitled to, at the Company's sole discretion, either (i) monthly salary payments for twelve (12) months, based on her monthly rate of base salary at the date of such termination, or (ii) a lump-sum payment of her salary for such 12 month period, based on her monthly rate of base salary at the date of such termination. Ms. Taylor shall also be entitled to receive (i) payment for accrued and unpaid vacation pay and (ii) all bonuses that have accrued during the term of the Employment Agreement, but not been paid. All non-vested options shall vest immediately.

Note 13: Concentrations

For the three and nine months ended September 30, 2011, approximately 59% and 62%, respectively, of the Company's net revenues were derived from customers in the United States and approximately 41% and 38%, respectively, of the Company's net revenues were derived from international customers. For the three and nine months ended September 30, 2010, approximately 75% and 66%, respectively, of the Company's net revenues were derived from customers in the United States and approximately 25% and 34%, respectively, of the Company's net revenues were derived from international customers.

The following is a schedule of revenue by geographic location (in thousands):

	Three Months Ended September 30, (unaudited)		Nine Months Ended September 30, (unaudited)	
	2011	2010	2011	2010
North and South America	$ 5,029	$ 6,295	$ 13,565	$ 15,244
Europe, Middle East, and Africa	1,734	559	5,501	5,361
Asia Pacific	1,500	1,402	2,087	1,890
Total	$ 8,263	$ 8,256	$ 21,153	$ 22,495

The Company purchases principally all of its silicon wafers from a single supplier located in Taiwan.

Note 14: Subsequent Events

The 2011 Incentive Stock Plan (the "2011 Plan") was approved by the Company's shareholders on November 3, 2011. The 2011 Plan provides for grants of common stock, and options to purchase common stock, to employees, officers, directors and consultants. The Board of Directors reserved 1.4 million shares of common stock for issuance under the 2011 Plan. In addition, the 2011 Plan includes an evergreen provision that provides for an annual increase in common stock available for issuance however, on October 31, 2011 the Board committed to submit an amendment to the 2011 Plan to shareholders to eliminate the evergreen provision and to prohibit the repricing or exchange of stock options without stockholder approval. The Board also committed to maintain an average run rate over 2012 that does not exceed 4.5%. Run rate is defined as the sum of the number of stock options granted during the year, divided by the Company's fully diluted shares outstanding. These options have a term of up to 10 years and vest over a schedule determined by the Compensation Committee.

On November 3, 2011,pursuant to the terms of his employment agreement, the Compensation Committee of the Board granted Andrew Sculley options to purchase 188,333 shares of the Company's common stock exercisable at $4.03, the closing market price on the date of the grant. The options will vest one third on June 1, 2012, one third on June 1, 2013, and one third on December 31, 2013. In addition, the Compensation Committee granted the Directors as a whole options to purchase 256,666 shares of the Company's common stock exercisable at $4.03, the closing market price on the date of the grant, of which 145,833 will vest immediately and 110,833 shares will vest on December 31, 2011.

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.

Restatement of Previously Issued Consolidated Financial Statements

We have restated our previously issued consolidated financial statements, related disclosures, and management's discussion and analysis of financial condition and results of operations for the quarters ended March 31, June 30, and September 30, 2009; March 31, June 30 and September 2010; and March 31, 2011 and for the years ended December 31, 2009 and 2010 for the following:

- To correct errors in the accounting for certain warrants. Specifically, we previously classified as equity instruments warrants that should have been classified as derivative liability instruments based on the terms of the warrants and the applicable accounting guidance.

- To correct an error in the calculation of earnings per share ("EPS"). We issued Preferred Stock – Series B which participates in dividends with our common stock; as a result, we should have used the two-class method for calculating EPS.

The restatement of our previously issued consolidated financial statements delayed our filing of our Form 10-Q for the period ended June 30, 2011.

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 intellectual property portfolio that includes patents, manufacturing know-how and unique proprietary technologies to create high performance OLED-on-silicon microdisplays and related optical systems. We believe our technology, intellectual property portfolio, and position in the marketplace gives us a leadership position in OLED and OLED-on-silicon microdisplay technology. We believe that we are the only company to demonstrate publicly, market, and produce in significant quantities to the mass market high resolution full-color small molecule OLED-on-silicon microdisplays. We are aware of one company that is beginning to ship OLED microdisplays into the market and one additional company that we believe is preparing to do so.

At September 30, 2011, we had a total of 88 full-time and part-time employees, an increase of 31% from December 31, 2010. The majority of the increase in headcount was due to the personnel needed for the additional production shifts. In addition, we hired a design team, located in California, with experience working on OLED microdisplay designs to work internally on our research and development projects. The in-house design team reduces our dependence on third party design providers and will strengthen our ability to more cost-effectively develop new microdisplays.

A detailed discussion of our business may be found in Part I, “Business,” of our 2010 Annual Report on Form 10-K/A for the year ended December 31, 2010.

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 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

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 related to, among others, allowance for doubtful accounts, warranty reserves, inventory reserves, stock-based compensation expense, deferred tax asset valuation allowances, litigation and other loss contingencies. 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.

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. eMagin measures the fair value of our warrants based on the Monte Carlo Simulation approach.

Stock-based Compensation

eMagin maintains several stock equity incentive plans. The 2005 Employee Stock Purchase Plan (the "ESPP") would, once implemented, provide our employees with the opportunity to purchase common stock through payroll deductions. Employees could then purchase stock semi-annually at a price that is 85% of the fair market value at certain plan-defined dates. As of September 30, 2011, the number of shares of common stock available for issuance was 300,000. As of September 30, 2011, the plan had not been implemented.

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 incentive stock option ("ISO") 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 nine months ended September 30, 2011, there were 1,204,608 options granted from the 2003 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, 2011, there were 200,000 options granted from the 2008 plan.

The 2011 Incentive Stock Plan (the "2011 Plan") was approved by the Company's shareholders on November 3, 2011. The 2011 Plan provides for grants of common stock, and options to purchase common stock, to employees, officers, directors and consultants. The Board of Directors reserved 1.4 million shares of common stock for issuance under the 2011 Plan. In addition, the 2011 Plan provides for an annual increase in common stock available for issuance equal to the greater of 20% of the diluted shares outstanding or the number of shares subject to options granted during the prior 12-months. However, on October 31, 2011 the Board committed to submit an amendment to the 2011 Plan to shareholders to eliminate the provision authorizing an annual increase in stock available and to prohibit the re-pricing or exchange of stock options without stockholder approval. The Board also committed to maintain an average run rate over the year that does not exceed 4.5%. Run rate is defined as the sum of the number of stock options granted during the year, divided by the Company's fully diluted shares outstanding. These options have a term of up to 10 years and vest over a schedule determined by the Compensation Committee.

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.

Stock Repurchase Plan

On August 24, 2011, eMagin's Board of Directors approved a stock repurchase plan. The Company has been authorized to repurchase common stock not to exceed $2.5 million in total value. The common stock repurchased will be considered authorized but un-issued shares. As of September 30, 2011, the Company had not repurchased any common stock.

Income Taxes

For the three and nine months ended September 30, 2011, we recorded income tax expense of approximately $488 thousand and $542 thousand, respectively, as compared with an income tax expense of approximately $56 thousand and $75 thousand, respectively, for the three and nine months ended September 30, 2010. The effective tax rate for 2011 is projected to be 32.8% as compared to an effective tax rate of 2% for 2010. The increase in the effective tax rate is due to the valuation allowance which had been carried against our net deferred tax asset in 2010.

In preparing our consolidated financial statements, we are required to estimate income taxes in each of the jurisdictions in which we operate. The process involves estimating our current tax expense together with assessing temporary differences resulting from the differing treatment of items for accounting and tax purposes. These differences result in deferred tax assets and liabilities. Operating losses and tax credits, to the extent not already utilized to offset taxable income also represent deferred tax assets. We must assess the likelihood that any deferred tax assets will be recovered from future taxable income, and to the extent we believe that recovery is not likely, we must establish a valuation allowance. Significant judgment is required in determining our provision for income taxes, deferred tax assets and liabilities and any valuation allowance recorded against our deferred tax assets.

In determining future taxable income, assumptions are made to forecast operating income, the reversal of temporary timing differences and the implementation of tax planning strategies. Management uses significant judgment in the assumptions it uses to forecast future taxable income which are consistent with the forecasts used to manage the business. Realization of the deferred tax asset is dependent upon future earnings of which there is uncertainty as to the timing. We will continue to monitor the realizability of the deferred tax asset.

At December 31, 2010, a partial valuation allowance against the net deferred tax assets was $32.4 million. At September 30, 2011, eMagin assessed its ability to realize its deferred tax assets by reviewing positive and negative evidence which included our operating results and forecasts of future taxable income and concluded that no change to the valuation allowance was necessary. The partial valuation allowance will be maintained until further sufficient positive evidence exists to support an additional reduction or negative evidence to support an increase in the valuation allowance.

NEW ACCOUNTING PRONOUNCEMENTS

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

RESULTS OF OPERATIONS

THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2011 COMPARED TO THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2010

Revenues

Revenues for the three and nine months ended September 30, 2011 were approximately $8.3 million and $21.2 million, respectively, as compared to approximately $8.3 million and $22.5 million, respectively, for the three and nine months ended September 30, 2010, a decrease of approximately $1.3 million or 6% for the nine month period. Lower revenue for the nine month period was primarily due to lower than planned production output which also caused a postponement in filling Z800 system orders and to R&D engineering resources being allocated to production output causing a shortfall in billable hours on R&D contracts.

Product revenue is comprised of sales of displays, Z800 systems, and other hardware. For the three and nine months ended September 30, 2011, product revenue decreased approximately $0.6 million or 9% and $1.3 million or 7%, respectively, as compared to the three and nine months ended September 30, 2010. The decrease in product revenue for the three month period was driven by the product mix sold and a decrease in the average sales price per display. The decrease in product revenue for the nine month period was driven primarily by the lack of Z800 system shipments and also by the product mix sold and though, we had an increase in sales volume, the average sales price per display was lower than in the first nine months of 2010. Last year, we produced a custom display module that caused the average sale price to be higher than normal and without this custom display, the average sales price would have increased 3% for the three months ended September 30, 2011. We continue to have unfilled orders even though we made progress in resolving our production issues in the second and third quarters of 2011.

Contract revenue is comprised of revenue from research and development or non-recurring engineering (“NRE”) contracts. For the three months ended September 30, 2011, contract revenue increased approximately $638 thousand or 48% as compared to the three months ended September 30, 2010 and decreased $80 thousand or 2% as compared to the nine months ended September 30, 2010. As we continued to resolve our production issues in third quarter, it allowed our research and development resources to focus on the active research and development contracts.

Cost of Goods Sold

Cost of goods sold is comprised of costs of product and contract revenues. 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 performance of contracts. Cost of goods sold for the three and nine months ended September 30, 2011 was approximately $3.9 million and $10.9 million, respectively, as compared to approximately $2.8 million and $9.0 million, respectively, for the three and nine months ended September 30, 2010, an increase of approximately $1.1 million and $1.9 million, respectively. Cost of goods sold as a percentage of revenues was 47% and 52%, respectively, for the three and nine months ended September 30, 2011 as compared to 34% and 40%, respectively, for the three and nine months ended September 30, 2010. Though our cost of goods as a percentage of revenue is higher for the three and nine months of 2011 as compared to 2010 as a result of increased labor costs due to additional production shifts and lower yield, we continue to see improvement in our yield in the third quarter of 2011 as we addressed our production issues. We anticipate continued improvement in our yield.

The following table outlines product, contract and total gross profit and related gross margins for the three and nine months ended September 30, 2011 and 2010 (dollars in thousands):

	Three months ended	Nine months ended

	September 30, 2011	September 30, 2010	September 30, 2011	September 30, 2010
	(unaudited)		(unaudited)	
Product revenue gross profit	$ 3,404	$ 4,831	$ 8,010	$ 11,236
Product revenue gross margin	54%	70%	48 %	63%
Contract revenue gross profit	$ 955	$ 637	$ 2,221	$ 2,289
Contract revenue gross margin	49%	48%	48 %	49%
Total gross profit	$ 4,359	$ 5,468	$ 10,231	$ 13,525
Total gross margin	53%	66%	48 %	60%

The gross profit for the three and nine months ended September 30, 2011 was approximately $4.4 million and $10.2 million, respectively, as compared to approximately $5.5 million and $13.5 million, respectively, for the three and nine months ended September 3, 2010, a decrease of $1.1 million and $3.3 million, respectively. Gross margin was 53% for the three months ended September 2011 down from 66 % for the three months ended September 30, 2010. Gross margin was 48% for the nine months ended September 30, 2011 down from 60% for the nine months ended 2010.

The product gross profit for the three and nine months ended September 30, 2011 was approximately $3.4 million and $8.0 million, respectively, as compared to approximately $4.8 million and $11.2 million, respectively, for the three and nine months ended September 30, 2010, a decrease of $1.4 million and $3.2 million, respectively. Product gross margin was 54% and 48%, respectively, for the three and nine months ended September 30, 2011 down from 70% and 63%, respectively, for both the three and nine months ended September 30, 2010. For the three and nine month periods of 2011, our gross margin was unfavorably impacted by an increase in costs being spread over a lower revenue base and a lower effective average selling price per display due to product mix changes. There was improvement in our gross margin in this quarter as compared to 2011 year to date as our revenues increased and our production increased year over year.

The contract gross profit for the three and nine months ended September 30, 2011 was approximately $1.0 million and $2.2 million, respectively, as compared to approximately $0.6 million and $2.3 million, respectively, for the three and nine months ended September 30, 2010, an increase of $0.4 million and a decrease of $0.1 million, respectively. Contract gross margin was 49% and 48%, respectively, for the three and nine months ended September 30, 2011 relatively unchanged from the same periods ended September 30, 2010. Our contract revenues and gross margins year over year have stayed relatively consistent in the 48% to 49% range.

Operating Expenses

Research and Development. Research and development (“R&D”) expenses are company-funded and include salaries and related benefits, development materials and other costs specifically allocated to the development of new microdisplay products, OLED materials and subsystems. R&D related costs associated with fulfilling contracts are categorized as contract cost of goods sold. R&D expenses for the three and nine months ended September 30, 2011 were approximately $0.8 million and $2.1 million as compared to $0.5 million and $1.9 million for the three and nine months ended September 30, 2010. The increase of approximately $0.3 million and $0.2 million, respectively, is related to an increase in headcount and related expenses to support R&D activities.

Selling, General and Administrative. Selling, general and administrative expenses consist principally of salaries and related benefits, professional services fees and marketing, general corporate, and administrative expenses. Selling, general and administrative expenses for the three and nine months ended September 30, 2011 were approximately $2.0 million and $6.4 million, respectively, as compared to approximately $2.1 million and $6.9 million, respectively, for the three and nine months ended September 30, 2010. The selling, general and administrative expenses for the three month period ended September 30, 2011 as compared to September 30, 2010 were relatively unchanged. The decrease of approximately $0.5 million for the nine months ended September 30, 2011 was primarily related to a reduction of legal fees of $0.3 million and settlement expenses of $0.9 million offset by an increase in personnel costs of $0.4 million, $0.2 million of recruiting fees, and $0.1million associated with charge to bad debt expense.

Other Income (Expense), net. Other income (expense), net consists primarily of interest income earned on investments, interest expense, and income (expense) applicable to the change in the fair value of the warrant liability. For the three and nine months ended September 30, 2011, interest expense primarily associated with the Company’s line of credit was approximately $26 thousand and $85 thousand, respectively, as compared to approximately $21 thousand and $79 thousand, respectively, for the three and nine months ended September 30, 2010. Other income, primarily interest income, for the three and nine months ended September 30, 2011 was approximately $3 thousand and $32 thousand, respectively, as compared to approximately $2 thousand and $10 thousand, respectively, for the three and nine months ended September 30, 2010.

Change in Fair Value of Warrant Liability. For the three months ended September 30, 2011 and 2010, the change in fair value of the warrant liability was income of $3.0 million and $0.7 million, respectively. For the nine months ended September 30, 2011, the change in fair value of the warrant liability was income of $2.5 million as compared to a charge of $9.6 million for the nine months ended September 30, 2010. The change in the fair value of the warrant liability is primarily due to the change in the common stock price of eMagin period over period. The change in fair value of the warrant liability had no impact on our cash balances, operations, or operating income. There will be no future effect on earnings for the outstanding warrants due to the modification to remove the anti-dilution provisions.

Liquidity and Capital Resources

As of September 30, 2011, we had approximately $13.7 million of cash, cash equivalents, and investments in certificates of deposit ("CDs") as compared to $12.4 million at December 31, 2010. Of the $13.7 million in cash, approximately $7.2 million was invested in CDs.

Cash flow provided by operating activities during the nine months ended September 30, 2011 was approximately $1.6 million, attributable to our net income of approximately $3.8 million offset by net non-cash expenses of $0.8 million and the change in operating assets and liabilities of $1.4 million. Cash flow provided by operating activities during the nine months ended September 30, 2010 was approximately $6.6 million, attributable to our net loss of approximately $5.0 million offset by non-cash expenses of approximately $10.8 million and approximately $0.8 million from the change in operating assets and liabilities.

Cash used in investing activities during the nine months ended September 30, 2011 was approximately $4.0 million of which $2.6 million purchased CDs and approximately $1.4 million for equipment purchases primarily for upgrading our production line. 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 for the production line and purchase CDs of $3.5 million.

Cash provided by financing activities during the nine months ended September 30, 2011 was approximately $1.1 million, representing proceeds from the exercise of stock options and warrants as compared to the cash provided by financing activities during the nine months ended September 30, 2010 was approximately $0.6 million, also, from the exercise of stock options and warrants.

Credit Facility

At September 30, 2011, we had a credit facility with Access Business Finance, LLC (“Access”) that provides for up to a maximum amount of $3 million based on a borrowing base equivalent of 75% of eligible accounts receivable. The interest on the credit facility is equal to the Prime Rate plus 5% but may not be less than 8.25% with a minimum monthly interest payment of $1 thousand. The credit facility will automatically renew on September 1, 2012 for a one year term unless written notice is provided. We did not draw on our credit facility during the first nine months of 2011.

The credit facility contains the customary representations and warranties as well as affirmative and negative covenants. We were in compliance with all debt covenants as of September 30, 2011.

We expect our business to experience revenue growth which may result in higher accounts receivable levels and may require increased production and/or higher inventory levels. We anticipate that our cash needs to fund these requirements as well as other operating or investing cash requirements over the next twelve months will be less than our current cash on hand, investments and the cash we anticipate generating from operations. We anticipate that we will not require additional funds over the next twelve months other than perhaps for discretionary capital spending. If unanticipated events arise during the next twelve months, we believe we can raise sufficient funds. However, 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 4T. Controls and Procedures

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.

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 not effective.

Restatement of Condensed Consolidated Financial Statements

On August 10, 2011, the Audit Committee of the Board of Directors ("Audit Committee") in consultation with the Company's management concluded that the financial statements included in the Company's Annual Reports issued on Form 10-K for the years ended December 31, 2009 and 2010 and quarterly reports issued on Form 10-Q for the quarters ended March 31, September 30, and September 30, 2009; March 31, September 30, and September 30, 2010; and March 31, 2011 did not use the proper method to calculate earnings per share and as a result, should not be relied upon. On August 15, 2011, after consulting with the Audit Committee on August 10, 2011 and with the Company's auditors and former auditors, management concluded that the Company did not properly account for certain common stock warrants as liabilities and as a result, the financial statements, as mentioned above, should not be relied upon. The Audit Committee authorized and directed Company's management to restate its consolidated financial statements for the above mentioned periods. All amended financial statements were filed with the SEC as of October 11, 2011. As a result of a deficiency in our internal control over financial reporting relating to the accounting for common stock warrants, as of the end of the period covered by this report our management has reassessed the effectiveness of our disclosure controls and procedures and has determined that our disclosure controls and procedures were not effective.

Remediation Plan

Since the determination regarding this deficiency, we have devoted significant effort and resources to remediation and improvement of our internal control over financial reporting. While we had processes in place to identify and apply developments in accounting standards, we enhanced these processes to better evaluate our research of the nuances of complex accounting standards. Our enhancements included retaining a third party consultant, who is a technical accounting professional, to assist us in the interpretation and application of new and complex accounting guidance. Additionally, we have improved training of accounting personnel and communication among our internal staff, our legal team and our consultant. Management will continue to review and make necessary changes to the overall design of our internal control environment.

Changes in Internal Controls

Other than mentioned above, there were no changes in our internal controls over financial reporting during the fiscal quarter ended September 30, 2011 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

None.

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/A for the year ended December 31, 2010. There were no material changes from the risk factors during the nine months ended September 30, 2011.

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

Pursuant to various cashless warrant and option exercises, the Company issued 526,348 shares of common stock in the nine months ended September 30, 2011. 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 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)
101.INS	XBRL Instance Document (2)
101.SCH	XBRL Taxonomy Extension Schema Document (2)
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document (2)

101.DEF	XBRL Taxonomy Extension Definition Linkbase Document (2)
101.LAB	XBRL Taxonomy Extension Label Linkbase Document (2)
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document (2)

(1) Filed herewith.

* Pursuant to applicable securities laws and regulations, the Company is deemed to have complied with the reporting obligation relating to the submission of interactive data files in such exhibits and is not subject to liability under any anti-fraud provisions of the federal securities laws as long as the Company has made a good faith attempt to comply with the submission requirements and promptly amends the interactive data files after becoming aware that the interactive data files fails to comply with the submission requirements. Users of this data are advised that, pursuant to Rule 406T, these interactive data files are deemed not filed and otherwise are not subject to liability.

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 10 day of November 2011.

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)