EMAGIN CORP
Form 10-Q
August 13, 2014

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

Form 10-Q

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

For the quarterly period ended June 30, 2014
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)

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 R No ¨

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

Large accelerated filer £ Accelerated filer £ Non-accelerated filer £ 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 July 31, 2014 was 24,995,982.

eMagin Corporation
Form 10-Q

For the Quarter ended June 30, 2014

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ITEM 1. Condensed Consolidated Financial Statements

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

	June 30, 2014 (unaudited)	December 31, 2013
ASSETS		
Current assets:		
Cash and cash equivalents	$ 2,095	$ 4,032
Investments	3,500	6,250
Accounts receivable, net	6,055	4,319
Inventories, net	5,549	3,434
Prepaid expenses and other current assets	899	745
Total current assets	18,098	18,780
Long-term investments	—	750
Equipment, furniture and leasehold improvements, net	9,136	9,119
Other assets	106	27
Total assets	$ 27,340	$ 28,676
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 1,674	$ 1,470
Accrued expenses	1,977	2,812
Other current liabilities	605	395
Total current liabilities	4,256	4,677
Commitments and contingencies (Note 8)		
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 June 30, 2014 and December 31, 2013	—	—
Common stock, $.001 par value: authorized 200,000,000 shares, issued and outstanding, 24,995,982 shares as of June 30, 2014 and 23,928,619 as of December 31, 2013	25	24
Additional paid-in capital	227,801	226,051
Accumulated deficit	(204,242)	(201,576)
Treasury stock, 162,066 shares as of June 30, 2014 and December 31, 2013	(500)	(500)
Total shareholders' equity	23,084	23,999
Total liabilities and shareholders' equity	$ 27,340	$ 28,676

See notes to Condensed Consolidated Financial Statements.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Revenue:				
Product	$6,956	$6,773	$13,215	$14,901
Contract	62	255	81	630
Total revenue, net	7,018	7,028	13,296	15,531
Cost of goods sold:				
Product	4,838	4,437	9,170	8,974
Contract	11	200	26	416
Total cost of goods sold	4,849	4,637	9,196	9,390
Gross profit	2,169	2,391	4,100	6,141
Operating expenses:				
Research and development	1,282	1,454	2,708	2,643
Selling, general and administrative	1,931	2,077	4,050	4,317
Total operating expenses	3,213	3,531	6,758	6,960
Loss from operations	(1,044)	(1,140)	(2,658)	(819)
Other income (expense):				
Interest expense, net	(10)	(11)	(21)	(21)
Other income, net	7	23	14	36
Total other income (expense), net	(3)	12	(7)	15
Loss before benefit from income taxes	(1,047)	(1,128)	(2,665)	(804)
Benefit from income taxes	—	(120)	—	—
Net loss	$(1,047)	$(1,008)	$(2,665)	$(804)
Less net income allocated to participating securities	—	—	—	—
Net loss allocated to common shares	$(1,047)	$(1,008)	$(2,665)	$(804)
Loss per share, basic	$(0.04)	$(0.04)	$(0.11)	$(0.03)
Loss per share, diluted	$(0.04)	$(0.04)	$(0.11)	$(0.03)
Weighted average number of shares outstanding:				
Basic	23,940,800	23,586,413	23,859,455	23,556,743
Diluted	23,940,800	23,586,413	23,859,455	23,556,743

See notes to Condensed Consolidated Financial Statements.

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

	Six Months Ended June 30,	
	2014	2013
	(unaudited)	
Cash flows from operating activities:		
Net loss	$ (2,665)	$ (804)
Adjustments to reconcile net loss to net cash (used in) provided by operating activities:		
Depreciation and amortization	538	425
Amortization of bond premium	—	17
Inventory reserve	321	16
Stock-based compensation	650	1,078
Loss (gain) on sale of asset	7	(9)
Changes in operating assets and liabilities:		
Accounts receivable	(1,737)	292
Inventories, net	(2,437)	(355)
Prepaid expenses and other current and long-term assets	(235)	(88)
Accounts payable, accrued expenses, and other current liabilities	(421)	(322)
Net cash (used in) provided by operating activities	(5,979)	250
Cash flows from investing activities:		
Purchase of equipment	(567)	(552)
Proceeds from sale of asset	7	15
Maturities of investments	5,500	7,250
Purchase of investments	(2,000)	(7,000)
Net cash provided by (used in) investing activities	2,940	(287)
Cash flows from financing activities:		
Proceeds from exercise of stock options and warrants	1,102	257
Net cash provided by financing activities	1,102	257
Net (decrease) increase in cash and cash equivalents	(1,937)	220
Cash and cash equivalents, beginning of period	4,032	4,385
Cash and cash equivalents, end of period	$ 2,095	$ 4,605
Cash paid for interest	$ 6	$ 3
Cash paid for taxes	$ —	$ 20

See notes to Condensed Consolidated Financial Statements.

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eMAGIN CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

Note 1: 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. All significant intercompany balances and transactions have been eliminated in consolidation. 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, 2013. The results of operations for the period ended June 30, 2014 are not necessarily indicative of the results to be expected for the full year. The consolidated condensed financial statements of December 31, 2013 are derived from audited financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2013.

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.

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.

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). Progress is generally based on a cost-to-cost approach however an alternative method may be used such as physical progress, labor hours or others depending on the type of contract. Physical progress is determined as a combination of

input and output measures as deemed appropriate by the circumstances. Contract costs include all direct material, labor and subcontractor 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.

New Accounting Pronouncement

In May 2014, the Financial Accounting Standards Board issued Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers (Topic 606) ("ASU 2014-09"), which amends the existing accounting standards for revenue recognition. ASU 2014-09 is based on principles that govern the recognition of revenue at an amount an entity expects to be entitled when products are transferred to customers. ASU 2014-09 will be effective for the Company beginning January 1, 2017. Early adoption is not permitted. The new revenue standard may be applied retrospectively to each prior period presented or retrospectively with the cumulative effect recognized as of the date of adoption. The Company is currently evaluating the impact of adopting the new revenue standard on its consolidated financial statements.

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Investments

Investments consist of FDIC-insured certificates of deposit ("CDs") which are classified as held-to-maturity since the Company has the positive intent and ability to hold them until maturity. The CDs are carried at cost which approximates fair value. As of June 30, 2014, the investments mature within one year.

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.

The following table provides a summary of the activity related to the Company's warranty liability included in other current liabilities, (in thousands):

	Three Months Ended June 30. (unaudited)		Six Months Ended June 30. (unaudited)	
	2014	2013	2014	2013
Warranty accrual, beginning of period	$380	$276	$394	$276
Provision for warranty costs	437	89	517	181
Warranty expenditures	(214)	(77)	(308)	(169)
Warranty accrual, end of period	$603	$288	$603	$288

Net (Loss) Income per Common Share

Basic (loss) income per share is computed using the weighted average number of common shares outstanding during the period, and excludes any dilutive effects of common stock equivalent shares, such as stock options, warrants, and convertible preferred stock. Diluted (loss) income per share is computed using the weighted average number of common shares outstanding and potentially dilutive common stock equivalent shares outstanding during the period. Common stock equivalent shares are excluded from the computation if their effect is anti-dilutive.

The Company's Series B Convertible Preferred stock ("Preferred Stock – Series B") is considered a participating security as the preferred stock participates in dividends with the common stock, which requires the use of the two-class method when computing basic and diluted earnings per share. The Preferred Stock – Series B is not required to absorb any net loss. Though the Company paid a one-time special dividend in 2012, the Company does not expect to continue to pay dividends on its common or preferred stock in the near future.

For the three and six months ended June 30, 2014 and 2013, the Company reported a net loss and as a result, basic and diluted net loss per common share are the same. Therefore, in calculating net loss per share amounts, shares underlying the potentially dilutive common stock equivalents were excluded from the calculation of diluted net income per common share because their effect was anti-dilutive.

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The following is a table of the potentially dilutive common stock equivalents for the three and six month periods ended June 30, 2014 and 2013 that were not included in diluted EPS as their effect would be anti-dilutive:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Options	4,679,929	5,605,713	4,679,929	5,605,713
Convertible preferred stock	7,545,333	7,545,333	7,545,333	7,545,333
Total potentially dilutive common stock equivalents	12,225,262	13,151,046	12,225,262	13,151,046

Note 2: Accounts Receivable, net

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 consisted of the following (in thousands):

	June 30, 2014 (unaudited)	December 31, 2013
Accounts receivable	$ 6,200	$ 4,464
Less allowance for doubtful accounts	(145)	(145)
Net receivable	$ 6,055	$ 4,319

Note 3: Inventories, net

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

	June 30, 2014 (unaudited)	December 31, 2013
Raw materials	$ 2,778	$ 1,905
Work in process	1,768	987
Finished goods	1,419	637
Total inventories	5,965	3,529
Less inventory reserve	(416)	(95)
Total inventories, net	$ 5,549	$ 3,434

Note 4: Line of Credit

At June 30, 2014, the Company had a 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 terms are: interest rate is Prime plus 4% but not less than 7.25%, the minimum monthly interest payment is $1,000 and the early termination fee is $6,000. The renewal date of the line of credit is September 1, 2014. The Company's obligations under the credit facility are secured by its assets. For the six months ended June 30, 2014, the Company had not borrowed on its line of credit.

Note 5: 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.

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The following table summarizes the allocation of non-cash stock-based compensation to our expense categories for the three and six month periods ended June 30, 2014 and 2013 (in thousands):

	Three Months Ended June 30. (unaudited)		Six Months Ended June 30. (unaudited)	
	2014	2013	2014	2013
Cost of revenue	$ 33	$ 72	$ 103	$ 151
Research and development	42	137	185	292
Selling, general and administrative	85	250	362	635
Total stock compensation expense	$ 160	$ 459	$ 650	$ 1,078

At June 30, 2014, total unrecognized compensation costs related to stock options was approximately $0.7 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 years.

The following key assumptions were used in the Black-Scholes option pricing model to determine the fair value of stock options granted:

	For the Six Months Ended June 30,	
	2014	2013
Dividend yield	0 %	0 %
Risk free interest rates	0.78 – 1.61%	0.35 - 1.48 %
Expected volatility	60.3 to 67.8%	70.9 to 73.8%
Expected term (in years)	3.25 to 5.0	3.5 to 5.0

The Company does not expect to pay dividends in the near future therefore the Company used an expected dividend yield of 0%. The risk-free interest rate used in the Black-Scholes option pricing model is based on the implied yield at the time of grant 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 equivalent term. The expected term of options represents the period that the Company's stock-based awards are expected to be outstanding and was determined based on historical experience and vesting schedules of similar awards.

A summary of the Company's stock option activity for the six months ended June 30, 2014 is presented in the following table (unaudited):

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (In Years)	Aggregate Intrinsic Value
Outstanding at December 31, 2013	4,597,186	$3.82		
Options granted	195,423	3.11		
Options exercised	(67,363)	1.06		

Options forfeited	(35,309)	4.50		
Options cancelled or expired	(10,008)	3.69		
Outstanding at June 30, 2014	4,679,929	$3.83	4.44	$1,397,761
Vested or expected to vest at June 30, 2014 (1)	4,664,155	$3.83	4.18	$1,397,761
Exercisable at June 30, 2014	4,285,632	$3.83	4.17	$1,397,761

(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. For the three and six months ended June 30, 2014, the aggregate intrinsic value of options exercised was approximately $9 thousand and $93 thousand, respectively. The Company issues new shares of common stock upon exercise of stock options.

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Note 6: Shareholders' Equity

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

As of June 30, 2014 and December 31, 2013, there were 5,659 shares of Preferred Stock – Series B issued and outstanding.

Common Stock

The Company received approximately $7 thousand and $72 thousand for the exercise of 6,080 and 67,363 stock options in the three and six months ended June 30, 2014, respectively. The Company received approximately $233 thousand and $257 thousand for the exercise of 150,960 and 163,615 stock options in the three and six months ended June 30, 2013, respectively. In the three and six months ended June 30, 2014, the Company received approximately $1.0 million for the exercise of 1 million warrants.

Note 7: Income Taxes

The Company's effective tax rate is calculated quarterly based upon current assumptions relating to the full year's estimated operating results and various tax-related items. The Company's effective tax rate for both the six month periods ended June 30, 2014 and 2013 was 0%. The difference between the effective tax rate of 0% and the U.S. federal statutory rate of 34% for the six months ended June 30, 2014 was primarily due to recognizing a full valuation allowance. The difference between the effective tax rate of 0% and the U.S. federal statutory rate of 34% for the six months ended June 30, 2013 was primarily due to the change in the valuation allowance.

At December 31, 2013, the Company determined that based on all available evidence, both positive and negative, and based on the weight of the available evidence, including the Company's 2013 operating loss and projected cumulative loss through 2014, it was more likely than not that none of its deferred tax assets would be realized and therefore, recorded a full valuation allowance. As the Company incurred an operating loss for the three month period ended June 30, 2014 and is still projecting a cumulative loss through 2014, it is still more likely than not that none of its deferred tax assets would be realized and therefore, the Company continued to record a full valuation allowance. The Company's net operating loss carry forward amounts substantially expire in 2028.

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 8: Commitments and Contingencies

Royalty Payments

On January 13, 2014, Global OLED Technology, LLC ("GOT") filed a complaint against the Company in the New York State Supreme Court sitting in Dutchess County, NY seeking damages for unpaid annual minimum royalties, unpaid royalties on net sales of certain licensed products, unpaid interest, and damages for breach of confidentiality provisions, in each case allegedly arising under a certain license agreement. GOT also sought a declaratory judgment mandating specific performance of the parties obligations under the license agreement in accordance with the terms and conditions thereof, a full accounting of net sales thereunder and recoupment of reasonable costs and attorneys' fees. Following the filing of the complaint, GOT and the Company engaged in discussions in attempts to amicably resolve the dispute between the parties without the costs associated with a lengthy litigation. The Company recorded a $0.5 million liability on the Company's Consolidated Balance Sheets as of December 31, 2013 and March 31, 2014,

respectively, and a selling, general and administrative expense on the Company's Consolidated Statements of Operations for the year ended December 31, 2013 as a reasonable estimate of the loss contingency related to this matter.

On April 29, 2014, the Company and GOT entered into a settlement agreement resolving the matter in full. Pursuant to the settlement agreement, the parties agreed to terminate the patent license agreements entered into in 1998 and 1999, respectively, between FED Corporation (predecessor to the Company) and Eastman Kodak Company (predecessor to GOT), in exchange for mutual releases and the payment by the Company of a one-time settlement amount, substantially all of which was recorded as an expense by the Company as described above. In addition, the parties agreed to dismiss with prejudice the lawsuit commenced by GOT in January 2014.

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Operating Leases

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. The Company 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, 2019. The administrative offices are located in Bellevue, Washington where the current lease expires on August 31, 2014 and the Company has negotiated a new lease for approximately 1,500 square feet effective September 1, 2014. Effective July 1, 2014, the Company has a new lease for approximately 1,800 square feet of office space for design and product development in Santa Clara, California with the lease expiring October 31, 2015.

Rent expense was approximately $287 thousand and $589 thousand, respectively, for the three and six months ended June 30, 2014 and approximately $303 thousand and $606 thousand, respectively, for the three and six months ended 2013.

Equipment Purchase Commitments

The Company has committed to equipment purchases of approximately $0.5 million at June 30, 2014.

Note 9: Concentrations

For the three and six months ended June 30, 2014, approximately 44% and 45%, respectively, of the Company's net revenues were derived from customers in the United States and approximately 56% and 55%, respectively, of the Company's net revenues were derived from international customers. For the three and six months ended June 30, 2013, approximately 66% and 64%, respectively, of the Company's net revenues were derived from customers in the United States and approximately 34% and 36%, respectively, of the Company's net revenues were derived from international customers. For the three and six months ended June 30, 2014, there was one customer that accounted for 18% and 12%, respectively, of its net revenue. For the three and six months ended June 30, 2013, two customers accounted for 33% and 26%, respectively, of its net revenue. As of June 30, 2014, two customers accounted for 37% of its accounts receivable.

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

	Three Months Ended June 30, (unaudited)		Six Months Ended June 30, (unaudited)	
	2014	2013	2014	2013
North and South America	$ 3,295	$ 4,718	$ 6,301	$ 10,340
Europe, Middle East, and Africa	3,128	1,905	5,523	4,012
Asia Pacific	595	405	1,472	1,179
Total	$ 7,018	$ 7,028	$ 13,296	$ 15,531

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

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations Statement of Forward-Looking Information

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

Except for the historical information contained herein, some of the statements in this Report contain forward-looking statements that involve risks and uncertainties. These statements are found in the sections entitled "Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Risk Factors." They include statements concerning: our business strategy; expectations of market and customer response; liquidity and capital expenditures; future sources of revenues; expansion of our proposed product line; and trends in industry activity generally. In some cases, you can identify forward-looking statements by words such as "may," "will," "should," "expect," "plan," "could," "anticipate," "intend," "believe," "estimate," "predict," "potential," "goal," or "continue" or similar terminology. These statements are only predictions and involve known and unknown risks, uncertainties and other factors, including, but not limited to, the risks outlined under "Risk Factors," that may cause our 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 successfully implement resolutions related to customer stop orders; 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; our ability to successfully launch new equipment on our manufacturing line; 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

In the second quarter, eMagin continued deliveries of our display products, shipping products to over 87 different customers. Our new OLED deposition tool had its best quarter yet in terms of throughput after we had successfully addressed a number of problems with the tool. Investments continued in developing new processes that provide ultra-high brightness displays, an important attribute for applications that are used in direct sunlight or daylight such as wearable personal headsets and avionic head mounted displays (HMD). Our technical team successfully demonstrated a direct-patterned ultra-high brightness display in June, and is on track to begin producing high-resolution, high-brightness displays for sale later this year. A new tool for low-volume production has been installed and is currently being brought up to manufacturing readiness.

We successfully met the challenges associated with a first quarter 2014 stop ship order from three of our customers regarding a product issue. A stop ship order essentially delays product shipments until the particular issue(s) are resolved with the customer. The issues relating to the stop ship order have now been mostly resolved. For the first customer, shipments have resumed with no expected loss of revenue. Shipments to the second customer resumed and shipments continued uninterrupted to this customer for its other programs. The customer changed to a new display configuration for this program as did the third customer. No loss of overall revenue is expected for the second customer but some shipments originally scheduled for 2014 may extend into 2015. For the third customer, production shipments of the new display configuration are expected to begin shipping once their qualification process is complete and we expect less revenue under this program than we originally anticipated.

As a result of the status of the stop ship orders, improved R&D contract outlook and demand for our state-of-the-art microdisplays, we continue to anticipate that the last three quarters of 2014 will have higher average revenue than Q1 2014.

Financial Result

In the second quarter, revenues rebounded from first quarter, which was impacted by the stop order, as revenues increased to $7.0 million from revenues of $6.3 million last quarter. Gross margin sustained the improvement we saw in first quarter over Q4 last year in the second quarter, which was significant in improving bottom line results in both quarters. Operating expenses decreased from first quarter as second quarter operating loss narrowed to $1.0 million from $1.6 million in the first quarter of 2014.

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New Business

In the second quarter, there has been significant interest in our new products especially for our high brightness options, our XLS and XLT type products. The XLS provides our customers with significantly higher brightness in color for the latest Augmented Reality optical and image overlay systems. Samples have been delivered and are being added to the system architecture for both commercial and military applications. We believe XLT is becoming the technology of choice for military avionic systems. We expect that revenue from this market segment will become significant in the 2015 through the 2020 time frame.

Recently, the Company was notified it has been awarded a number of new R&D contracts. This was announced in a press release dated July 17, 2014. We believe these awards will significantly increase R&D contract revenues in the coming quarters above the level of the past two quarters beginning in third quarter 2014. The awards also provide funding for important research and development regarding the Company's high brightness and OLED manufacturing process improvement initiatives. The first of these R&D contracts has been signed and details will be released once the necessary approvals have been obtained from third parties.

New Technology Development

During the second quarter progress was made in a number of technology areas, including the ultra-high brightness OLED display development effort. An ultra-high brightness VGA-type demonstration display was fabricated and demonstrated. Additionally, a new tool was installed in July to produce ultra-high brightness and high resolution directly patterned color OLED devices. Prototype ultra-high resolution high brightness OLED displays are expected to be fabricated and sampled to customers in Q3 2014. As a result of further R&D efforts, the already existing high brightness OLED-XLS product lifetime was improved by about 25 percent. Also, the R&D team has developed a new seal structure that has the potential to increase the overall yield and reliability of our display products. Certain displays for certain customers are already receiving displays with this new seal process.

The production qualification of our new DSVGA display was completed in the second quarter. This display is targeted to replace the long-running SVGA+ display with our latest digital technology and product improvements. First samples of our SXGA096 product are scheduled to be available in the third quarter. The SXGA096 will provide the high resolution on a SXGA display but with a smaller form factor and lower cost of production than larger pixel SXGA displays.

Manufacturing

Throughput improved during the second quarter thanks in part to the deployment of a 24/7 operation in our clean rooms and to the new OLED deposition tool which was successfully run to its rated maximum run rate for several weeks. The higher volume not only led to additional sales but also to building inventory that supported the Company's commercial activities during its early July factory shutdown. The shutdown addressed equipment maintenance but also major improvements in clean room and packaging operations. Additional equipment in the display assembly area was ordered and delivered in the second quarter that will improve process consistency as well as reducing cycle time. The results are expected to materialize during the third quarter.

At July 31, 2014, we had a total of 91 employees, of which 88 were full-time employees as compared to a total of 111 employees, of which 107 were full-time employees at December 31, 2013.

A detailed discussion of our business may be found in Part I, "Business," of our 2013 Annual Report on Form 10-K for the year ended December 31, 2013 as filed with the Securities and Exchange Commission on March 13, 2014.

CRITICAL ACCOUNTING POLICIES

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.

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). Progress is generally based on a cost-to-cost approach however an alternative method may be used such as physical progress, labor hours or others depending on the type of contract. Physical progress is determined as a combination of input and output measures as deemed appropriate by the circumstances. Contract costs include all direct material, labor and subcontractor 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.

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Income Taxes

Our deferred tax assets and their potential realizability are evaluated each quarter to determine if any changes should be made to the valuation allowance. At December 31, 2013, we determined that based on all available evidence, both positive and negative, and based on the weight of the available evidence, including our 2013 operating loss and projected cumulative loss through 2014, it was more likely than not that none of our deferred tax assets would be realized and therefore, recorded a full valuation allowance. As we incurred an operating loss for the six month period ended June 30, 2014 and are still projecting a cumulative loss through 2014, it is still more likely than not that none of our deferred tax assets would be realized and therefore, we continued to record a full valuation allowance.

Other critical accounting policies, as described in our Annual Report on Form 10-K for the fiscal year ended December 31, 2013, relate to product warranty, use of estimates, fair value of financial instruments and stock-based compensation, and additional information on accounting for income taxes.

RESULTS OF OPERATIONS

THREE MONTHS AND SIX MONTHS ENDED JUNE 30, 2014 COMPARED TO THREE AND SIX MONTHS ENDED JUNE 30, 2013

Revenues

	Three Months Ended June 30,			Six Months Ended June 30,		
	2014	2013 (unaudited) (in thousands)	Change	2014	2013 (unaudited) ($ in thousands)	Change
Product	$6,956	$6,773	$183	$13,215	$14,901	$(1,686)
Contract	$62	$255	$(193)	$81	$630	$(549)
Total revenue, net	$7,018	$7,028	$(10)	$13,296	$15,531	$(2,235)

Revenues for the three and six months ended June 30, 2014 were approximately $7.0 million and $13.3 million, respectively, as compared to approximately $7.0 million and $15.5 million, respectively.

Product revenue is comprised primarily of sales of displays, as well as sales of other hardware. For the three months ended June 30, 2014, product revenue increased approximately $0.2 million or 3% as compared to the three months ended June 30, 2013. The increase in product revenue is due primarily to an increase in the display average selling price. For the six months ended June 30, 2014, product revenue decrease 1.7 million or 11% as compared to the six months ended June 30, 2013. The year to date decrease is due primarily to fewer year to date display shipments.

Contract revenue is comprised of revenue from research and development (“R&D”) or non-recurring engineering (“NRE”) contracts. For the three and six months ended June 30, 2014, contract revenue decreased approximately $0.2 million and $0.5 million, respectively, as compared to the three months and six months ended June 30, 2013, respectively. We believe the decrease is primarily the result of a reduction in funding of R&D contracts by the U.S. Government, due to recent budget issues. The U.S. Government is the source of most of our R&D contracts.

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Cost of Goods Sold

	Three Months Ended June 30,			Six Months Ended June 30,		
	2014	2013 (unaudited)	Change	2014	2013 (unaudited)	Change
	(in thousands)			($ in thousands)		
Product	$4,838	$4,437	$401	$9,170	$8,974	$196
Contract	$11	$200	$(189)	$26	$416	$(390)
Total cost of goods sold	$4,849	$4,637	$212	$9,196	$9,390	$(194)

Cost of goods sold is comprised of costs of product and contract revenues. Cost of product revenue includes materials, labor and manufacturing overhead, warranty costs and depreciation 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 month period ended June 30, 2014 as compared to the three month period ended June 30, 2013 increased $0.2 million. Cost of goods sold for the six month period ended June 30, 2014 as compared to the six month period ended June 30, 2013 decreased $0.2 million. Cost of goods sold as a percentage of revenues was 69% for both the three and six month periods ended June 30, 2014 as compared to 66% and 60%, respectively, for the three and six month periods ended June 30, 2013.

The following table outlines product, contract and total gross profit and related gross margins for the three and six months ended June 30, 2014 and 2013 (dollars in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
	(unaudited)		(unaudited)	
Product revenue gross profit	$2,118	$2,336	$4,046	$5,927
Product revenue gross margin	30 %	34 %	31 %	40 %
Contract revenue gross profit	$51	$55	$54	$214
Contract revenue gross margin	82 %	21 %	68 %	34 %
Total gross profit	$2,169	$2,391	$4,100	$6,141
Total gross margin	31 %	34 %	31 %	40 %

The gross profit for the three and six months ended June 30, 2014 as compared to the three and six months ended June 30, 2013 decreased approximately $0.2 million and $2.0 million, respectively. For both the three and six months ended June 30, 2014, the gross margin was 31% as compared to 34% and 40%, respectively, for the three and six months ended June 30, 2013.

The product gross profit for the three and six months ended June 30, 2014 as compared to the three and six months ended June 30, 2013 decreased approximately $0.2 million and $1.9 million, respectively. Product gross margin was 30% and 31%, respectively, for the three and six months ended June 30, 2014 down from 34% and 40%, respectively, for the three and six month periods ended June 30, 2013. The 9% decrease in gross profit for the three month period and the 32% decrease in gross profit for the six month period was primarily due to higher labor, materials, warranty and other product costs and lower yields.

The contract gross profit for the three months ended June 30, 2014 as compared to the same period in 2013 was relatively unchanged. The contract gross profit for the six months ended June 30, 2014 as compared to the six months ended June 30, 2013 decreased approximately $0.2 million. Contract gross margin for the three and six months ended June 30, 2014 increased to 82% and 68%, respectively, from 21% and 34%, respectively, for the same three and six month periods in 2013. The change in the contract gross margin is due to the nature of the contract and the amount of third party expenses incurred in fulfilling the contract.

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Operating Expenses

	Three Months Ended June 30,			Six Months Ended June 30,		
	2014	2013 (unaudited) ($ in thousands)	Change	2014	2013 (unaudited) ($ in thousands)	Change
Research and development expense	$1,282	$1,454	$(172)	$2,708	$2,643	$65
Percentage of net revenue	18%	21%		20%	17%	
Selling, general and administrative expense	$1,931	$2,077	$(146)	$4,050	$4,317	$(267)
Percentage of net revenue	28%	30%		30%	28%	
Total operating expenses	$3,213	$3,531	$(318)	$6,758	$6,960	$(202)
Percentage of net revenue	46%	51%		50%	45%	

Research and Development. Research and development expenses are company-funded and include salaries and related benefits, development materials and other costs specifically allocated to the development of new technologies and 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 months ended June 30, 2014 decreased approximately $0.2 million or 12% as compared to the three months ended June 30, 2013 and increased $65,000 or 2% for the six months ended June 30, 2014 as compared to the six months ended June 30, 2013. As a percentage of revenue, Q2 2014 decreased to 18% of revenue as compared to 21% for Q2 2013 and for the year 2014 increased to 20% as compared to 17% for the year 2013. The changes in R&D costs are due to the amount of active R&D contract work and the nature of those contracts. A large portion of R&D expenses are labor oriented and tend to increase each year due to salary and benefit increase and lack of personnel turnover.

Selling, General and Administrative. Selling, general and administrative (“SG&A”) 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 six months ended June 30, 2014 decreased approximately $0.2 million or 7% and $0.3 million or 6%, respectively, as compared to the three and six months ended June 30, 2013. As a percentage of revenue, Q2 2014 decreased to 28% of revenue as compared to 30% for Q2 2013 and for the year 2014 increased to 30% as compared to 28% for the year 2013. The decrease in SG&A expenses for the quarter and year to date is due to lower stock option expense offset by an increase in salaries and benefits.

Other Income (Expense), net. Other income (expense), net consists primarily of interest income earned on investments, interest expense and gain/loss on sale of assets. For both the three and six month periods ended June 30, 2014 and 2013, interest expense was approximately $11 thousand and $21 thousand, respectively. We have no debt upon which we are incurring interest expense however we pay fees to keep our line of credit available. Other income of which the majority is interest income for the three and six months ended June 30, 2014 was approximately $7 thousand and $14 thousand, respectively, as compared to approximately $23 thousand and $36 thousand, respectively, for the three and six months ended June 30, 2013.

Liquidity and Capital Resources

We had approximately $5.6 million of cash, cash equivalents, and investments at June 30, 2014 as compared to approximately $11.0 million at December 31, 2013. Of the $5.6 million in cash, approximately $3.5 million was

invested in certificates of deposit ("CDs").

Cash flow used by operating activities during the six months ended June 30, 2014 was approximately $6.0 million, attributable to our net loss of approximately $2.7 million and change in operating assets and liabilities of $4.8 million of which accounts receivable was a change of approximately $1.7 million and net inventories was approximately $2.4 million offset by our net non-cash expenses of $1.5 million. Cash flow provided by operating activities during the six months ended June 30, 2013 was approximately $0.3 million, attributable to our net non-cash expenses of $1.5 million offset by our net loss of approximately $0.8 million and change in operating assets and liabilities of $0.4 million.

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Cash provided by investing activities during the six months ended June 30, 2014 was approximately $2.9 million of which net short-term investments proceeds were approximately $3.5 million offset by primarily equipment purchases of approximately $0.6 million. Presently, we have committed approximately $0.5 million for capital expenditures for the balance of 2014. Cash used in investing activities during the six months ended June 30, 2013 was approximately $0.3 million of which $0.6 million was used to purchase equipment offset by net proceeds of $0.3 million of short-term investments.

Cash provided by financing activities during the six months ended June 30, 2014 was approximately $1.1 million from option and warrant exercises as compared to $0.3 million related to option exercises during the six month period ended June 30, 2013.

Credit Facility

At June 30, 2014, 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 4% but may not be less than 7.25% with a minimum monthly interest payment of $1 thousand. The credit facility will automatically renew on September 1, 2014 for a one year term unless written notice is provided. We did not draw on our credit facility during the six months ended June 30, 2014 or at any time since its inception in September 2010 and there is no outstanding balance.

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 June 30, 2014.

Our cash needs to fund our operations and investment requirements over the next twelve months may be more than our current cash on hand, investments and the cash we anticipate generating from operations. We may not require additional funds over the next twelve months. If we do require additional funds, 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

Market rate risk

We are exposed to market risk related to changes in interest rates.

Interest rate risk

We hold our cash in cash and cash equivalents and certificates of deposits. We do not hold derivative financial instruments or equity securities. At June 30, 2014, we have not drawn on our revolving line of credit and therefore do not have any related interest rate risk. A change in interest rates would not have had a material effect on our consolidated financial position, results of operations, or cash flows in the three and six months ended June 30, 2014.

Foreign currency exchange rate risk

We do not have any material foreign currency exchange rate risk.

ITEM 4. 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, as amended (the "Exchange Act")) as of the end of the period covered by this Quarterly Report on Form 10-Q.

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. Based on our evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of the period covered by this report, our disclosure controls and procedures were effective.

There were no changes in our internal controls over financial reporting during the fiscal quarter ended June 30, 2014 that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

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PART II - OTHER INFORMATION

ITEM 1. Legal Proceedings

On January 13, 2014, Global OLED Technology, LLC ("GOT") filed a complaint against the Company in the New York State Supreme Court sitting in Dutchess County, NY seeking damages for unpaid annual minimum royalties, unpaid royalties on net sales of certain licensed products, unpaid interest, and damages for breach of confidentiality provisions, in each case allegedly arising under a certain license agreement. GOT also sought a declaratory judgment mandating specific performance of the parties obligations under the license agreement in accordance with the terms and conditions thereof, a full accounting of net sales thereunder and recoupment of reasonable costs and attorneys' fees. Following the filing of the complaint, GOT and the Company engaged in discussions in attempts to amicably resolve the dispute between the parties without the costs associated with a lengthy litigation. The Company recorded a $0.5 million liability on the Company's Consolidated Balance Sheets as of December 31, 2013 and March 31, 2014, respectively, and a selling, general and administrative expense on the Company's Consolidated Statements of Operations for the year ended December 31, 2013 as a reasonable estimate of the loss contingency related to this matter.

On April 29, 2014, the Company and GOT entered into a settlement agreement resolving the matter in full. Pursuant to the settlement agreement, the parties agreed to terminate the patent license agreements entered into in 1998 and 1999, respectively, between FED Corporation (predecessor to the Company) and Eastman Kodak Company (predecessor to GOT), in exchange for mutual releases and the payment by the Company of a one-time settlement amount, substantially all of which was recorded as an expense by the Company as described above. In addition, the parties agreed to dismiss with prejudice the lawsuit commenced by GOT in January 2014.

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, 2013. There were no material changes from the risk factors during the six months ended June 30, 2014.

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

Unregistered Sales of Equity Securities

None.

Issuer Repurchases of Equity Securities

None.

ITEM 3. Defaults Upon Senior Securities

None.

ITEM 4. Mine Safety Disclosures

None.

ITEM 5. Other Information

None.

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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.
(2) Furnished herewith.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized on this 13th day of August 2014.

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