MICROVISION INC
Form 10-K/A
May 04, 2006

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

FORM 10-K/A
(Amendment No. 3)

[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2005

Commission file number 0-21221

Microvision, Inc.

(Exact name of Registrant as Specified in its Charter)

Delaware	**91-1600822**
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification Number)

6222 185th Avenue NE
Redmond, Washington 98052

(Address of Principal Executive Offices including Zip Code)

(425) 415-6847

(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, par value $0.001

(Title of class)

Indicate by check mark if the registrant is a well-known seasoned issuer (as defined in Rule 405 of the Act). Yes

o No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes

o No x

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section13 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

x No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

x

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 o Accelerated filer x Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes

o No x

The aggregate market value of the common stock held by non-affiliates of the registrant as of June 30, 2005 was approximately $106,307,000 (based on the closing price for the registrant's Common Stock on the NASDAQ National Market of $5.10 per share).

The number of shares of the registrant's Common Stock outstanding as of March 1, 2006 was 25,243,000.

Documents Incorporated by Reference

NONE

Refiling 10KA to include consents inadvertently omitted from 10KA filing of May 1, 2006.

Microvision, Inc.
2005 ANNUAL REPORT ON FORM 10-K

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PART I

Preliminary Note Regarding Forward-Looking Statements

The information set forth in this report in Item 1 "Business" and in Item 7 "Management's Discussion and Analysis of Financial Condition and Results of Operations" includes "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended (the "Securities Act") and 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and is subject to the safe harbor created by those sections. Such statements may include, but are not limited to, projections of revenues, income or loss, capital expenditures, plans for product development and cooperative arrangements, future operations, financing needs or plans of the Company, as well as assumptions relating to the foregoing. The words "believe," "expect," "will," "anticipate," "estimate," "target," "project," "plan," and similar expressions identify forward-looking statements, which speak only as of the date the statement was made. Certain factors that realistically could cause actual results to differ materially from those projected in the forward-looking statements are set forth in Item 1A. "Risk Factors Relating to the Microvision Business."

ITEM 1. BUSINESS

Overview

The company has historically included both Microvision, Inc. ("Microvision" or the "Company") and Lumera Corporation ("Lumera"), a subsidiary that was consolidated prior to July 2004. In July 2004, Lumera completed an initial public offering of its common stock. After July 2004, due to the change in ownership percentage, Microvision changed to the equity method of accounting for its investment in Lumera. Microvision designs and markets scanned beam display and image capture products.

Scanned Beam Displays

Microvision has developed prototype color scanned beam displays, including hand-held, head-worn and projection versions, and is currently refining and further developing its scanned beam display technology for potential automotive, defense, aerospace, industrial, medical and consumer applications. Microvision also produces and sells the Nomad® Expert Technician System, a wireless, wearable computer with a head-worn see-through display. The Nomad is targeted at truck and automotive repair and military applications. Microvision believes the scanned beam display technology may be useful in a variety of applications, including mobile communications, head-up displays for vehicles, entertainment and consumer displays, and computing and visual simulation applications. Microvision expects that, in contrast to display solutions that use non-scanning technologies, its scanned beam display technology will enable the production of high quality displays that are small and lightweight, use low power, can be held or worn comfortably, and are competitively priced.

Microvision's scanned beam technology portfolio includes a combination of proprietary technology it has developed, technology licensed from other companies and the Virtual Retinal Display ™ technology licensed from the University of Washington.

Image Capture Devices

Microvision has also developed and sells hand-held bar code scanner products that use its proprietary scanning technology. Microvision believes that some of the basic scanning components of the scanned beam display technology may also be used to develop image capture products, such as miniature high-resolution laser cameras and 1D and 2D bar code readers that may have higher performance and lower cost than those currently available in the market.

Display Technology

Microvision's scanned beam display technology is fundamentally different from existing commercialized display technologies in that it uses a fast-moving beam of light to create an image. The scanned beam display creates a high resolution, full motion image at the eye on an intermediate surface when projected onto a screen.

The drive electronics of the scanned beam display acquire and process signals from the image or data source to control and synchronize the color mix and placement of individual picture elements (pixels). Color pixels are generated by combining modulated red, green and blue light sources. The intensity of each of the light sources is varied to generate a complete palette of colors and shades. Optical elements direct the beam of light toward the viewer's eye or onto a screen depending on the application. The pixels are arranged by a repetitive horizontal scanner motion that rapidly sweeps the light beam to place the pixels into rows; vertical scanner motion moves the light beam up/downward to points where successive rows of pixels are drawn. This process is continued until an entire field of rows has been placed and a full image appears to the user.

Scanned beam technology can be used to create an augmented vision display that allows the user to annotate the user's normal view with electronically displayed information. The user's vision is unobstructed, allowing full hand-eye coordination while having access to electronic information that is displayed on the user's field of view. The image, in the form of light, is directed to the eye in much the same way as light is commonly reflected from our natural environment. With the scanned beam technology an image can be overlaid on a user's field of view.

Scanned beam display technology can also be used to achieve a more conventional front or rear projection display. The screen may be transparent, providing for example, the user with a head-up display capability and that overlays the digital information on the view of the outside world. Projection could be used for head-up display applications that demand high brightness, high-resolution and long life in a rugged environment, such as automotive displays. Scanned beam display technology could also be incorporated into other products such as video projectors, large-screen monitors, or rear-projection televisions.

Display Components

Scanned beam display technology consists of the following primary components:

Scanners. The Company uses a single micro-electro-mechanical system ("MEMS") bi-axial scanner to direct the light beam that creates the image. Microvision currently uses these scanners in its commercial display products and in other prototype displays. Microvision expects to continue development to reduce the size, cost and power consumption of the bi-axial MEMS scanner for use in miniature displays. Microvision believes its MEMS scanning technology is a key technical asset and its MEMS design capability is a core competence. The Company believes that it has a leading position in the development and supply of optical MEMS technology that provides it with a competitive advantage in the marketplace.

Continued development of the scanning sub-system will allow scanning capability to meet standard video formats, including high definition television, HDTV, as well as new digital video standards.

Drive Electronics. The drive electronics of the scanned beam display are the components that convert an image to a signal to drive the light sources and scanner to create the image. Microvision is undertaking efforts in three areas where additional development of the drive electronics is necessary:

- Further miniaturization using integrated circuits or ASICs and improved packaging techniques,
- Refining the techniques of driving the light sources and scanners to improve display quality and reduce power consumption and,
- Improving the compatibility of the drive electronics with existing and emerging video standards. Microvision's current product and demonstration units are compatible with North American video format standards and accommodate output from most personal computers.

Light Sources. The light source creates the light beam that paints the image on a screen or on the viewer's eye. In a full-color scanned beam display, red, green and blue light sources are modulated and mixed to generate the desired color and brightness. Low power solid-state lasers, laser diodes and light- emitting diodes are suitable light sources for the scanned beam display. Blue and green solid-state lasers are currently available but are useful only for scanned beam display applications where cost and size are less important. Miniaturized laser diodes are commercially available in red, and a number of companies are developing blue laser diodes in anticipation of high volume consumer electronics applications. Microvision is working with companies that have developed suitable green lasers to build prototype automotive head up displays and miniature projectors as well as other potential product offerings. Miniaturized light-emitting diodes are less expensive and consume less power than laser diodes. Microvision is working with companies that have developed custom red, blue and green light-emitting diodes that provide sufficient brightness for many scanned beam display applications. Microvision has built working prototypes of full-color scanned beam displays with these light-emitting diodes.

Microvision expects to continue using laser diodes and compact lasers for augmented vision and projection display applications that require enhanced brightness. Microvision intends to rely on third party developments or to contract with other companies to continue development light sources necessary to enable its planned products.

Optics. For applications where the scanned beam display is to be worn, it is desirable to have an exit pupil (the range within which the viewer's eye can move and continue to see the image) that is large enough to allow comfortable and consistent viewing of the display. Microvision has developed optics and system designs that accomplish this design objective. The company anticipates additional design and engineering of the optics and systems designs will improve the competitiveness of its display offerings from commercial applications. Microvision has refined optics designs for both monocular (one-eye) and biocular (two-eye) systems. Microvision also has developed a full binocular system, which incorporates two separate video channels (one for each eye) to provide the user with full stereoscopic viewing of three-dimensional imagery. Microvision's ongoing optics development is directed at the creation of optical systems that exhibit lower distortion, are lighter weight and are more cost-effective to manufacture than previous optical systems.

Current and Prospective Display Products

Integrated Photonics Module

The Company is developing a modular integrated photonics module that will be a common integrated subsystem in future display products. The integrated photonics module consists of a MEMS scanner, electronics to drive the MEMS scanner, a light source module, and electronics to drive the video input and output, system controller and buffer memory component. The Company believes that the modular integrated photonics module could be readily modified to meet OEM product requirements for different display product configurations. These product configurations may require modification of the integrated photonics module for a specific OEM product. The following are some of the potential products the Company is planning to develop based on the integrated photonics module.

Automotive Head-Up Display

During 2005, Microvision continued to improve upon its prototype head-up displays for automotive manufacturers and Tier 1 suppliers to automotive companies. These prototypes demonstrate that scanned beam display technology can be used in a head-up display that projects a day-light or night-time readable image onto the windscreen of an automobile to provide the vehicle operator with a variety of information related to the car's operation. The Company believes that its technology provides three distinct advantages over competing technologies for head- up display applications:

- Size- The Microvision prototype display is less than half the size of current competitive offerings. Total package size is a primary consideration in the design of an instrument panel for an automobile.
- Contrast Ratio - The Microvision prototype has a contrast ratio an order of magnitude higher than current competitive offerings. The high contrast ratio allows the driver to see the display in bright daylight and see though the display at night.
- Installation Cost - The Microvision prototype can be electronically optimized to the unique curvature of a particular automobile's windshield. The current competitive offerings must be manually adjusted during installation to match the varying curvature tolerances of different windshields.

Microvision's goal is to enter into an agreement with at least one Tier 1 supplier to develop and manufacture a head up display during 2006. The Tier 1 supplier would work with Microvision and the automobile manufacturers to integrate Microvision's head up display into an automotive instrument panel.

The automotive head up display market is highly competitive. The current competitive products are based on liquid crystal display or vacuum fluorescent display technology which is more mature than the scanned beam display technology. The Company's competitors in the head up display market have substantially greater financial, technical and other resources than Microvision and may develop further improvements that could reduce or eliminate the anticipated advantages of Microvision's proposed products.

Pico Projector

During 2005, the Company developed a prototype micro projector. The Company believes that the target of this development is a commercial hand held device or an embedded solution that can project full color images from a portable media source or mobile computer onto a surface chosen by the user. Several large consumer electronics companies are developing and conducting consumer trials of micro projectors based on very small display panel technologies. In January 2006, the Company demonstrated its prototype "pico projector" at the Consumer Electronics Show in Las Vegas. The Company's goal is to enter into an agreement that would result in development, manufacture and distribution of a pico projector based on the Company's planned integrated photonic module. The Company believes its scanned beam display technology will provide a smaller form factor than small projectors based on competing display technologies.

The consumer display market is highly competitive. The Company believes that the pico projector will compete with other projection display technologies as well as traditional flat panel displays. The Company's competitors in the consumer display market have substantially greater financial, technical and other resources than Microvision and may develop further improvements of screen display technology that could reduce or eliminate the anticipated advantages of Microvision's proposed products.

Full Color Eyewear

The Company believes that the integrated photonic module it is developing can be customized to enable displays that more closely resemble eyewear than other technologies allow. The Company is evaluating the market and technical risk associated with three distinct color eyewear solutions.

- Highly mobile "Glance-able" display: In this configuration, the user could glance down occasionally at a worn display. This device would be suitable for light business use such as mobile web surfing and reading e-mail. The Company believes that high resolution, high contrast, and small package size could be important differentiators between its scanned beam display solution and competing solutions.

- Look-around or see-through display: In this configuration, the user could view a full screen display in see-through or occluded mode. This configuration would be suitable for viewing longer pieces of streaming video for entertainment or business applications.
- Fully occluded immersive display: In this configuration, the user could view a very wide screen high resolution video stream. This configuration would be suitable for interactive gaming applications and simulators.

In any of these configurations, the Company believes that high resolution, high brightness, small package size, and lower cost could be important differentiators between its scanned beam display solution and competing solutions. The Company plans to evaluate potential designs for one or more of these potential solutions during 2006. The Company is working with potential partners in the consumer electronics industry to define the customer requirements for these solutions and determine if the scanned beam display technology has advantages over existing technologies for these potential product offerings. The Company expects that if it can be shown that the scanned beam display technology has significant advantage over existing technologies it will be able to attract partners to further develop, manufacture and distribute its potential products.

The consumer display market is highly competitive. The Company believes that any color eye wear product will compete primarily with LCD and OLED based solutions. The Company's competitors in the consumer display market have substantially greater financial, technical and other resources than Microvision and may develop further improvements of screen display technology that could reduce or eliminate the anticipated advantages of Microvision's proposed products.

Nomad

In March 2004, Microvision introduced a new version of the Nomad System. The Nomad Expert Technician System, ("Nomad") is a hands free wearable computer with a head-worn display that enables technicians and other mobile workers to overlay relevant information on their task thereby reducing task time. The new version is about 40% smaller, lighter and costs less to manufacture than the prior version. Microvision is working closely with transportation and manufacturing companies to develop the Nomad for truck and automotive maintenance applications. In maintenance applications, the automotive technician uses the Nomad to receive repair instructions and other information directly into his or her field of view while he or she is performing the repair. The Nomad functions as a wireless thin client computer and is linked to a remote server computer.

The Nomad has not gained the commercial acceptance the Company had planned when the Nomad was introduced. The Company has reduced its cost in manufacturing overhead, sales and marketing relating to Nomad, until it develops a go to market strategy that will be more successful. The Company is working with a small number of potential customers to define business cases for the Nomad. Defining the business case consists of studying the potential user's work environment, identifying operations that could be performed more economically using Nomad, conducting trials to demonstrate the cost savings, getting user feedback, making improvements to the Nomad, and then developing sales strategy and tools to demonstrate the advantage of the proven benefit. The Company expects it will require at least the first half of 2006 to define business cases for Nomad.

Microvision is producing Nomad at its headquarters facility in Washington State. Microvision is distributing the Nomad to end customers in the United States through its sales force. Microvision is also selling Nomad in Europe and Asia through a small number of independent manufacturer's representatives.

The Nomad competes with other products that bring information to the point of task, including laptop and notebook computers, tablet computers, and personal digital assistants. These other devices must be held, wrist mounted, or placed on a stationary object and the user must look away from the task to get information. In contrast, the Nomad is head-worn (i.e. hands free) and provides images to the user's eye with no screen to block the viewer's field of vision. Other companies are marketing head-worn displays, but the displays are generally occluded and typically provide a fraction of the full-page view provided by the Nomad. Microvision believes that Nomad provides higher brightness and higher contrast than competing devices and provides true "see through" capability. Microvision also believes that

the manufacturing cost in high volume of Nomad and potential future displays using its scanned beam display technology could be less than that of competing technologies, due principally to the lower cost of scanned beam display components and lower capital investment to build high volume manufacturing capacity compared to other competing technologies.

Current and Prospective Imaging Products

Flic

Microvision sells the Flic laser bar cod scanner, a hand held laser bar code scanner and the Flic Cordless Scanner, a Bluetooth version of the Flic Scanner. Flic Scanners feature a proprietary design that provides for lower power consumption and total operating cost than many other bar code scanners currently available. Microvision expects the sales volume for Flic Scanner will grow as more companies release products incorporating the Flic.

Flic Scanners are manufactured for Microvision by a contract manufacturer located in Batam, Indonesia. Microvision distributes branded and private- labeled scanners directly to end users through value added resellers, original equipment manufacturers and phone and internet orders.

The bar code scanning industry is highly competitive. Flic Scanners compete with existing laser wand and CCD imager scanners produced by established bar code scanner companies. Flic Scanners compete on the basis of price, form factor, and performance. The bar code industry is dominated by Symbol Technologies, which sells products that directly compete with the Flic and Flic Cordless products.

Image capture

Microvision is applying its scanned beam and other proprietary technology to develop products that capture images and other information. Such products include bar code readers and miniature high-resolution "laser cameras. In December 2004, Microvision entered into an agreement with Ethicon Endo-Surgery Inc. a subsidiary of Johnson & Johnson to integrate Microvision's scanned beam technology into certain medical products for human medical applications. Under the agreement, Microvision is developing prototype units that will be used in product evaluation.

Microvision believes that certain components of the scanned beam technology can also be used to develop two-dimensional bar code readers as well as high resolution laser cameras that have cost and performance advantages over existing imaging technologies for certain applications.

Business Strategy

Microvision's objective is to be a leading provider of scanned beam displays and image capture products and related technologies for a broad range of professional and consumer applications. Key elements of Microvision's strategy to achieve this objective include:

Strategic Partnering to Extend Marketing and Technical Reach

Microvision's key technologies have applications in several markets and products. Microvision has contracted with, and plans to continue to pursue, strategic partners who can provide distribution channels, resources and services that otherwise would require substantial time and additional cost for Microvision to develop independently. Microvision will select strategic partners to provide support depending on the specific requirements of markets and products.

Sale of Components or "Engines" Containing Scanning Technology

. Certain potential applications of the scanned beam display technology, such as automotive HUD or pico projector could require integration of Microvision's technology with other related technologies. In markets requiring high volume production of scanned beam components or

subsystems that can be integrated with other components, Microvision may provide designs for or the supply of components, subsystems and systems to original equipment manufacturers under licensing and/or agreements.

Engineering Services to Develop Custom Products

. Microvision expects that some customers will require unique designs for displays. Microvision expects that such relationships will generally involve a period of co- development during which engineering and marketing professionals from potential customers or original equipment manufacturers would work with Microvision's technical staff to specify, design and develop a product appropriate for the targeted market and application. Microvision would charge fees to its customers or original equipment manufacturers to fund the costs of the engineering effort incurred on such development projects. The nature of the relationships with such customers or original equipment manufacturers may vary from partner to partner depending on the proposed specifications for the scanned beam technology, the product to be developed, and the customers' or original equipment manufacturers' design, manufacturing and distribution capabilities. Microvision believes that by limiting its own direct manufacturing investment for consumer products, it will reduce the capital requirements and risks inherent in taking the scanned beam technology to the consumer market.

Licensing of Proprietary Technology to Original Equipment Manufacturers for Volume Manufacture of Products

. Microvision believes that, in consumer markets, the ability of personal display products to compete effectively is largely driven by the ability to price aggressively for maximum market penetration. Significant economies of scale in volume purchasing, manufacturing and distribution are important factors in driving costs down to achieve pricing objectives and profitability. Microvision may seek both initial license fees from such arrangements as well as ongoing per unit royalties.

Development of an Intellectual Property Portfolio.

Microvision believes that it can enhance its competitive position by reducing the cost and improving the performance of its scanned beam technology and by developing an extensive portfolio of intellectual property and proprietary rights. A key part of Microvision's technology development strategy includes developing and protecting (i) concepts relating to the function, design and application of scanned beam display systems; (ii) component technologies and integration techniques essential to the commercialization of the scanned beam display and image capture technologies that are expected to reduce the cost and improve the performance of the system; and (iii) component technologies and integration techniques that reduce technical requirements and accelerate the pace of commercial development. Microvision is continuing to develop a portfolio of patents and proprietary processes and techniques that relate directly to the functionality and commercial viability of scanned beam technologies.

Human Factors, Ergonomics and Safety

As part of its research and development activities, Microvision conducts ongoing research on the cognitive, physiological and ergonomic factors that must be addressed by products incorporating the scanned beam display technology and the safety of scanned beam display technology, including such issues as the maximum permissible laser exposure limits established by American National Standards Institute ("ANSI") and others. Researchers from the University of Washington Human Interface Technology Lab and other independent institutions have concluded that laser exposure to the eye resulting from use of the scanned beam displays under normal operating conditions would be below the calculated maximum permissible exposure level set by ANSI. The Nomad display has been certified as a Class 1 laser product ("safe for eye viewing") by Underwriters Laboratories.

Competitive Conditions

The information display industry is highly competitive. Microvision's products and the scanned beam display technology will compete with established manufacturers of miniaturized cathode ray tube and flat panel display devices. Microvision's competitors include companies such as Sony Corporation and Texas Instruments Incorporated, most of which competitors have substantially greater financial, technical and other resources than Microvision and many of which are developing alternative miniature display technologies. Microvision will also compete with other developers of miniaturized display devices. Microvision's competitors may succeed in developing information display technologies and products that could render the scanned beam display technology or Microvision's proposed products commercially infeasible or technologically obsolete.

The electronic information display industry has been characterized by rapid and significant technological advances. The scanned beam display technology and Microvision's proposed products may not remain competitive with such advances, and Microvision may not have sufficient funds to invest in new technologies, products or processes. Although Microvision believes that its scanned beam display technology and proposed display products could deliver images of a quality and resolution substantially better than those of commercially available miniaturized liquid crystal displays and cathode ray tube based display products, manufacturers of liquid crystal displays and cathode ray tubes may develop further improvements of screen display technology that could reduce or eliminate the anticipated advantages of Microvision's proposed products.

Microvision competes with other companies in the display industry and other technologies for government funding. In general, Microvision's government customers plan to integrate Microvision's technology into larger systems. Ongoing contracts are awarded based on Microvision's past performance on government contracts, the customer's progress in integrating Microvision's technology into the customer's overall program objectives, and the status of the customer's overall program.

The image capture industry is also highly competitive. Microvision's current and planned bar code products will compete with existing laser and wand type scanners produced by established bar code companies. Microvision's current products compete on the basis of price and performance. The bar code industry is dominated by Symbol Technologies. Symbol Technologies sells products that directly compete with Microvision's current and planned bar code products.

Intellectual Property and Proprietary Rights

University of Washington

In 1993, Microvision acquired the exclusive rights to the Virtual Retinal Display technology under a license agreement with the University of Washington. Additional development of the Virtual Retinal Display technology took place at the University of Washington Human Interface Technology Laboratory pursuant to Microvision's research agreement. The University of Washington has received eighty-seven patents including forty-six U.S. patents on the Virtual Retinal Display technology and has an additional four U.S. patent applications pending in the United States and twenty-three foreign counterpart applications in certain foreign countries.

Microvision's ability to compete effectively in the information display market will depend, in part, on its ability and the ability of the University of Washington and other licensors to maintain the proprietary nature of the Virtual Retinal Display technology or other technologies, including claims related to the ability to superimpose images on the user's field of view, a Virtual Retinal Display using optical fibers, an expanded exit pupil and the mechanical resonance scanner.

The Virtual Retinal Display technology comprises a substantial part of Microvision's scanned beam display technology. The Virtual Retinal Display technology was originally developed at the University of Washington's Human Interface Technology Lab. The scope of the license covers all commercial uses of the Virtual Retinal Display technology worldwide, including the right to grant sublicenses. The license expires upon the expiration of the last of the University of Washington's patents that relate to the Virtual Retinal Display, unless sooner terminated by Microvision or the University of Washington as discussed below. In granting the license, the University of Washington retained limited, non-commercial rights with respect to the Virtual Retinal Display technology, including the right to use the technology for non-commercial research and for instructional purposes and the right to comply with applicable laws regarding the non-exclusive use of the technology by the United States government. The University of Washington also has the right to consent to Microvision's sublicensing arrangements and to the prosecution and settlement by Microvision of infringement disputes. In addition, the University of Washington retains the right to publish for academic purposes information it creates regarding the Virtual Retinal Display technology.

Microvision could lose the exclusivity under the license agreement if it fails to respond to any infringement action relating to the Virtual Retinal Display technology within 90 days of learning of such claim. In the event of the termination of its exclusivity, Microvision would lose its rights to grant sublicenses and would no longer have the first right to take action against any alleged infringement. In addition, each of Microvision or the University of Washington has the right to terminate the license agreement in the event that the other party fails to cure a material breach within 30 days of written notice. Microvision may terminate the license agreement at any time by serving 90 days prior written notice on the University of Washington. In the event of any termination of the license agreement, the license granted to Microvision would terminate.

Under the terms of the license agreement, Microvision agreed to pay a non- refundable fee of $5.1 million, which was fully paid in August 1997, and to issue to the University of Washington shares of Microvision's common stock, which shares have been issued. In addition, the University of Washington is entitled to receive ongoing royalties. Microvision also entered into a research agreement with the University of Washington to further develop the Virtual Retinal Display technology, payments of which were credited to the license fee.

Other Licenses and Intellectual Property

During 1998, Microvision entered into a license agreement with a third party whereby it acquired the exclusive license to certain intellectual property related to the design and fabrication of micro miniature devices using semiconductor fabrication techniques. The licensor has received thirty-eight patents including eighteen U.S. patents and has three patent applications pending pertaining to the Microvision field of use.

Microvision also generates intellectual property as a result of its ongoing performance on development contracts and as a result of its internal research and development activities. Microvision has over one hundred and twenty patent applications and received fifty patents including thirty-four U.S. patents in its own name resulting from these activities. The inventions covered by such applications generally relate to component miniaturization, specific implementation of various system components and design elements to facilitate mass production.

Microvision considers protection of these key enabling technologies and components to be a fundamental aspect of its strategy to penetrate diverse markets with unique products. As such, it intends to continue to develop its portfolio of proprietary and patented technologies at the system, component and process levels.

Microvision also relies on unpatented proprietary technology. To protect its rights in these areas, Microvision requires all employees and, where appropriate, contractors, consultants, advisors and collaborators, to enter into confidentiality and non-compete agreements. There can be no assurance, however, that these agreements will provide meaningful protection for Microvision's trade secrets, know-how or other proprietary information in the event of any unauthorized use, misappropriation or disclosure of such trade secrets, know-how or other proprietary information.

Microvision has registered the word trademarks "NOMAD", "FLIC", "FLICPRINT", "FLICWARE", "MICROHUD", and the design marks "NOMAD" (stylized) and "O" (design) with the United States Patent and Trademark Office. Microvision has filed for trademark registration for the "tri-curve" logo design mark with the United States Patent and Trademark Office. Microvision has registered the word marks "NOMAD", "FLIC", and "MICROHUD"; and the design trademarks "NOMAD" (stylized) and "O" (design) with various foreign jurisdictions. Microvision has filed for registration of various other marks with various foreign jurisdictions.

Additional Information

Microvision performs research and development to design and develop the integrated photonics module and modifications to the integrated photonics module that will be required for specific applications. Research and development expense for the Company for the fiscal years ended December 31, 2005, 2004 and 2003 was $6.6 million, $14.7 million, and $23.3 million, respectively. Excluding Lumera, research and development expense was

$6.6 million, $13.6 million and $16.8 million, respectively.

Prior to 2004, substantially all of Microvision's revenue has been generated from development contracts to develop the scanned beam display technology to meet customer specifications. Microvision's customers have included both the United States government and commercial enterprises. In 2005, 35% of revenue was derived from performance on development contracts with the United States government, 42% from performance on development contracts with commercial customers and the remainder from sales of Nomad and Flic units. In 2005, Ethicon Endo-Surgery Inc. accounted for 33%, and a U. S. government customer accounted for 27% of total revenue. In 2004, 42% of revenue was derived from performance on development contracts with the United States government, 35% from performance on development contracts with commercial customers and the remainder from sales of Nomad and Flic units. In 2004, one commercial customer accounted for 11% of total of total revenue. Each of Microvision's contracts with the United States government can be terminated for convenience by the United States government at any time. See Management's Discussion and Analysis of Financial Condition and Results of Operations.

Microvision had a backlog of $3.4 million at December 31, 2005 compared to a backlog of $7.1 million at December 31, 2004. The backlog at December 31, 2005, is composed of $2.8 million in development contracts, including amendments, entered into through December 31, 2005 and $579,000 in product orders. Microvision plans to complete all of the backlog contracts during 2006.

Employees

As of March 1, 2006, Microvision had 142 employees.

Further Information

Microvision was founded in 1993 as a Washington corporation and reincorporated in 2003 under the laws of the State of Delaware. Our principal office is located at 6222 185th Avenue NE, Redmond WA 98052 and our telephone number is 425-415-6847.

Microvision's Internet address is www.microvision.com. Microvision makes available free of charge its annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities and Exchange Act of 1934 as soon as reasonably practicable after it electronically files such material with, or furnishes it to, the SEC. Investors can access this material by visiting Microvision's website, clicking on "Investors," and then clicking on "SEC Filings."

ITEM 1A. RISK FACTORS.

Risk Factors Relating to the Microvision Business

We have a history of operating losses and expect to incur significant losses in the future.

We have had substantial losses since our inception. We cannot assure you that we will ever become or remain profitable.

- As of December 31, 2005, we had an accumulated deficit of $215.7 million.
- We incurred consolidated net losses of $128.1 million from inception through 2002, $26.2 million in 2003, $33.2 million in 2004 and $28.2 million in 2005.

The likelihood of our success must be considered in light of the expenses, difficulties and delays frequently encountered by companies formed to develop and market new technologies. In particular, our operations to date have focused primarily on research and development of the scanned beam technology and development of demonstration

units. We introduced our first two commercial products during 2002. We are unable to accurately estimate future revenues and operating expenses based upon historical performance.

We cannot be certain that we will succeed in obtaining additional development contracts or that we will be able to obtain substantial customer orders for our products. In light of these factors, we expect to continue to incur substantial losses and negative cash flow at least through 2006 and likely thereafter. We cannot be certain that we will achieve positive cash flow at any time in the future.

We will require additional capital to fund our operations and to implement our business plan. If we do not obtain additional capital, we may be required to curtail our operations substantially. Raising additional capital may dilute the value of current shareholders' shares.

Based on our current operating plan and budgeted cash requirements, we expect our cash to fund operations through July 2006. We will require additional capital to continue to fund our operations, including to:

- Further develop the scanned beam technology.
- Develop and protect our intellectual property rights.
- Fund long-term marketing and business development opportunities; and
- Add manufacturing capacity.

The Company can raise limited additional cash through the sale of its Lumera common stock in the public market under Rule 144 of the Securities Act of 1933 or through a private placement. As of March 1, 2006, Microvision owns approximately 322,000 shares of Lumera common stock that have not been pledged as collateral for the Company's convertible notes issued as of March 11, 2005 and December 1, 2005. Based on the March 1, 2006 closing price of $4.10, the Lumera shares that have not been pledged as collateral have a market value of approximately $1.3 million. The Company may be deemed to be an affiliate of Lumera. Under Rule 144 of the Securities Act, an affiliate is entitled to sell within any three-month period a number of shares of Lumera common stock that does not exceed the greater of 1% of the then outstanding shares of Lumera common stock or the average weekly trading volume of Lumera common stock on the NASDAQ National Market during the four calendar weeks preceding the filing of a notice of the sale on Form 144. The immediate sale of Lumera stock in the public market could have a negative impact on the Lumera stock price.

Our capital requirements will depend on many factors, including, but not limited to, the rate at which we can, directly or through arrangements with original equipment manufacturers, introduce products incorporating the scanned beam and image capture technologies and the market acceptance and competitive position of such products. If revenues are less than we anticipate, if the level and mix of revenues vary from anticipated amounts and allocations or if expenses exceed the amounts budgeted, we may require additional capital earlier than July 2006 to further the development of our technologies, for expenses associated with product development, and to respond to competitive pressures or to meet unanticipated development difficulties. In addition, our operating plan provides for the development of strategic relationships with systems and equipment manufacturers that may require additional investments by us.

Additional financing may not be available to us or, if available, may not be available on terms acceptable to us on a timely basis. Raising additional capital may involve issuing securities with rights and preferences that are senior to our common stock and may dilute the value of current shareholders' shares. If adequate funds are not available to satisfy either short-term or long-term capital requirements, we may be required to limit our operations substantially. This limitation of operations may include reductions in staff and operating costs as well as reductions in capital expenditures and investment in research and development.

The value of our investment in Lumera may decrease.

Lumera's stock price is subject to fluctuation and may decrease, lowering the value of our investment. As of March 1, 2006 we own approximately 12% of Lumera's common stock. Since we hold a large percentage of Lumera's common

stock, if an active market does not develop or is not sustained, it may be difficult for us to sell our shares of Lumera's common stock at an attractive price or at all. The likelihood of Lumera's success, and the value of the common stock we hold, must be considered in light of the risks frequently encountered by early stage companies, especially those formed to develop and market new technologies. These risks include Lumera's potential inability to establish product sales and marketing capabilities to establish and maintain markets for their potential products; and to continue to develop and upgrade their technologies to keep pace with changes in technology and the growth of markets using polymer materials. If Lumera is unsuccessful in meeting these challenges, its stock price, and the value of our investment, could decrease.

Our convertible notes may adversely impact our common stockholders or limit our ability to obtain additional financing.

In March 2005 and December 2005, we issued convertible notes. Among other provisions, these notes include material limitations on our ability to incur additional debt or incur liens while the convertible notes are outstanding. These limitations could materially adversely affect our ability to raise funds we expect to need in 2006 and 2007.

We cannot be certain that the scanned beam technology or products incorporating this technology will achieve market acceptance. If the scanned beam technology does not achieve market acceptance, our revenues may not grow.

Our success will depend in part on customer acceptance of the scanned beam technology. The scanned beam technology may not be accepted by manufacturers who use display technologies in their products, by systems integrators who incorporate our products into their products or by end users of these products. To be accepted, the scanned beam technology must meet the expectations of our potential customers in the defense, industrial, medical and consumer markets. If our technology fails to achieve market acceptance, we may not be able to continue to develop the scanned beam technology.

It may become more difficult to sell our stock in the public market.

Our common stock is listed for quotation on The NASDAQ National Market. To keep our listing on this market, we must meet NASDAQ's listing maintenance standards. If we are unable to continue to meet NASDAQ's listing maintenance standards, our common stock could be delisted from The NASDAQ National Market. If our common stock were delisted, we likely would seek to list the common stock on the NASDAQ SmallCap Market, the American Stock Exchange or on a regional stock exchange. Listing on such other market or exchange could reduce the liquidity for our common stock. If our common stock were not listed on the SmallCap Market or an exchange, trading of our common stock would be conducted in the over-the-counter market on an electronic bulletin board established for unlisted securities or directly through market makers in our common stock. If our common stock were to trade in the over-the-counter market, an investor would find it more difficult to dispose of, or to obtain accurate quotations for the price of, the common stock. A delisting from The NASDAQ National Market and failure to obtain listing on such other market or exchange would subject our securities to so-called penny stock rules that impose additional sales practice and market-making requirements on broker-dealers who sell or make a market in such securities. Consequently, removal from The NASDAQ National Market and failure to obtain listing on another market or exchange could affect the ability or willingness of broker-dealers to sell or make a market in our common stock and the ability of purchasers of our common stock to sell their securities in the secondary market. In addition, when the market price of our common stock is less than $5.00 per share, we become subject to penny stock rules even if our common stock is still listed on The NASDAQ National Market. While the penny stock rules should not affect the quotation of our common stock on The NASDAQ National Market, these rules may further limit the market liquidity of our common stock and the ability of investors to sell our common stock in the secondary market. During the first and second quarter of 2003, the third quarter of 2004, the second quarter and fourth quarter of 2005, and the first quarter of 2006, the market price of our stock traded below $5.00 per share. On March 1, 2006 the closing price of our stock was $3.46.

Our lack of the financial and technical resources relative to our competitors may limit our revenues, potential profits, overall market share or value.

Our current products and potential future products will compete with established manufacturers of existing products and companies developing new technologies. Many of our competitors have substantially greater financial, technical and other resources than us. Because of their greater resources, our competitors may develop products or technologies that are superior to our own. The introduction of superior competing products or technologies could result in reduced revenues, lower margins or loss of market share, any of which could reduce the value of our business.

We may not be able to keep up with rapid technological change and our financial results may suffer.

The information display industry has been characterized by rapidly changing technology, accelerated product obsolescence and continuously evolving industry standards. Our success will depend upon our ability to further develop the scanned beam technology and to cost effectively introduce new products and features in a timely manner to meet evolving customer requirements and compete with competitors' product advances.

We may not succeed in these efforts because of:

- delays in product development,
- lack of market acceptance for our products, or
- lack of funds to invest in product development and marketing.

The occurrence of any of the above factors could result in decreased revenues, market share and value.

We could face lawsuits related to our use of the scanned beam technology or other technologies. Defending these suits would be costly and time consuming. An adverse outcome in any such matter could limit our ability to commercialize our technology and products, reduce our revenues and increase our operating expenses.

We are aware of several patents held by third parties that relate to certain aspects of scanned beam displays and image capture products. These patents could be used as a basis to challenge the validity, limit the scope or limit our ability to obtain additional or broader patent rights of our patents or patents we have licensed. A successful challenge to the validity of our patents or patents we have licensed could limit our ability to commercialize the scanned beam technology and other technologies and, consequently, materially reduce our revenues. Moreover, we cannot be certain that patent holders or other third parties will not claim infringement by us with respect to current and future technology. Because U.S. patent applications are held and examined in secrecy, it is also possible that presently pending U.S. applications will eventually be issued with claims that will be infringed by our products or the scanned beam technology. The defense and prosecution of a patent suit would be costly and time consuming, even if the outcome were ultimately favorable to us. An adverse outcome in the defense of a patent suit could subject us to significant cost, to require others and us to cease selling products that incorporate scanned beam technology, to cease licensing scanned beam technology or to require disputed rights to be licensed from third parties. Such licenses, if available, would increase our operating expenses. Moreover, if claims of infringement are asserted against our future co-development partners or customers, those partners or customers may seek indemnification from us for damages or expenses they incur.

Our planned future products are dependent on advances in technology by other companies.

We rely on and will continue to rely on technologies, such as light sources and optical components that are developed and produced by other companies. The commercial success of certain of our planned future products will depend in part on advances in these and other technologies by other companies. Due to the current business environment, many companies that are developing new technologies are reducing expenditures on research and development. This may delay the development and commercialization of components we would use to manufacture certain of our planned

future products.

Our products may be subject to future health and safety regulations that could increase our development and production costs.

Products incorporating scanned beam display technology could become subject to new health and safety regulations that would reduce our ability to commercialize the scanned beam display technology. Compliance with any such new regulations would likely increase our cost to develop and produce products using the scanned beam display technology and adversely affect our financial results.

If we cannot manufacture products at competitive prices, our financial results will be adversely affected.

To date, we have produced limited quantities of our Nomad and Flic products and demonstration units for research, development and demonstration purposes. The cost per unit for these units currently exceeds the level at which we could expect to profitably sell these products. If we cannot lower our cost of production, we may face increased demands on our financial resources, possibly requiring additional equity and/or debt financing to sustain our business operations.

Our future growth will suffer if we do not achieve sufficient market acceptance of our products to compete effectively.

Our success depends, in part, on our ability to gain acceptance of our current and future products by a large number of customers. Achieving market- based acceptance for our products will require marketing efforts and the expenditure of financial and other resources to create product awareness and demand by potential customers. We may be unable to offer products consistently or at all that compete effectively with products of others on the basis of price or performance. Failure to achieve broad acceptance of our products by potential customers and to effectively compete would have a material adverse effect on our operating results.

Because we plan to continue using foreign contract manufacturers, our operating results could be harmed by economic, political, regulatory and other factors in foreign countries.

We currently use a contract manufacturer in Asia to manufacture our Flic product, and we plan to continue using foreign manufacturers to manufacture some of our other products where appropriate. These international operations are subject to inherent risks, which may adversely affect us, including:

- political and economic instability;
- high levels of inflation, historically the case in a number of countries in Asia;
- burdens and costs of compliance with a variety of foreign laws;
- foreign taxes; and
- changes in tariff rates or other trade and monetary policies.

If we experience delays or failures in developing commercially viable products, we may have lower revenues.

We began production of the current version of our Nomad product in the first quarter of 2004. In September 2002, we introduced our Flic product. In addition, we have developed demonstration units incorporating the scanned beam technology. However, we must undertake additional research, development and testing before we are able to develop additional products for commercial sale. Product development delays by us or our potential product development partners, or the inability to enter into relationships with these partners, may delay or prevent us from introducing products for commercial sale.

If we cannot supply products in commercial quantities, we will not achieve commercial success.

We are developing our capability to manufacture products in commercial quantities. Our success depends in part on our ability to provide our components and future products in commercial quantities at competitive prices. Accordingly, we will be required to obtain access, through business partners or contract manufacturers, to manufacturing capacity and processes for the commercial production of our expected future products. We cannot be certain that we will successfully obtain access to sufficient manufacturing resources. Future manufacturing limitations of our suppliers could result in a limitation on the number of products incorporating our technology that we are able to produce.

If our licensors and we are unable to obtain effective intellectual property protection for our products and technology, we may be unable to compete with other companies.

Intellectual property protection for our products is important and uncertain. If we do not obtain effective intellectual property protection for our products, processes and technology, we may be subject to increased competition. Our commercial success will depend in part on our ability and the ability of the University of Washington and our other licensors to maintain the proprietary nature of the scanned beam display and other key technologies by securing valid and enforceable patents and effectively maintaining unpatented technology as trade secrets. We try to protect our proprietary technology by seeking to obtain United States and foreign patents in our name, or licenses to third-party patents, related to proprietary technology, inventions, and improvements that may be important to the development of our business. However, our patent position and the patent position of the University of Washington and other licensors involve complex legal and factual questions. The standards that the United States Patent and Trademark Office and its foreign counterparts use to grant patents are not always applied predictably or uniformly and can change. Additionally, the scope of patents are subject to interpretation by courts and their validity can be subject to challenges and defenses, including challenges and defenses based on the existence of prior art. Consequently, we cannot be certain as to the extent to which we will be able to obtain patents for our new products and technology or the extent to which the patents that we already own or license from others protect our products and technology. Reduction in scope of protection or invalidation of our licensed or owned patents, or our inability to obtain new patents, may enable other companies to develop products that compete with ours on the basis of the same or similar technology.

We also rely on the law of trade secrets to protect unpatented know-how and technology to maintain our competitive position. We try to protect this know-how and technology by limiting access to the trade secrets to those of our employees, contractors and partners with a need to know such information and by entering into confidentiality agreements with parties that have access to it, such as our employees, consultants and business partners. Any of these parties could breach the agreements and disclose our trade secrets or confidential information, or our competitors might learn of the information in some other way. If any trade secret not protected by a patent were to be disclosed to or independently developed by a competitor, our competitive position could be materially harmed.

We could be exposed to significant product liability claims that could be time-consuming and costly, divert management attention and adversely affect our ability to obtain and maintain insurance coverage.

We may be subject to product liability claims if any of our product applications are alleged to be defective or cause harmful effects. For example, because our scanned beam displays are designed to scan a low power beam of colored light into the user's eye, the testing, manufacture, marketing and sale of these products involve an inherent risk that product liability claims will be asserted against us. Product liability claims or other claims related to our products, regardless of their outcome, could require us to spend significant time and money in litigation, divert management time and attention, require us to pay significant damages, harm our reputation or hinder acceptance of our products. Any successful product liability claim may prevent us from obtaining adequate product liability insurance in the future on commercially desirable or reasonable terms. An inability to obtain sufficient insurance coverage at an acceptable cost or otherwise to protect against potential product liability claims could prevent or inhibit the commercialization of our products.

We rely heavily on a limited number of development contracts with the U.S. government, which are subject to immediate termination by the government for convenience at any time, and the termination of one or more of these contracts could have a material adverse impact on our operations.

During 2005 and 2004, 35% and 42%, respectively, of Microvision's consolidated revenue was derived from performance on a limited number of development contracts with the U.S. government. Therefore, any significant disruption or deterioration of our relationship with the U.S. government would significantly reduce our revenues. Our government programs must compete with programs managed by other contractors for limited amounts and uncertain levels of funding. The total amount and levels of funding are susceptible to significant fluctuations on a year-to-year basis. Our competitors continuously engage in efforts to expand their business relationships with the government and are likely to continue these efforts in the future. Our contracts with the government are subject to immediate termination by the government for convenience at any time. The government may choose to use contractors with competing display technologies or it may decide to discontinue any of our programs altogether. In addition, those development contracts that we do obtain require ongoing compliance with applicable government regulations. Termination of our development contracts, a shift in government spending to other programs in which we are not involved, a reduction in government spending generally, or our failure to meet applicable government regulations could have severe consequences for our results of operations.

Our products have long sales cycles, which make it difficult to plan our expenses and forecast our revenues.

Our products have lengthy sales cycles that involve numerous steps including determination of a product application, exploring the technical feasibility of a proposed product, evaluating the costs of manufacturing a product and manufacturing or contracting out the manufacturing of the product. Our long sales cycle, which can last several years, makes it difficult to predict the quarter in which sales will occur. Delays in sales could cause significant variability in our revenues and operating results for any particular quarterly period.

Our development contracts may not lead to products that will be profitable.

Our developmental contracts, including without limitation those discussed in this document are exploratory in nature and are intended to develop new types of products for new applications. These efforts may prove unsuccessful and these relationships may not result in the development of products that will be profitable.

Our revenues are highly sensitive to developments in the defense industry.

Our revenues to date have been derived principally from product development research relating to defense applications of the scanned beam display technology. We believe that development programs and sales of potential products in this market will represent a significant portion of our future revenues. Developments that adversely affect the defense sector, including delays in government funding and a general economic downturn, could cause our revenues to decline substantially.

Our Virtual Retinal Display technology depends on our licenses from the University of Washington. If we lose our rights under the licenses, our operations would be adversely affected.

We have acquired the exclusive rights to the Virtual Retinal Display under a license from the University of Washington. The license expires upon expiration of the last of the University of Washington's patents that relate to this technology, which we currently anticipate will not occur until after 2011. We could lose our exclusivity under the license if we fail to respond to an infringement action or fail to use our best efforts to commercialize the licensed technology. In addition, the University of Washington may terminate the license upon our breach and has the right to consent to all sublicense arrangements. If we were to lose our rights under the license, or if the University of Washington were to refuse to consent to future sublicenses, we would lose a competitive advantage in the market, and may even lose the ability to commercialize our products completely. Either of these results could substantially

decrease our revenues.

We are dependent on third parties in order to develop, manufacture, sell and market our products.

Our strategy for commercializing the scanned beam technology and products incorporating the scanned beam technology includes entering into cooperative development, manufacturing, sales and marketing arrangements with corporate partners, original equipment manufacturers and other third parties. We cannot be certain that we will be able to negotiate arrangements on acceptable terms, if at all, or that these arrangements will be successful in yielding commercially viable products. If we cannot establish these arrangements, we would require additional capital to undertake such activities on our own and would require extensive manufacturing, sales and marketing expertise that we do not currently possess and that may be difficult to obtain. In addition, we could encounter significant delays in introducing the scanned beam technology or find that the development, manufacture or sale of products incorporating the scanned beam technology would not be feasible. To the extent that we enter into cooperative development, sales and marketing or other joint venture arrangements, our revenues will depend upon the performance of third parties. We cannot be certain that any such arrangements will be successful.

Loss of any of our key personnel could have a negative effect on the operation of our business.

Our success depends on our executive officers and other key personnel and on the ability to attract and retain qualified new personnel. Achievement of our business objectives will require substantial additional expertise in the areas of sales and marketing, research and product development and manufacturing. Competition for qualified personnel in these fields is intense, and the inability to attract and retain additional highly skilled personnel, or the loss of key personnel, could reduce our revenues and adversely affect our business.

We are dependent on a small number of customers for our revenue. Our quarterly performance may vary substantially and this variance, as well as general market conditions, may cause our stock price to fluctuate greatly and potentially expose us to litigation.

Our revenues to date have been generated primarily from a limited number of development contracts with U.S. government entities and commercial partners. Our quarterly operating results may vary significantly based on:

- reductions or delays in funding of development programs involving new information display technologies by the U.S. government or our current or prospective commercial partners;
- changes in evaluations and recommendations by any securities analysts following our stock or our industry generally;
- announcements by other companies in our industry;
- changes in business or regulatory conditions;
- announcements or implementation by our competitors of technological innovations or new products;
- the status of particular development programs and the timing of performance under specific development agreements;
- economic and stock market conditions; or
- other factors unrelated to our company or industry.

In one or more future quarters, our results of operations may fall below the expectations of securities analysts and investors and the trading price of our common stock may decline as a consequence. In addition, following periods of volatility in the market price of a company's securities, shareholders often have instituted securities class action litigation against that company. If we become involved in a class action suit, it could divert the attention of management, and, if adversely determined, could require us to pay substantial damages.

If we fail to manage expansion effectively, our revenue and expenses could be adversely affected.

Our ability to successfully offer products and implement our business plan in a rapidly evolving market requires an effective planning and management process. We have significantly expanded the scope of our operations. The growth in business and relationships with customers and other third parties has placed, and will continue to place, a significant strain on our management systems and resources. We will need to continue to improve our financial and

managerial controls, reporting systems and procedures and will need to continue to train and manage our work force.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None

ITEM 2. PROPERTIES

The Company currently leases approximately 67,000 square feet of combined use office, laboratory and manufacturing space at its headquarters facility in Redmond, Washington. The 90 month lease expires in 2013.

The Company also currently leases approximately 92,500 square feet of combined use office, laboratory and manufacturing space at its former headquarters facility in Bothell, Washington. The seven-year lease expires in April 2006. Lumera subleases approximately 18,000 square feet of space from Microvision within the Company's facility in Bothell, Washington which will expire in April 2006.

ITEM 3. LEGAL PROCEEDINGS

The Company is subject to various claims and pending or threatened lawsuits in the normal course of business. The Company is not currently party to any legal proceedings that management believes the adverse outcome of which would have a material adverse effect on the Company's financial position, results of operations or cash flows.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

There were no matters submitted to a vote of shareholders during the fourth quarter of the year ending December 31, 2005.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY RELATED SHAREHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITES.

The Company's common stock trades on The NASDAQ National Market under the symbol "MVIS." As of March 1, 2006, there were 377 holders of record of 25,243,000 shares of common stock outstanding. The Company has never declared or paid cash dividends on the common stock. The Company currently anticipates that it will retain all future earnings to fund the operation of its business and does not anticipate paying dividends on the common stock in the foreseeable future.

The Company's common stock began trading publicly on August 27, 1996. The quarterly high and low sales prices of the Company's common stock for each full quarterly period in the last two fiscal years and the year to date as reported by The NASDAQ National Market are as follows:

	Common Stock	
Quarter Ended	**HIGH**	**LOW**
2004		
March 31, 2004	$ 10.93	$ 7.34
June 30, 2004	10.00	5.06
September 30, 2004	8.95	3.75
December 31, 2004	8.00	5.04
2005		

March 31, 2005	$ 7.70	$ 5.03
June 30, 2005	6.77	4.15
September 30, 2005	6.49	5.04
December 31, 2005	6.53	3.02
2006		
January 1, 2006 to March 1, 2006	$ 4.25	$ 3.05

ITEM 6. SELECTED FINANCIAL DATA

A summary of selected financial data as of and for the five years ended December 31, 2005 is set forth below:

			Years En
	2005	2004	2003
		(in thousands, exce	
Statement of Operations Data:			
Revenue	$ 14,746	$ 11,418	$ 14,65
Net loss available for common shareholders	(30,284)	(33,543)	(26,16
Basic and diluted net loss per share	(1.35)	(1.56)	(1.4
Weighted average shares outstanding basic and diluted	22,498	21,493	17,94
Balance Sheet Data:			
Cash and cash equivalents	$ 6,860	$ 1,268	$ 10,70
Investments available-for-sale	--	--	11,07
Working capital	(4,723)	903	19,78
Total assets	23,363	25,538	33,91
Long-term liabilities	4,412	52	2,20
Mandatorily redeemable preferred stock	4,166	7,647	-
Total shareholders' equity	(3,509)	7,190	23,29

Lumera was deconsolidated in July 2004.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Overview

The Company commenced operations in May 1993 to develop and commercialize technology for displaying images and information onto the retina of the eye. In 1993, the Company acquired an exclusive license to the Virtual Retinal Display technology from the University of Washington and entered into a research agreement with the University of Washington to further develop the Virtual Retinal Display technology. The Company has continued to develop the Virtual Retinal Display technology as part of its broader research and development efforts relating to the scanned beam technology.

In February 2004, Microvision introduced a new version of its see-through monochrome head-worn display called Nomad Expert Technician System. The Company also produces and sells Flic, a hand-held bar code scanner. The Company has also developed demonstration scanned beam displays, including hand-held and head-worn color versions and is currently refining and developing its scanned beam display technology for potential medical, defense, industrial, aerospace and consumer applications. The Company expects to continue funding prototype and demonstration versions of products incorporating the scanned beam technology at least through 2006. Future revenues, profits and cash flow and the Company's ability to achieve its strategic objectives as described herein will depend on a number of factors, including acceptance of the scanned beam technology by various industries and original equipment manufacturers, market acceptance of products incorporating the scanned beam technology and the

technical performance of such products.

The Company has incurred substantial losses since its inception and expects to incur a substantial loss during the year ended December 31, 2006.

Key Accounting Policies and Estimates

The Company's discussions and analysis of its financial condition and results of operations are based upon the Company's consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires the Company to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent liabilities. On an on-going basis, the Company evaluates its estimates, including those related to revenue recognition, contract losses, bad debts, investments and contingencies and litigation. The Company bases its estimates on historical experience, terms of existing contracts, its evaluation of trends in the display and image capture industries, information provided by its current and prospective customers and strategic partners, information available from other outside sources, and on various other assumptions management believes 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 may differ from these estimates under different assumptions or conditions.

The Company believes the following key accounting policies require its more significant judgments and estimates used in the preparation of its consolidated financial statements:

Revenue Recognition

. The Company recognizes contract revenue as work progresses on long-term, cost plus fixed fee and fixed price contracts using the percentage-of-completion method, which relies on estimates of total expected contract revenue and costs. The Company uses this revenue recognition methodology because it can make reasonably dependable estimates of the revenue and costs. Recognized revenues are subject to revisions as the contract progresses to completion and actual revenue and cost become certain. Revisions in revenue estimates are reflected in the period in which the facts that give rise to the revision become known.

Revenue from product shipments is recognized in accordance with Staff Accounting Bulletin No. 104 "Revenue Recognition." Revenue is recognized when there is sufficient evidence of an arrangement, the selling price is fixed and determinable and collection is reasonably assured. Revenue for product shipments is recognized upon acceptance of the product by the customer or expiration of the contractual acceptance period, after which there are no rights of return. Provisions are made for warranties at the time revenue is recorded. Warranty expense was not material for any periods presented.

Losses on Uncompleted Contracts

. The Company maintains an allowance for estimated losses if a contract has an estimated cost to complete that is in excess of the remaining contract value. The entire estimated loss is recorded in the period in which the loss is first determined. The Company determines the estimated cost to complete a contract through a detail review of the work to be completed, the resources available to complete the work and the technical difficulty of the remaining work. If the actual cost to complete the contract is higher than the estimated cost, the entire loss is recognized. The actual cost to complete a contract can vary significantly from the estimated cost, due to a variety of factors including availability of technical staff, availability of materials and technical difficulties that arise during a project. Most of the Company's development contracts are cost plus fixed fee type contracts. Under these types of contracts, the Company is not required to spend more than the contract value to complete the contracted work.

Allowance for uncollectible receivables

. The Company maintains allowances for uncollectible receivables, including accounts receivable, cost and estimated earnings in excess of billings on uncompleted contracts and receivables from related parties. The Company reviews several factors in determining the allowances including the customer's past payment history and financial condition. If the financial condition of our customers or the related parties with

whom the Company has receivables were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances could be required.

Inventory.

The Company values inventory at the lower of cost or market with cost determined on a weighted average cost basis. The Company reviews several factors in determining the market value of its inventory including evaluating the replacement cost of the raw materials and the net realizable value of the finished goods. If we do not achieve our targeted sales prices, if market conditions for our components or products were to decline or if we do not achieve our sales forecast, additional reductions in the carrying value of the inventory would be required.

Warrants and Derivatives.

The Company has issued convertible notes that include rights to convert the notes into Microvision common stock. The Company also issued warrants to purchase common stock in connection with the notes. The Company accounts for these derivatives and warrants under the guidance provided by FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities and* Emerging Issues Task Force Issue No. 00-19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock.* The Company uses the Black Scholes option pricing model to estimate the value of these instruments. The Company uses the Black Scholes model because it is widely accepted and provides comparability across a wide range of similar companies. The use of the Black Scholes model requires management to evaluate a range of estimates and determine the reasonable estimate of future stock volatility and interest rates. Changes in these estimates could result in a materially different valuation of the instruments. Other models for valuing these instruments exist and the use of an alternative model could result in a materially different valuation of the instruments.

Litigation.

The Company believes that the probability of an unfavorable outcome to any potential pending or threatened litigation is low and therefore has not recorded an accrual for any potential loss. The Company's current estimated range of liability related to any potential pending litigation is based on claims for which our management can estimate the amount and range of potential loss. As additional information becomes available, the Company will assess the potential liability related to any pending litigation and, if appropriate, revise its estimates. Such revisions in the Company's estimates of the potential liability could materially impact our results of operation and financial position.

The key accounting policies described above are not intended to be a comprehensive list of all of our accounting policies. In many cases, the accounting treatment of a particular transaction is specifically dictated by generally accepted accounting principles, with no need for management to apply its judgment or make estimates. There are also areas in which management's judgment in selecting any available alternative would not produce a materially different result to the Company's consolidated financial statements. Additional information about Microvision's accounting policies, and other disclosures required by generally accepted accounting principles, are set forth in the notes to the Company's consolidated financial statements.

Inflation has not had a material impact on the Company's net sales, revenues, or income from continuing operations over the Company's three most recent fiscal years.

Results of Operations

Since 2000, Microvision has held an investment in Lumera. From inception to July 2004, Lumera was a consolidated subsidiary and treated as a separate segment within the Company. Subsequent to July 2004, Lumera became an equity method investment and the Company now operates under one segment.

Prior to Lumera's initial public offering in July 2004, the Company was organized into two segments - Microvision, which is engaged in scanned beam displays and related technologies, and Lumera, which is engaged in optical systems components technology. Up to the date of Lumera's initial public offering, the segments were determined based on how management viewed and evaluated the Company's operations.

A portion of each segments' administration expenses arose from shared services and infrastructure that Microvision had provided to both segments in order to realize economies of scale and to efficiently use resources. These

efficiencies include costs of certain legal, accounting, human resources and other Microvision corporate and infrastructure costs. These expenses were allocated to the segments and the allocation was determined on a basis that the Company considered to be a reasonable reflection of the utilization of services provided to, or benefits received by, the segments.

After Lumera's initial public offering, Lumera became a significant unconsolidated equity investment of Microvision.

The following tables reflect the results of the Company's reportable segments for the years ended December 31, 2004 and 2003 under the Company's management system. The performance of each segment was measured based on several metrics. Since July 2004 Microvision has operated as one segment. These results were used, in part, by management, in evaluating the performance of, and in allocation of resources to, each of the segments (in thousands):

	Year Ended December 31, 2004			
	Microvision	Lumera	Elimination	Total
Contract Revenue	$ 8,135	$ 686	$ --	$ 8,82
Product Revenue	2,597	--	--	2,59
Cost of Contract Revenue	5,106	433	--	5,53
Cost of Product Revenue	3,868	--	--	3,86
Research and development expense	13,581	1,129		14,71
Marketing, general and administrative expense	17,795	1,433	--	19,22
Non-cash compensation expense	821	1,297	--	2,11
Interest income	270	2	--	27
Interest expense	31	120	--	15
Segment loss	32,257	3,724	(2,438)	33,54
Depreciation	1,711	695	--	2,40
Expenditures for capital assets	970	70	--	1,04
Segment assets	25,538	--		25,53

	Year Ended December 31, 2003			
	Microvision	Lumera	Elimination	Total
Contract Revenue	$ 11,792	$ 1,725	$ --	$ 13,51
Product Revenue	1,135	--	--	1,13
Cost of Contract Revenue	5,015	1,014		6,02
Cost of Product Revenue	1,017			1,01
Research and development expense	16,755	6,561	--	23,31
Marketing, general and administrative expense	14,557	1,270	--	15,82
Non-cash compensation expense	1,115	1,041	--	2,15
Interest income	342	39	--	38
Interest expense	51	--	--	5
Segment loss	25,205	8,083	(7,125)	26,16
Depreciation	1,924	1,185	--	3,10
Expenditures for capital assets	1,094	455	--	1,54
Segment assets	37,224	4,058	(7,364)	33,91

YEAR ENDED DECEMBER 31, 2005 COMPARED TO YEAR ENDED DECEMBER 31, 2004

Contract Revenue.

Contract revenue increased by $2.6 million, or 29%, to $11.4 million from $8.8 million in 2004. The increase resulted from a higher level of development contract business performed in 2005 than that performed in 2004 on contracts entered into in both 2005 and 2004. In 2005, 43% and 35% of contract revenue was earned from development

contracts with a single commercial customer and a single U. S. government customer, respectively.

Contract revenue is earned from the Company's work on development contracts with the United States government and commercial enterprises. In 2005, 46% of contract revenue was derived from performance on development contracts with the United States government and 54% from performance on development contracts with commercial customers. In comparison, 55% of contract revenue was derived from performance on development contracts with the United States government and 45% from performance on development contracts with commercial customers in 2004. The Company expects contract revenue to fluctuate significantly from year to year.

In June 2005, the Company entered into a $4.4 million contract with General Dynamics C4 Systems to continue the development of a helmet-mounted display for the Air Warrior Block 3 system. General Dynamics is under contract with the U.S. Army's Product Manager -- Air Warrior in Huntsville, Ala., to develop and integrate the Air Warrior Block 3 system. The Microvision helmet-mounted display is being designed as a full-color, see-through, daylight and night- readable, high-resolution display.

The Company had a contract revenue backlog of $2.8 million at December 31, 2005. The backlog is composed of development contracts, including amendments, entered through December 31, 2005. The Company plans to complete all of the contract backlog during 2006.

Product Revenue.

Microvision earns product revenue from the sale of Nomad and Flic. Microvision recognizes revenue on product sales upon customer acceptance or when the right to return has expired. Product revenue increased $800,000 or 29% to $3.4 million from $2.6 million in 2004. Revenue from Nomad sales increased by approximately $900,000 in 2005 from 2004, while revenue from Flic sales decreased by approximately $100,000 over the same period.

During 2005, Microvision earned $1.8 million from the sale of approximately 300 Nomads compared to $864,000 from the sale of approximately 200 Nomads in 2004. Microvision introduced a new version of the Nomad in March 2004. The new version is 40% smaller than the previous version and cost less to produce. Microvision is targeting truck and automotive repair and military applications for the Nomad.

The Nomad has not gained the commercial acceptance the company had planned when the product was introduced. In January 2006 the Company took steps to reduce its cost in manufacturing, sales and marketing of Nomad until it develops a go to market strategy that will be more successful. The Company is working with a small number of potential customers to define applications and business cases for the Nomad. Defining the business case consists of studying the potential customers work environment, identifying operations that could be performed more economically using Nomad, conducting trials to demonstrate the cost savings, collecting customer feedback, making modifications or improvements to the applications or the Nomad, and then developing sales tools to take advantage of the proven benefits. The company expects to take at least the first half of 2006 to develop a go to market strategy for Nomad. Until the go to market strategy is complete the Company expects limited sales of Nomad.

During 2005 and 2004, Microvision recorded $1.6 million and $1.7 million respectively, in revenue from sales of Flic barcode scanners. Revenue from Flic was negatively impacted in 2005 by delays in product shipments from the Company's contract manufacturer. The Company is working closely with its contract manufacturer to improve deliveries of Flic.

The Company had a product revenue backlog of $579,000 at December 31, 2005. The backlog is composed primarily of orders for Flic received through December 31, 2005. The Company plans to deliver all products in backlog during 2006.

Cost of Contract Revenue.

Cost of contract revenue includes both the direct and allocated indirect costs of performing on development contracts. Direct costs include labor, materials and other costs incurred directly in performing specific projects. Indirect costs include labor and other costs associated with operating the Company's research and product development department and building the technical capabilities of the Company. Cost of contract revenue is determined both by the level of direct costs incurred on development contracts and by the level of indirect costs incurred in managing and building the technical capabilities and capacity of the Company. The cost of contract revenue can fluctuate substantially from period to period depending on the level of both the direct costs incurred in the performance of projects and the level of indirect costs incurred.

Cost of contract revenue increased by $917,000, or 17%, to $6.5 million from $5.5 million. On a percentage of contract revenue basis, cost of contract revenue decreased to 57% from 63% in 2004. The change in cost of contract revenue as a percentage of contract revenue is primarily attributable to changes in the contract costs mix. Total direct costs in 2005 increased approximately 23% from 2004. The direct labor cost portion of direct cost increased by approximately 8% from 2004. The increase in direct labor cost resulted from a higher volume of contract work performed during 2005 compared to 2004.

Research and development overhead is allocated to both cost of contract revenue and research and development expense based on the proportion of direct labor cost incurred in cost of contract revenue and research and development, respectively.

The Company expects that cost of contract revenue on an absolute dollar basis will increase in the future. This increase will likely result from planned additional development contract work that the Company expects to perform, and commensurate growth in the Company's personnel and technical capacity required to perform on such contracts. The cost of contract revenue, as a percentage of contract revenue, can fluctuate significantly from period to period depending on the contract mix and the level of direct and indirect cost incurred.

Cost of Product Revenue.

Cost of product revenue includes both the direct and allocated indirect costs of manufacturing Nomads and Flics sold to customers. Direct costs include labor, materials and other costs incurred directly in the manufacture of Flic and Nomad. Indirect costs include labor and other costs associated with maintaining Microvision manufacturing capabilities and capacity. Cost of product revenue increased $4.7 million or 123% to $8.6 million from $3.9 million in 2004.

Microvision's costs to produce Nomad units during 2005 were substantially higher than product revenue. Until October 2004, Microvision classified production cost in excess of product revenue as research and development expense. In October 2004, management determined that Nomad production and manufacturing processes were sufficiently mature to support "commercial production" as described in SFAS No. 2 "Accounting for Research and Development Costs". As a result of this determination Microvision began full absorption of manufacturing overhead cost.

Cost of product revenue in 2005 includes the write off of $3.0 million of Nomad inventory and $700,000 of Flic inventory. The write-off's were due to changes in product design and customer demand that caused components and accessories to become obsolete or excess to forecasted demand. Microvision values inventory at the lower of cost or market. Microvision also reduces the value of its raw material inventory to its estimated scrap value when management determines that it is not probable that the inventory will be utilized through normal production during the next 12 months.

Manufacturing overhead is allocated to inventory, cost of product revenue, cost of contract revenue, and research and development expense based on the proportion of direct material purchased for the respective activity. During 2005, the Company expensed approximately $1.5 million of manufacturing overhead associated with production capacity in

excess of production requirements

In January 2006, the Company implemented a plan that included steps to reduce production costs. These steps included ongoing activities to improve product quality and reductions in overhead costs. The Company expects gross margins on product sales to improve in 2006.

The Company expects that cost of product revenue on an absolute dollar basis will increase in the future. This increase will likely result from increased shipments of commercial products. The Company expects that cost of product revenue will be higher than product revenue until the Company achieves sales volumes that match its production capability.

Research and Development Expense.

Research and development expense consists of:

- compensation related costs of employees and contractors engaged in internal research and product development activities,
- research fees paid to the University of Washington under the Lumera Sponsored Research Agreement (prior to July 2004),
- laboratory operations, outsourced development and processing work,
- fees and expenses related to patent applications, prosecution and protection,
- related operating expenses and
- costs relating to acquiring and maintaining licenses.

Research and development expense decreased by $8.1 million, or 55%, to $6.6 million from $14.7 million in 2004.

Research and development expense in 2004 included approximately $4.3 million in manufacturing overhead associated with Nomad production. The Company classified Nomad manufacturing expense in excess of Nomad product revenue as research and development expense until the Nomad design and production capabilities were sufficiently mature to support commercial production in the fourth quarter of 2004.

Research and Development expense attributable to Lumera was $1.1 million in 2004. The decrease in Research and Development expense attributable to Lumera accounts for 14% of the decrease in consolidated Research and Development expense.

The Company allocates research and development resources to customer funded projects and internally funded projects based on management's determination of customer requirements, product development requirement, and the availability of research and development resources to meet project objectives. During 2005 the Company allocated $917,000 more resources to customer funded projects than in 2004.

The Company believes that a substantial level of continuing research and development expense will be required to develop commercial products using the scanned beam technology. Accordingly, the Company anticipates that its research and development expenditures will continue to be significant. These expenses could be incurred as a result of:

- subcontracting work to development partners,
- expanding and equipping in-house laboratories,
- acquiring rights to additional technologies,
- incurring related operating expenses, and
- hiring additional technical and support personnel.

The Company expects that the amount of spending on research and product development will remain high in future quarters as we:

- continue development and commercialization of the Company's scanned beam technology,
- accelerate development of the integrated photonics module to meet emerging market opportunities, and

- pursue other potential business opportunities.

Sales, Marketing, General and Administrative Expense.

Sales, marketing, general and administrative expenses include compensation and support costs for sales, marketing, management and administrative staff, and for other general and administrative costs, including legal and accounting, consulting and other operating expenses.

The Company's marketing activities include corporate awareness campaigns, such as web site development and participation at trade shows, corporate communications initiatives, and working with potential customers and joint venture partners to identify and evaluate product applications in which the Company's technology could be integrated or otherwise used.

Sales, marketing, general and administrative expenses increased by $695,000, or 4%, to $19.9million from $19.2 million in 2004. The increase in sales, marketing, general and administrative expenses are due to the increase in sales and marketing activity related to Nomad and Flic sales. The Company has added sales staff, demonstration equipment and promotion materials to support increased sales of Nomad and Flic.

In 2000, the Board of Directors authorized Microvision to provide unsecured lines of credit to each of its three senior officers. No loans have been made under either Microvision's Executive Option Exercise Note Plan or the Executive Loan Plan since July 2002, and Microvision does not intend to make any additional loans under these plans. A total of $2,723,000 was issued and remains outstanding under the Executive Loan Plan. There are currently no outstanding loans under the Executive Option Exercise Note Plan.

In 2005, Microvision determined that certain of its senior officers may have had insufficient net worth and short-term earnings potential to repay their outstanding loans. As a result, Microvision recorded additional allowances for doubtful accounts for the receivables from senior officers of $1,031,000. The balance of the allowance for doubtful accounts for receivables from senior officers was $1.9 million at December 31, 2005. Two of the officers left the Company in January 2006. In accordance with the terms, the loans will be due in January 2007. Microvision has no plans to forgive any portion of the principal of the outstanding receivable balance.

In January 2006, the Company took the following steps to reduce sales, marketing, general and administrative expense:

- Reduced the number of executive officers and vice presidents by 50%.
- Reduced the sales and marketing costs for Nomad until the Company completes a new go to market strategy.

After the expected decline in 2006 compared to 2005, the Company anticipates sales, marketing, general and administrative expenses will increase as product revenue increases in future periods and as the Company:

- adds to its sales and marketing staff,
- makes additional investments in sales and marketing activities, and
- increases the level of corporate and administrative activity.

Non-Cash Compensation Expense.

Non-cash compensation expense includes the amortization of the value of stock options granted to individuals who are not employees or directors of the Company for services provided to the Company as well as employee stock based compensation expenses. Non-cash compensation expense decreased by $1.7 million or 80% to $429,000 from $2.1 million in 2004.

The following table shows the components of non-cash compensation expense for 2005 and 2004, respectively.

	2005	2004
Microvision stock, options and warrants issued to third parties	$ 335,000	$ 587,000
Microvision stock options issued to employees	59,000	54,000
Microvision stock and options issued to Independent Directors	35,000	46,000
Lumera options issued to Microvision employees	--	134,000
Lumera non-cash compensation expense	--	1,297,000
	$ 429,000	$ 2,118,000

At December 31, 2005, the Company had $85,000 of unamortized non-cash compensation expense that will be amortized over the next two years.

Interest Income and Expense.

Interest expense increased in 2005 by $3.1 million to $3.3 million from $151,000 in 2004. In March 2005, the Company raised $10 million before issuance costs of $423,000 from the issuance of convertible notes ("March Notes") and warrants to purchase an aggregate of 462,000 shares of Microvision common stock. In December 2005, the Company raised $10 million before issuance costs of $134,000 from the issuance of convertible notes ("December Notes"), 838,000 shares of Microvision common stock and warrants to purchase 1,089,000 shares of Microvision common stock. This increase in interest expense relates to the stated interest on the March Notes and December Notes, (together "the Notes") as well as the amortization of the discount recorded on the Notes due to the warrants and embedded derivative feature of the Notes. The Company expects interest expense will be substantially higher than in previous periods as a result of these transactions.

Loss on debt extinguishment

.

In July 2005, the Company entered into an agreement to amend the Company's March Notes. In connection with the amendment, the Company issued three year warrants to purchase 750,000 shares of Microvision common stock with an exercise price of $6.84 per share. The conversion price of the amended notes and exercise price of the warrants are subject to anti-dilution adjustments. In addition, the price at which the note holder can convert the March Notes to Microvision common stock was reduced to $5.85 per share, and the price at which the Company can mandatorily convert the March Notes to Microvision common stock was reduced to $10.24. The Company has pledged 1,750,000 shares of its Lumera common stock as collateral for the March Notes. As a result of the amendment, the amended notes are no longer exchangeable into Lumera common stock.

The Company has concluded that the amendment of the March Notes met the criteria of a debt extinguishment and recorded a charge of $3,313,000 for the change in the fair value of the debt in July 2005. The charge was measured as the value of the additional warrants that were issued to the note holders and the fair value of the reduced price at which the debt could be converted to Microvision common stock. The additional warrants were valued using the Black Scholes option-pricing model with the following assumptions: expected volatility of 75%; expected dividend yield of 0%; risk free interest rate of 4.62%; and contractual life of three years. The warrants were initially valued at $2,295,000. The change in the conversion price was valued using the Black Scholes option-pricing model with the following assumptions: expected volatility of 75%; expected dividend yield of 0%; risk free interest rate of 4.62%; and contractual life equal to the length of the option. The change in the conversion price was valued at $1,018,000.

Gain on derivative feature of notes payable.

The following table summarizes the accounting for the Company's Notes:

	Notes	Warrants	Embedded derivative feature	s
March 10, 2005 issuance	$ 5,395	$ 1,650	$ 2,955	$
Debt restructuring at July 25, 2005		2,295	1,018	
Conversion of debt to common stock at October 11, 2005	(1,398)		(439)	
December 1, 2005 issuance	3,667	2,200	1,116	
Principal payments on notes	(867)			
Discount accretion for the year ended December 31, 2005	2,546			
Changes in market value for the year ended December 31, 2005		(2,693)	(3,282)	
Balances at December 31, 2005	$ 9,343	$ 3,452	$ 1,368	$

In connection with the issuance of the Company's March Notes, the Company concluded that the note holders' right to convert all or a p