MICROVISION INC
Form 10-K/A
April 27, 2005

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

FORM 10-K/A
(Amendment No. 2)

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

For the fiscal year ended December 31, 2004

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)

19910 North Creek Parkway
Bothell, Washington 98011-3008

(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 whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No

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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.

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Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes x No

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The aggregate market value of the common stock held by non-affiliates of the registrant as of June 30, 2004 was approximately $175,047,000 (based on the closing price for the registrant's Common Stock on the Nasdaq National Market of $8.40 per share).

The number of shares of the registrant's Common Stock outstanding as of March 1, 2005 was 21,481,000.

PART I

Preliminary Note Regarding Forward-Looking Statements

The information set forth in this report in Item 1 "Description of 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 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and is subject to the safe harbor created by that section. 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 1 "Description of Business - Risk Factors Related to the Company's Business."

ITEM 1. DESCRIPTION OF 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 information display and image capture products.

Scanned Beam Displays

Microvision is producing and selling the Nomad® Expert Technician System, a wireless, wearable computer with a head-worn see-through display. Microvision introduced this second generation version of the Nomad Augmented Vision System in March 2004 and is initially targeting the automotive repair market and military applications. Microvision has also 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 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 includes 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 also sells the Flic® Laser Bar Code Scanner, a hand-held bar code scanner that uses its proprietary scanning technology. Microvision has introduced a Bluetooth wireless version, the Flic Cordless Laser Bar Code Scanner. Microvision believes that 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 2D bar code readers that may have higher performance and lower cost than those currently available.

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. By continuously scanning a rapidly moving low power beam of light, the scanned beam display creates a high resolution, full motion image in the eye or on an intermediate 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. Color pixels are generated by 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 into the viewer's eye or onto an intermediate screen. The pixels are arranged by a horizontal scanner motion that sweeps the light beam to place the pixels into a row and a vertical scanner motion that moves the light beam up/downward 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.

The 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 is able to retain full binocular vision and full

hand-eye coordination while having electronic information 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.

The scanned beam display technology can also be used to achieve a more conventional front or rear projection display. The screen may be transparent, providing the user with a head-up display capability and overlaying 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. To produce an image, a horizontal and a vertical scanner or a single micro-electro-mechanical system ("MEMS") bi-axial scanner directs the light beam that creates the image. Microvision currently uses these scanners in Nomad 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.

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

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) of 10 to 15 millimeters. Microvision has developed optics and system designs that produce exit pupils up to 15 millimeters. Additional design and engineering of the optics and systems designs will improve Microvision's competitive position for 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.

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. 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 prototype full-color scanned beam displays with these light-emitting diodes.

Microvision expects to continue using laser diodes 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 of the desired wavelengths of blue and green laser diodes.

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 has identified 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.

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.

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 automotive companies to develop the Nomad for automotive maintenance applications. In maintenance applications, the automotive technician uses the Nomad to provide repair instructions and other information directly in 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. In trials, technicians using the Nomad have reported substantial efficiency gains in performing repairs.

The U.S. Army has deployed 100 Nomad systems in the US Army's Stryker Brigade Combat Team in Iraq. The helmet-mounted Nomad Augmented Vision System provides the vehicle commander with a head-up, daylight-readable, remote display from the Stryker vehicle's onboard battlefield computer while allowing the commander to operate from the hatch opening. The Nomad allows the commander to observe the surroundings, while choosing the optimum path ahead, commanding the vehicle and using tactical information.

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, through independent manufacturers' representatives and through original equipment manufacturers. Microvision is also selling Nomad in Europe and Asia through a small number of independent manufacturer's representatives.

Microvision believes Nomad will compete 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 to be used and the user must look away from the task to get information. In contrast, the Nomad is head-worn (i.e. hands free) and allows images to be painted on the viewer'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, higher resolution, and higher contrast than competing devices and provides true "see through" capability with lower power consumption. Microvision also believes that the manufacturing cost 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 technologies.

Flic

Microvision sells the Flic Scanner, a hand held laser bar code scanner and the Flic Cordless Scanner, a Bluetooth version of the Flic Scanner. All 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 that the sales volume for Flic Scanner will grow as potential customers complete their trials and application developers release solutions incorporating Flic Scanners.

Flic Scanners are manufactured for Microvision by a contract manufacturer located in Batam, Indonesia. Microvision distributes branded and private- labeled Flic 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. The agreement includes terms for product development and a supply agreement for certain products.

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.

Automotive Head-Up Displays

During 2004, Microvision continued to improve upon its prototype automotive head-up displays for automotive companies and Tier 1 suppliers to automotive companies. These head-up displays use scanners, light sources and electronic components similar to those in the Nomad display, but use optics that are unique for this head-up display application. These prototypes demonstrate that scanned beam display technology can be used in a head-up display that projects a day- light or night-light readable image onto the windscreen of an automobile to provide the vehicle operator with a variety of information related to the car's operation. Microvision believes that it can further develop these prototypes into products that will meet the automotive companies' specifications for size, brightness, image quality and cost. Microvision plans to continue this sponsored research and development work in 2005.

Microdisplays

Microvision continues to develop color prototype microdisplays that could be integrated into an electronic viewfinder in a digital still camera, a digital video camera or a cell phone. Microvision continues to reduce the size, cost and power requirements of its prototype microdisplays. Microvision believes that the advances in the scanned beam display technology that are achieved for the microdisplay platform will migrate to Nomad and other products resulting in lower cost. Microvision is performing sponsored and internally funded research and development to improve the

performance and reduce the cost of its color microdisplay product development.

Business Strategy

Microvision's objective is to be a leading provider of personal display and imaging products and 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 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. Examples of activities that Microvision plans to continue to pursue through strategic partnering are:

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.

Manufacture and Sale of High Performance Products

. Microvision anticipates providing high performance products to professional end-users in markets with lower product volume requirements. Microvision expects that end- users in this category will include professionals in defense, industry and medicine. Depending upon the circumstances, Microvision may manufacture these products using standard component suppliers and contract manufacturers as required, may license its technology to original equipment manufacturers or may seek to form one or more joint ventures to manufacture the products.

Sale of Components or "Engines" of Scanning Technology

. Certain potential applications of the scanned beam display technology, such as electronic viewfinders, cellular phones or two-dimensional bar code readers could require integration of Microvision's technology with other unrelated 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 components, subsystems and systems to original equipment manufacturers under licensing agreements.

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.

Platform Model to Leverage Core Technologies and Components

Microvision is developing the scanned beam display technology as a platform technology. Microvision believes that modularized scanning components or subsystems could be integrated with a variety of other interchangeable system components to more efficiently create a wide range of commercial and defense products. Such products could use the same platform scanning component or subsystem but would be configured for a particular application by using other

interchangeable system components. Microvision has currently identified the following key product categories that could benefit from further modular scanning component development:

- High Performance Helmet-Mounted Displays
- Augmented Vision and Augmented Reality Displays
- Near-Eye, Mass-Market Color Displays
- Image Capture / Professional Cameras
- Projection Systems (Front- or Rear-Projection)

For example, products in any of these categories could utilize a common MEMS scanner to direct the beam of light. A wearable Nomad display and a projection display could use the same MEMS scanner combined with different optics, light source or drive electronics components. Microvision believes that this leverage of the MEMS scanner with other components will allow greater economies of scale in its fabrication.

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 the scanned beam display system; (ii) component technologies and integration techniques essential to the commercialization of the scanned beam display technology 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 the scanned beam technology.

Additional Information

Microvision performs research and development to achieve advances necessary for large-scale application, full-color capability in highly miniaturized versions and design of new architectures for specific applications. Research and development expense for the Company for the fiscal years ended December 31, 2004, 2003 and 2002 was $14.7 million, $23.3 million and $25.5 million respectively. Excluding Lumera, research and development expense was $13.6 million, $16.8 million, and $18.4 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 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. In 2003, 27% of Microvision's revenue was earned from development contracts with a single commercial customer. 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 $7.1 million at December 31, 2004 compared to a backlog of $2.6 million at December 31, 2003. The backlog is composed of $7.0 million in development contracts, including amendments, entered into through December 31, 2004 and $114,000 and $43,000 in orders for Nomad and Flic respectively. Microvision plans to complete all of the backlog contracts during 2005.

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 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 forty-five patents on the Virtual Retinal Display technology and has an additional fourteen U.S. patent applications pending in the United States and twenty-four 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 thirteen patents and has twenty-nine 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 filed fifty-four patent applications and received thirty 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 mark "Microvision" with its associated "tri-curve" logo with the United States Patent and Trademark Office. Microvision has filed for registration of various other marks including "Virtual Retinal

Display," "VRD," "Nomad," and "Flic" in the United States Patent and Trademark Office. These marks were examined and entered into the opposition phase, where an opposition was filed against the Virtual Retinal Display mark. Microvision believes the opposition filing is without merit and that it should prevail in the proceedings. Regardless of the outcome, Microvision believes that it will be entitled to continue to use the terms "Virtual Retinal Display," "VRD," "Nomad," and "Flic".

Employees

As of March 1, 2005, Microvision had 166 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 19910 North Creek Parkway, Bothell, Washington 98011 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."

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 and we anticipate an operating loss at least through the year ending December 31, 2005. We cannot assure you that we will ever become or remain profitable.

- As of December 31, 2004, we had an accumulated deficit of $187.5 million.
- We incurred consolidated net losses of $100.9 million from inception through 2001, $27.2 million in 2002, $26.2 million in 2003, and $33.2 million in 2004.

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 2005 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 continue to fund our operations and to implement our business plan. If we do not obtain additional capital, we may be required to limit 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 believe that we can fund our operations from existing sources of liquidity though 2005. We will require additional capital to continue to fund our operations, including to:

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

We will require additional capital to fund our operations in 2006. 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 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. 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. 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 optical material technologies and the market acceptance and competitive position of such products. 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. This limitation of operations may include reductions in capital expenditures and reductions in staff and discretionary cost, which may include non-contractual research cost.

The value of our investment in Lumera may decrease.

A significant portion of our assets and present source of liquidity are constituted by our investment in Lumera. Lumera's stock price is subject to fluctuation and may decrease, lowering the value of our investment. We own approximately 33% 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 Senior Secured Exchangeable Convertible Notes may adversely impact our common stockholders or limit our ability to obtain additional financing.

In March 2005, we issued the Senior Secured Exchangeable Convertible Notes (the "Notes") described in Item 7 - Management's Discussion and Analysis of Financial Condition and Results of Operation - Liquidity and Capital Resources. Among other provisions, the Notes include material limitations on our ability to incur additional debt or incur liens while the Notes are outstanding. These limitations could materially adversely affect our ability to raise funds we expect to need in 2006.

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 consumers 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 second, third and fourth quarters of 2002, the first and second quarter of 2003, and the third quarter of 2004, the market price of our stock traded below $5.00 per share. On March 1, 2005 the closing price of our stock was $5.59.

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 Nomad and Flic 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 Flic, and we plan to continue using foreign manufacturers to manufacture some of our 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 Nomad in the first quarter of 2004. In September 2002, we introduced Flic. 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 2004 and 2003, 42%, and 49% 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 cycle that involve numerous steps including discussion 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 exploratory arrangements may not lead to products that will be profitable.

Our developmental contracts, including our relationships with parties such as the U.S. government, Ethicon Endo-Surgery, Inc., Canon, BMW and Volkswagen of America, 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.

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 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 2. DESCRIPTION OF PROPERTY

The Company currently leases approximately 92,500 square feet of combined use office, laboratory and manufacturing space at its headquarters facility in Bothell, Washington. The seven-year lease expires in 2006.

Lumera rents approximately 16,000 square feet space from Microvision within the Company's headquarters facility in Bothell, Washington.

The Company also leases approximately 5,200 square feet of combined use office and laboratory space in San Mateo, California. The 42 month lease expires in 2005. Microvision closed its branch office in San Mateo, California during 2003 and currently subleases this office space.

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, 2004.

PART II

ITEM 5. MARKET FOR THE REGISTRANT'S COMMON STOCK AND RELATED SHAREHOLDER MATTERS.

The Company's common stock trades on the NASDAQ National Market under the symbol "MVIS." As of March 1, 2005, there were 375 holders of record of 21,481,000 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**
2003		
March 31, 2003	$ 8.20	$ 3.43
June 30, 2003	6.76	3.85
September 30, 2003	9.38	5.89
December 31, 2003	9.09	6.50
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		
January 1, 2005 to March 1, 2005	$ 7.70	$ 5.03

ITEM 6. SELECTED FINANCIAL DATA

A summary of selected financial data as of and for the five years ended December 31, 2004 is set forth below:

	Years En		
	2004	2003	2002
		(in thousands, exce	
Statement of Operations Data:			
Revenue	$ 11,418	$ 14,652	$ 15,91
Net loss available for common shareholders	(33,543)	(26,163)	(27,17
Basic and diluted net loss per share	(1.56)	(1.46)	(1.9
Weighted average shares outstanding basic and diluted	21,493	17,946	14,06
Balance Sheet Data:			
Cash, cash equivalents and investments available-for-sale	$ 1,268	$ 21,778	$ 15,17
Working capital	903	19,781	14,51
Total assets	25,538	33,918	32,26
Long-term liabilities	52	2,204	1,48
Mandatorily redeemable preferred stock	7,647	--	-
Total shareholders' equity	7,190	23,295	17,41

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 2005. 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, 2005.

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 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.

The Company's product sales generally include acceptance provisions. The Company recognizes revenue for product shipments upon acceptance of the product by the customer or expiration of the contractual acceptance period.

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 general 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 or if market conditions for our components or products were to decline, additional reductions in the carrying value of the inventory would be required.

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, which begin on page 36 of this Annual Report on Form 10-K.

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

Until 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. The segments were determined based on how management views and evaluates the Company's operations.

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

In connection with the Lumera initial public offering, all Lumera Series A and Series B Preferred Stock was converted into Lumera common stock. Immediately after the offering, Microvision owned 5,434,000 shares, or 33%, of the common stock of Lumera. As a result of the change in ownership percentage, Microvision changed the method of accounting for its investment in Lumera to the equity method. Microvision recorded a non-cash change in ownership interest gain of $13.7 million to stockholders equity as a component of additional paid-in capital during the third quarter. Microvision consolidated Lumera's results through July 2004 in its consolidated financial statements.

The following tables reflect the results of the Company's segments under the Company's management system. The performance of each segment is measured based on several metrics. 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, 2002			
	Microvision	Lumera	Elimination	Total
Contract Revenue	$ 14,443	$ 946	$ --	$ 15,38
Product Revenue	528	--	--	52
Cost of Contract Revenue	6,139	330		6,46
Cost of Product Revenue	528			52
Research and development expense	18,362	7,157	--	25,51
Marketing, general and administrative expense	15,577	1,221	--	16,79
Non-cash compensation expense	841	1,143	--	1,98
Interest income	860	199	--	1,05
Interest expense	59	--	--	5
Segment loss	26,219	8,698	(7,741)	27,17
Depreciation	1,894	1,049	--	2,94
Expenditures for capital assets	792	562	--	1,35
Segment assets	30,144	8,589	(6,466)	32,26

YEAR ENDED DECEMBER 31, 2004 COMPARED TO YEAR ENDED DECEMBER 31, 2003

Contract Revenue.

Contract revenue decreased by $4.7 million, or 35%, to $8.8 million from $13.5 million in 2003. The decrease resulted from a lower level of development contract business performed in 2004 than that performed in 2003 on contracts entered into in both 2004 and 2003.

Contract revenue is earned from the Company's work on development contracts with the United States government and commercial enterprises. In 2004, 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 comparison to 53% of revenue was derived from performance on development contracts with the United States government and 47% from performance on development contracts with commercial customers in 2003. In 2003, 29% of consolidated contract revenue was earned from development contracts with a single commercial customer. The Company expects contract revenue to fluctuate significantly from year to year.

In May 2004, Microvision entered into a $3.9 million contract modification with the U.S. Army's Aviation Applied Technology Directorate to continue work on an advanced helmet mounted display and imaging system to be used in the Virtual Cockpit Optimization Program.

In December 2004, Microvision entered into a $6.2 million contract with Ethicon Endo-Surgery, Inc., a subsidiary of Johnson & Johnson, to integrate Microvision's technology into certain medical products. The contract includes an exclusive license for Microvision's technology for certain human medical applications during the term of the development agreement.

The Company had a contract revenue backlog of $7.0 million at December 31, 2004. The backlog is composed of development contracts, including amendments, entered through December 31, 2004. The Company plans to complete all of the contract backlog during 2005.

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 $1.5 million or 129% to $2.6 million from $1.1 million in 2003. The increase resulted from increased sales of both Flic and Nomad in 2004.

During 2004, Microvision earned $864,000 from the sale of 208 Nomads compared to $855,000 from the sale of 133 Nomads in 2003. 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 automotive repair applications for the Nomad. The Nomad is currently installed in 62 automotive repair facilities.

During 2004 and 2003, Microvision recorded $1,732,000 and $280,000 respectively, in revenue from sales of Flic barcode scanners.

The Company had a product revenue backlog of $157,000 at December 31, 2004. The backlog is composed of orders for Nomad and Flic received through December 31, 2004. The Company plans to deliver all products in backlog during 2005.

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 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 decreased by $449,000, or 8%, to $5.5 million from $6.0 million. On a percentage of revenue basis, cost of contract revenue increased by 43 % to 63% from 44% in 2003. The change in cost of revenue as a percentage of revenue is primarily attributable to changes in the contract costs mix. Total direct costs in 2004 decreased approximately 6% from 2003. The direct labor cost portion of direct cost decreased by approximately 6% from 2003. The decrease in direct labor cost resulted from a lower volume of contract work performed during 2004 compared to 2003.

During 2004, the Company experienced unplanned technical difficulties on one significant project. As a result of the difficulties, more direct costs than planned were incurred in completing the project resulting in a lower gross margin

during 2004 than in 2003.

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 $2.8 million or 266% to $3.9 million from $1.1 million in 2003.

Microvision's costs to produce Nomad units during 2004 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. During the fourth quarter of 2004, the cost of product revenue exceeded product revenue for both the Flic and Nomad products.

Cost of product revenue in 2004 includes the write off of $764,000 of Flic inventory and $479,000 of Nomad inventory. The write off's were due to changes in product design and customer demand that caused components and accessories to become obsolete or slow moving. Microvision values inventory at the lower of cost or market. Microvision also reduces the value of its 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.

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,
- laboratory operations, outsourced development and processing work,
- fees and expenses related to patent applications, prosecution and protection,
- related operating expenses and
- cost relating to acquiring and maintaining licenses.

Research and development expense decreased by $8.6 million, or 37%, to $14.7 million from $23.3 million in 2003.

Research and Development expense attributable to Lumera decreased $5.5 million, or 83%, to $1.1 million from $6.6 million in 2003. The decrease in Research and Development expense attributable to Lumera accounts for 64% of the decrease in consolidated Research and Development expense.

In April 2004, Lumera and the University of Washington entered into a fourth amendment to the Sponsored Research Agreement that requires payments of $125,000 for quarters ending March 31, 2004 and June 30, 2004 and eliminates the contingent payment of $2.0 million. For each of the quarters ending September 30, 2004 and December 31, 2004, Lumera was required to pay $250,000. The agreement will terminate in 2005 after payments of $375,000 are made in quarters ending March 31, 2005 and June 30, 2005. Total payments under the Sponsored Research Agreement will be $5.8 million instead of the original $9.0 million. Lumera recognizes research and development expense under the Sponsored Research Agreement on a straight line basis over the term of the agreement. At the time of the fourth amendment to the Sponsored Research Agreement, Lumera had recognized $6.5 million in expense related to the Sponsored Research Agreement. In April 2004, Lumera recorded a reduction in its liability and an offsetting reduction in expense of $2.4 million to reduce the cumulative expense recognized under the Sponsored Research Agreement to the expense incurred under the fourth amendment on a straight line basis.

Research and development expense in 2003 included $645,000 for the closure of Microvision's research and development facility in San Mateo, California. Microvision consolidated its research and development activities in Bothell, Washington in May 2003.

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 microdisplays and imaging products 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 $3.4 million, or 22%, to $19.2 million from $15.8 million in 2003. 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. The Company expects sales, marketing, general and administrative expenses to increase as product revenue increases in future periods 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 $38,000 or 2% to $2.1 million from $2.2 million in 2003.

In September 2003, Microvision issued two warrants to purchase an aggregate of 70,000 shares of common stock to a third party for services provided to Microvision. One warrant grants the holder the right to purchase up to 60,000 shares of common stock at a price of $7.50 per share. The warrant vested in three equal tranches on the date of grant, in December 2003 and in March 2004. The other warrant to purchase up to 10,000 shares of common stock at a price of $12.00 per share vested in March 2004. The deferred compensation related to these warrants was amortized to non-cash compensation expense over the fourteen month service period of the agreement. There is no amortization remaining at December 31, 2004. Non-cash amortization expense related to these warrants was $140,000 and $192,000 for 2004 and 2003 respectively. The total value of the warrants was estimated on December 31, 2003 and the grant date at $318,000 and $328,000, respectively. The fair values of the warrants were estimated on the date of grant and December 31, 2003, using the Black-Scholes option-pricing model with the following weighted-average assumptions: expected volatilities of 83%, risk-free interest rates of 2.7% and dividend yields of zero percent. The expected lives used at the measurement dates above were 4 years and 3.9 years, respectively.

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In August 2000, Microvision entered into five-year consulting agreements with two independent consultants to provide strategic business and financial consulting services. Under the terms of the agreements, each consultant received a warrant to purchase 100,000 shares of common stock at an exercise price of $34.00 per share. The warrants vested over three years and the unvested portions were subject to remeasurement at each balance sheet date during the vesting period until the end of the vesting period on June 7, 2003. The original value of the warrants was estimated at $5.5 million, however, due to decreases in the Company stock price, the value in June 2003 was estimated to be $3.0 million. In 2004 and 2003, total non-cash amortization for these agreements was $447,000 and $595,000, respectively. The fair values of the warrants were determined in June 2003 and the issue date, using the Black- Scholes option-pricing model with the following weighted-average assumptions: dividend yield of zero percent, expected volatility of 83% for both measurement dates, risk-free interest rates of 4.0% and 5.9%, and expected lives of 7.4 and 9.2 years. Deferred compensation related to these warrants at December 31, 2004 was $270,000.

During 2004, Lumera granted options to purchase 415,000 shares of Class A common stock to Lumera employees and directors with a weighted-average exercise price of $2.00. Lumera subsequently determined that the fair market value of its common stock was greater than the exercise price of the options. Lumera recorded aggregate charges of $216,000 during 2004 related to these grants.

During 2004, Lumera granted vested options to purchase 40,000 shares of Class A common stock to Microvision employees with a weighted-average exercise price of $2.00. Lumera subsequently determined that the fair market value of its common stock was greater than the exercise price of the options. The Company recorded aggregate charges of $134,000 during 2004 related to these grants.

The following table shows the components of non-cash compensation expense for 2004 and 2003, respectively.

	2004	2003
Microvision stock options issued to third parties	587,000	849,000
Microvision stock options issued to employees	54,000	265,000
Microvision stock and options issued to Independent Directors	46,000	1,000
Lumera options issued to Microvision employees	134,000	--
Lumera non-cash compensation expense	1,297,000	1,041,000
	$ 2,118,000	$ 2,156,000

At December 31, 2004, the Company had $305,000 of unamortized non-cash compensation expense that will be amortized over the next year.

Interest Income and Expense.

Interest income in 2004 decreased by $109,000, or 29%, to $272,000 from $381,000 in 2003. This decrease resulted primarily from lower average cash and investment securities balances in 2004 than the average cash and investment securities balances in the prior year.

Interest expense was consistent with 2004 because the amount of borrowings did not change significantly.

Loss on equity in investment subsidiary

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In July 2004, Lumera completed an initial public offering of its common stock. In connection with the offering, all Lumera Series A and Series B Preferred Stock was converted to Lumera common stock. Immediately after the offering, Microvision owned 5,434,000 shares, or 33%, of the common stock of Lumera. As a result of the change in ownership percentage, Microvision has changed the method of accounting for its investment in Lumera to the equity method. Under the equity method, Microvision recorded its ownership interest in the net book value of Lumera immediately following the initial public offering as an investment in equity method subsidiary of $11.9 million. Microvision records its pro rata share of Lumera's income or loss as an adjustment in the value of its investment in Lumera. For the period from July 2004 to December 31, 2004 Microvision's share in Lumera's losses was $1.7 million.

Income Taxes.

No provision for income taxes has been recorded because the Company has experienced net losses from inception through December 31, 2004. At December 31, 2004, Microvision had net operating loss carry-forwards of approximately $168.0 million for federal income tax reporting purposes. In addition, Microvision has research and development tax credits of $2.2 million. The net operating losses begin expiring in 2008 if not previously utilized. In certain circumstances, as specified in the Internal Revenue Code, a 50% or more ownership change by certain combinations of Microvision's shareholders during any three-year period would result in a limitation on Microvision's ability to utilize a portion of its net operating loss carry-forwards. Microvision has determined that such a change of ownership occurred during 1995 and that the annual utilization of loss carry-forwards generated through the period of that change will be limited to approximately $761,000. An additional change of ownership occurred in 1996 and the

limitation for losses generated in 1996 is approximately $1.6 million.

Non-cash Beneficial Conversion Feature of Preferred Stock.

In September 2004, Microvision raised $10.0 million before issuance costs of $90,000 from the sale of 10,000 shares of convertible preferred stock and a warrant to purchase 361,795 shares of common stock. The preferred stock is convertible on demand by the holder into common stock at a conversion price of $6.91 per share of common stock. The initial conversion price is subject to adjustment in the event Microvision issues common stock or derivative securities at a price per share of common stock below the market price or the conversion price of the preferred stock. In addition, upon the request of the preferred stockholder, Microvision is required to redeem the preferred stock for cash in certain circumstances, including in the event of a material breach of our representations, warranties or covenants under the purchase agreement or a change in control. Accordingly, Microvision has classified the preferred stock as "mandatorily redeemable convertible preferred stock" in its consolidated balance sheet.

The preferred stock terms include a dividend of 3.5% per annum, payable quarterly in cash or registered common stock, at the election of the Company, subject to certain conditions. The preferred stock matures on September 10, 2007, at which time it is payable in cash or registered common stock, at the election of the Company, subject to certain conditions. Some of the conditions which would preclude the Company from paying in common stock are not within the Company's immediate control. The Company can elect to convert the preferred stock into common stock if the common stock price exceeds $12.09 per share, subject to certain conditions.

The warrant vested on the date of grant, has an exercise price of $8.16 per share and expires on September 10, 2009. The initial exercise price is subject to adjustment in the event the Company issues common stock or derivative securities at a price per share of common stock below the market price or the exercise price of the warrant.

The net cash proceeds of $9,910,000 were allocated to the preferred stock and the warrant based on the relative fair values of the securities. The warrants were valued using the Black-Scholes option-pricing model with the following assumptions: expected volatility, 75%, risk free interest rate of 3.4%, and a contractual life 5 years. $1.3 million of the proceeds were allocated to the warrant and were recorded as an increase to additional paid-in capital.

Subsequent to the relative fair value allocation, the effective accounting conversion price of the convertible preferred stock was less than the closing price of Microvision's common stock on the date of commitment to purchase the preferred stock. This beneficial conversion feature was measured as $1.2 million, which represents the difference between the fair value of the common stock and the effective accounting conversion price. This beneficial conversion feature was recorded to additional paid-in capital and will be recorded as a deemed dividend to preferred stockholders (accretion) over the stated life of the preferred stock which is three years.

YEAR ENDED DECEMBER 31, 2003 COMPARED TO YEAR ENDED DECEMBER 31, 2002

Contract Revenue.

Contract revenue decreased by $1.9 million, or 12%, to $13.5 million from $15.4 million in 2002. The decrease resulted from a lower level of development contract business in 2003 than that performed in 2002 on contracts entered into in both 2003 and 2002.

In 2003, 53% of contract revenue was derived from performance on development contracts with the United States government, 47% from performance on development contracts with commercial customers. In comparison,

to 86% of revenue was derived from performance on development contracts with the United States government and 14% from performance on development contracts with commercial customers in 2002. In 2003, 29% of consolidated contract revenue was earned from development contracts with a single commercial customer.

During 2003, the Company entered into several development contracts with both commercial and government entities for further development of the scanned beam technology to meet specific customer applications.

- In February 2003, Microvision extended a development agreement with Canon to further develop miniature displays for use in consumer products including digital cameras and digital video equipment.
- In April 2003, Microvision entered into a $2.2 million contract modification with the U.S. Army's Aviation Applied Technology Directorate to continue work on an advanced helmet mounted display and imaging system to be used in the Virtual Cockpit Optimization Program.
- In April 2003, Microvision entered into a $1.6 million contract modification with the U.S. Army's Medical Research Acquisition Activities, Telemedicine and Advanced Technology Research Center to continue development of a mobile wireless personal display system for medical applications.
- In October 2003, Microvision entered into a new agreement with Canon to further develop miniature displays for use in consumer products including digital cameras and digital video equipment.
- In December 2003, Lumera entered into a contract extension with a U.S. government agency to continue development of electro-optical polymer materials and devices for wideband optical modulators.
- During 2003, Microvision performed development work for several automotive companies including BMW and Volkswagen of America, to develop automotive displays using the scanned beam technology. The total value of these contracts was approximately $1.3 million.

The Company had a contract revenue backlog of $3.8 million at December 31, 2003.

Product Revenue.

Product revenue increased by $607,000, or 115 % to 1.1 million from $528,000 in 2002.

During 2003, Microvision recorded $855,000 in product revenue from the sale of 133 Nomads. In September 2003, Microvision entered into a contract with the Program Executive Office Soldier within the U.S. Army to supply the Stryker Brigade Combat Team with 100 Nomads. In addition, Microvision continued development of a next generation Nomad that was launched in February 2004.

During 2003, Microvision recorded $280,000 in product revenue from sales of Flic barcode scanners. In January 2003, Microvision entered into a supply agreement to provide a private labeled Flic bar code scanner to NCR. During 2003, Microvision and NCR worked together to optimize the Flic performance for NCR's customers. NCR placed orders for $392,000 of product during the fourth quarter of 2003. Microvision ended the year with a backlog of $378,000 in Flic product and accessories

Cost of Contract Revenue.

Cost of contract revenue decreased by $481,000, or 7%, to $6.0 million from $6.5 million in 2002. On a percentage of revenue basis, cost of contract revenue increased by 5 % to 44% from 42% in 2002. The change in cost of revenue as a percentage of revenue is primarily attributable to changes in the contract mix. Total direct costs decreased by approximately 14% from 2002. The direct labor cost portion of direct cost decreased by approximately 10% from 2002. The decrease in direct labor cost resulted from a lower volume of contract work performed during 2003 compared to 2002.

Cost of Product Revenue.

Cost of product revenue increased by $530,000, or 100%, to $1.1 million from $528,000 in 2002. Microvision's costs to produce Nomad units during 2003 were substantially higher than product revenue. In 2003, Microvision classified production cost in excess of product revenue as research and development expense. Through December 31, 2003, Nomad production and the design and manufacturing processes had not become sufficiently mature to support "commercial production" as described in SFAS No. 2 "Accounting for Research and Development Costs."

Management periodically assesses the need to provide for obsolescence of inventory and adjusts the carrying value of inventory to its net realizable value when required. During 2003, Microvision recorded a write down of Nomad inventory of approximately $450,000.

Research and Development Expense

Research and development expense decreased by $2.2 million, or 9%, to $23.3 million from $25.5 million in 2002. During 2002, the Company recorded $1.5 million in expense relating to light source research performed for the Company by Cree Inc. The Company's research agreement with Cree ended in April 2002, resulting in a $1.4 million expense reduction in 2003 from 2002.

In 2003, Lumera recorded $1.9 million expense on its sponsored research agreement with the University of Washington compared to $2.4 million in 2002. The reduction in expense came as a result of two modifications to the sponsored research agreement with the University of Washington.

In May 2003, Microvision closed its research and development facility in San Mateo, California and consolidated its research and development activities in Bothell, Washington. Research and development expense for 2003 included $540,000 for the closing of Microvision's approximately 5,200 square foot facility in San Mateo and $290,000 for severance and relocation of 11 employees. Microvision paid $270,000 in severance and relocation costs in 2003. The accrual related to the closing of the facility at December 31, 2003 is $431,000.

Marketing, General and Administrative Expense.

Marketing, general and administrative expenses decreased by $971,000, or 6%, to $15.8 million from $16.8 million in 2002. The decrease was primarily attributable to a reduction in the charge to the allowance for doubtful accounts for receivables from senior officers.

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.

In 2002 and again in 2003, 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 an allowance for doubtful accounts for the receivables from senior officers of $200,000 and $700,000 during 2003 and 2002, respectively. The balance of the allowance for doubtful accounts for receivables from senior officers was $900,000 at December 31, 2003. Microvision has no plans to forgive any portion of the principal of the outstanding receivable balance.

Non-Cash Compensation Expense.

Non-cash compensation expense increased by $172,000 or 9% to $2.2 million from $2.0 million in 2002.

In September 2003, Microvision issued two warrants to purchase an aggregate of 70,000 shares of common stock to a third party for services provided to Microvision. The deferred compensation related to these warrants is being amortized to non-cash compensation expense over the fourteen month service period of the agreement. Non-cash amortization expense related to these warrants was $192,000 for 2003.

In August 2003, Lumera issued options to purchase an aggregate of 164,000 shares of its Class A Common Stock to two consultants in connection with entering into consulting agreements. Each holder was granted a warrant to purchase up to 82,000 shares of Class A Common Stock at a price of $3.65 per share with a ten year life. In aggregate, 41,000 of the options were vested on the grant date. The remaining 123,000 shares vest one-third on each subsequent annual anniversary of the grant date and are subject to remeasurement at each balance sheet date during th