MICROVISION INC
Form 10-K/A
May 01, 2006

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, 2005

Commission file number 0-21221

Microvision, Inc.

(Exact name of Registrant as Specified in its Charter)

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

6222 185th Avenue NE
Redmond, Washington 98052

(Address of Principal Executive Offices including Zip Code)

(425) 415-6847

(Registrant's Telephone Number, Including Area Code)

Securities registered pursuant to Section 12(b) of the Act:
None

Securities registered pursuant to Section 12(g) of the Act:
Common Stock, par value $0.001

(Title of class)

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

o No x

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

o No x

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes

x No o

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

x

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

Large accelerated filer o Accelerated filer x Non-accelerated filer o

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

o No x

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

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

Documents Incorporated by Reference

NONE

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

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PART I

Preliminary Note Regarding Forward-Looking Statements

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

ITEM 1. BUSINESS

Overview

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

Scanned Beam Displays

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

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

Image Capture Devices

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

Display Technology

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

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

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

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

Display Components

Scanned beam display technology consists of the following primary components:

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

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

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

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

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

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

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

Current and Prospective Display Products

Integrated Photonics Module

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

Automotive Head-Up Display

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

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

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

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

Pico Projector

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

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

Full Color Eyewear

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

- Highly mobile "Glance-able" display: In this configuration, the user could glance down occasionally at a worn display. This device would be suitable for light business use such as mobile web surfing and reading e-mail. The Company believes that high resolution, high contrast, and small package size could be important differentiators between its scanned beam display solution and competing solutions.
- Look-around or see-through display: In this configuration, the user could view a full screen display in see-through or occluded mode. This configuration would be suitable for viewing longer pieces of streaming video for entertainment or business applications.
- Fully occluded immersive display: In this configuration, the user could view a very wide screen high resolution video stream. This configuration would be suitable for interactive gaming applications and simulators.

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

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

Nomad

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

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

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

The Nomad competes with other products that bring information to the point of task, including laptop and notebook computers, tablet computers, and personal digital assistants. These other devices must be held, wrist mounted, or placed on a stationary object and the user must look away from the task to get information. In contrast, the Nomad is head-worn (i.e. hands free) and provides images to the user's eye with no screen to block the viewer's field of vision. Other companies are marketing head-worn displays, but the displays are generally occluded and typically provide a fraction of the full-page view provided by the Nomad. Microvision believes that Nomad provides higher brightness and higher contrast than competing devices and provides true "see through" capability. Microvision also believes that the manufacturing cost in high volume of Nomad and potential future displays using its scanned beam display technology could be less than that of competing technologies, due principally to the lower cost of scanned beam display components and lower capital investment to build high volume manufacturing capacity compared to other competing technologies.

Current and Prospective Imaging Products

Flic

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

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

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

Image capture

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

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

Business Strategy

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

Strategic Partnering to Extend Marketing and Technical Reach

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

Sale of Components or "Engines" Containing Scanning Technology

. Certain potential applications of the scanned beam display technology, such as automotive HUD or pico projector could require integration of Microvision's technology with other related technologies. In markets requiring high volume production of scanned beam components or subsystems that can be integrated with other components, Microvision may provide designs for or the supply of components, subsystems and systems to original equipment manufacturers under licensing and/or agreements.

Engineering Services to Develop Custom Products

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

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

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

Development of an Intellectual Property Portfolio.

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

Human Factors, Ergonomics and Safety

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

Competitive Conditions

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

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

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

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

Intellectual Property and Proprietary Rights

University of Washington

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

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

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

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

30 days of written notice. Microvision may terminate the license agreement at any time by serving 90 days prior written notice on the University of Washington. In the event of any termination of the license agreement, the license granted to Microvision would terminate.

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

Other Licenses and Intellectual Property

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

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

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

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

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

Additional Information

Microvision performs research and development to design and develop the integrated photonics module and modifications to the integrated photonics module that will be required for specific applications. Research and development expense for the Company for the fiscal years ended December 31, 2005, 2004 and 2003 was $6.6 million, $14.7 million, and $23.3 million, respectively. Excluding Lumera, research and development expense was $6.6 million, $13.6 million and $16.8 million, respectively.

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

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

Employees

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

Further Information

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

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

ITEM 1A. RISK FACTORS.

Risk Factors Relating to the Microvision Business

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

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

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

The likelihood of our success must be considered in light of the expenses, difficulties and delays frequently encountered by companies formed to develop and market new technologies. In particular, our operations to date have focused primarily on research and development of the scanned beam technology and development of demonstration units. We introduced our first two commercial products during 2002. We are unable to accurately estimate future revenues and operating expenses based upon historical performance.

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

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

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

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

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

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

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

The value of our investment in Lumera may decrease.

Lumera's stock price is subject to fluctuation and may decrease, lowering the value of our investment. As of March 1, 2006 we own approximately 12% of Lumera's common stock. Since we hold a large percentage of Lumera's common stock, if an active market does not develop or is not sustained, it may be difficult for us to sell our shares of Lumera's common stock at an attractive price or at all. The likelihood of Lumera's success, and the value of the common stock we hold, must be considered in light of the risks frequently encountered by early stage companies, especially those formed to develop and market new technologies. These risks include Lumera's potential inability to establish product sales and marketing capabilities to establish and maintain markets for their potential products; and to continue to develop and upgrade their technologies to keep pace with changes in technology and the growth of markets using polymer materials. If Lumera is unsuccessful in meeting these challenges, its stock price, and the value of our investment, could decrease.

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

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

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

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

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

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

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

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

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

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

We may not succeed in these efforts because of:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

ITEM 1B. UNRESOLVED STAFF COMMENTS

None

ITEM 2. PROPERTIES

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

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

ITEM 3. LEGAL PROCEEDINGS

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

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

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

PART II

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

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

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

	Common Stock	
Quarter Ended	**HIGH**	**LOW**
2004		
March 31, 2004	$ 10.93	$ 7.34
June 30, 2004	10.00	5.06
September 30, 2004	8.95	3.75
December 31, 2004	8.00	5.04
2005		
March 31, 2005	$ 7.70	$ 5.03
June 30, 2005	6.77	4.15
September 30, 2005	6.49	5.04
December 31, 2005	6.53	3.02
2006		
January 1, 2006 to March 1, 2006	$ 4.25	$ 3.05

ITEM 6. SELECTED FINANCIAL DATA

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

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

Lumera was deconsolidated in July 2004.

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

Overview

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

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

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

Key Accounting Policies and Estimates

The Company's discussions and analysis of its financial condition and results of operations are based upon the Company's consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires the Company to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent liabilities. On an on-going basis, the Company evaluates its estimates, including those related to revenue recognition, contract losses, bad debts, investments and contingencies and litigation. The Company bases its estimates on historical experience, terms of existing contracts, its evaluation of trends in the display and image capture industries, information provided by its current and prospective customers and strategic partners, information available from other outside sources, and on various other assumptions management believes to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

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

Revenue Recognition

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

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

Losses on Uncompleted Contracts

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

Allowance for uncollectible receivables

. The Company maintains allowances for uncollectible receivables, including accounts receivable, cost and estimated earnings in excess of billings on uncompleted contracts and receivables from related parties. The Company reviews several factors in determining the allowances including the customer's past payment history and financial condition. If the financial condition of our customers or the related parties with whom the Company has receivables were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances could be required.

Inventory.

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

Warrants and Derivatives.

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

Litigation.

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

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

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

Results of Operations

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

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

A portion of each segments' administration expenses arose from shared services and infrastructure that Microvision had provided to both segments in order to realize economies of scale and to efficiently use resources. These efficiencies include costs of certain legal, accounting, human resources and other Microvision corporate and infrastructure costs. These expenses were allocated to the segments and the allocation was determined on a basis that the Company considered to be a reasonable reflection of the utilization of services provided to, or benefits received by, the segments.

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

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

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

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

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

Contract Revenue.

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

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

The Company expects contract revenue to fluctuate significantly from year to year.

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

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

Product Revenue.

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

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

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

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

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

Cost of Contract Revenue.

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

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

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

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

Cost of Product Revenue.

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

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

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

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

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

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

Research and Development Expense.

Research and development expense consists of:

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

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

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

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

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

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

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

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

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

Sales, Marketing, General and Administrative Expense.

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

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

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

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

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

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

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

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

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

Non-Cash Compensation Expense.

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

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

	2005	2004
Microvision stock, options and warrants issued to third parties	$ 335,000	$ 587,000
Microvision stock options issued to employees	59,000	54,000
Microvision stock and options issued to Independent Directors	35,000	46,000
Lumera options issued to Microvision employees	--	134,000

Lumera non-cash compensation expense	--	1,297,000
	$ 429,000	$ 2,118,000

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

Interest Income and Expense.

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

Loss on debt extinguishment

.

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

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

Gain on derivative feature of notes payable.

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

	Notes	Warrants	Embedded derivative feature	s
March 10, 2005 issuance	$ 5,395	$ 1,650	$ 2,955	$

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

In connection with the issuance of the Company's March Notes, the Company concluded that the note holders' right to convert all or a portion of the notes into Microvision or Lumera common stock is an embedded derivative instrument as defined by FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. Accordingly, $2,955,000 of the cash proceeds were allocated to the embedded derivative instrument, which represents the fair value of the instrument on the date of issuance. The derivative instrument was valued using the higher of the Microvision or Lumera conversion feature. The value was determined using the Black Scholes option-pricing model with the following assumptions: expected volatility of 83%; expected dividend yield of 0%; risk free interest rate of 4.62%; and contractual life of six months to two years, which corresponds to the principal repayment dates. Due to change in the stock price and remaining life, the fair value of the embedded derivative instrument decreased to $2,463,000 at July 25, 2005 the date of the extinguishment. The change in value of $492,000 for the period from issuance to July 25, 2005, was recorded as a non-operating gain and is included in "Gain on derivative features of note payable, net" in the consolidated statement of operations.

The Company issued warrants to purchase 462,000 shares of common stock in connection with the issuance of the March Notes. The warrants vested on the date of grant, have an exercise price of $6.84 per share and expire in March 2010. The initial exercise price is subject to adjustment in the event Microvision issues common stock or common stock equivalents at a price per share of common stock below the exercise price of the warrant. Under the terms of the restructuring of the notes in July 2005, the Company issued three year warrants to purchase 750,000 shares of Microvision common stock at a price of $6.84. The warrants met the definition of a derivative instrument that must be accounted for as a liability under the provisions of Emerging Issues Task Force Issue No. 00-19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock,* because the Company cannot engage in certain corporate transactions affecting the common stock unless it makes a cash payment to the holders of the warrants. Accordingly, $1,651,000 of the cash proceeds were allocated to the original warrants and an additional $2,295,000 was allocated to the warrant issued in July 2005. These amounts which represent the fair value of the warrants on the date of issuance have been included in current liabilities. Subsequent changes in the fair value of the warrants will be recorded in the statement of operations each period. As of December 31, 2005, the warrants were valued using the Black Scholes option- pricing model with the following assumptions: expected volatilities of 65%and 58%; expected dividend yield of 0%; risk free interest rates ranging from 4.36% to 4.39%; and contractual lives of 4.2 years and 2.6 years. The change in value of the warrants of$2,671,000 for the year ended December 31, 2005 was recorded as a non-operating gain and is included in "Gain on Derivative Features of Note Payable Net" in the consolidated statement of operations.

The amended conversion feature described above continued to meet the definition of a derivative under FAS 133 and accordingly was recorded at fair value at issuance and included within long term liabilities. The carrying amount of the derivative will be adjusted to fair value at each balance sheet date. The derivative feature was valued at $331,000 at December 31, 2005 and the change in the value from July 25, 2005 to December 31, 2005 of $2,712,000 was recorded as a non operating gain and is included in "Gain on derivative features of note payable, net" in the consolidated statement of operations.

In October 2005, the noteholder converted $1.8 million of the March Notes to 310,000 shares of common stock. The value of the embedded derivative feature associated with the converted shares of $439,000 was recorded to additional paid in capital.

In connection with the issuance of the December Notes, the Company concluded that the note holders' right to convert all or a portion of the notes into Microvision common stock is an embedded derivative instrument as defined by FASB Statement No. 133, accordingly $1.1 million of the cash proceeds were allocated to the embedded derivative instrument, which represents the fair value of the instrument on the date of issuance. The value of the derivative feature was determined using the Black Scholes option-pricing model with the following assumptions: expected volatility of 58%; expected dividend yield of 0%; risk free interest rates ranging from 4.01% to 4.39%; and contractual life of four to sixteen months, which corresponds to the principal repayment dates. Due to change in the stock price and remaining life, the fair value of the embedded derivative instrument decreased to $1,038,000 at December 31, 2005. The change in value of $78,000 was recorded as a non-operating gain and is included in "Gain on derivative features of note payable, net" in the consolidated statement of operations.

The Company issued warrants to purchase 1,089,000 shares of common stock in connection with the issuance of the December Notes. The warrants vested on the date of grant, have an exercise price of $3.94 per share and expire in December 2010. The warrants met the definition of a derivative instrument that must be accounted for as a liability under the provisions of Emerging Issues Task Force Issue No. 00-19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock,* because the Company cannot engage in certain corporate transactions affecting the common stock unless it makes a cash payment to the holders of the warrants. Accordingly, $2.2 million of the cash proceeds were allocated to the original warrants which represent the fair value of the warrants on the date of issuance, and the amount was recorded as a current liability. Subsequent changes in the fair value of the warrants will be recorded in the statement of operations each period. As of December 31, 2005, the warrants were valued using the Black Scholes option- pricing model with the following assumptions: expected volatility of 65%; expected dividend yield of 0%; risk free interest rate of 4.35%; and contractual life of five years. The change in value of $22,000 was recorded as a non- operating gain and is included in "Gain on Derivative Features of Note Payable, Net" in the consolidated statement of operations.

Loss on equity in investment subsidiary

.

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. Microvision's share in Lumera's losses was $3.2 million for the year ended December 31, 2005 and $1.7 million for the period from July 2004 to December 31, 2004.

Gain on Sale of Securities of Equity Subsidiary.

During 2005 Microvision sold 812,000 shares of its Lumera common stock at prices between $4.04 and $5.00 per share. The total proceeds from the sales were $3,893,000. The sales price was higher than the average carrying value of the shares and the Company recognized a gain of $2.7 million in 2005.

Income Taxes.

No provision for income taxes has been recorded because the Company has experienced net losses from inception through December 31, 2005. At December 31, 2005, Microvision had net operating loss carry-forwards of approximately $191.0 million for federal income tax reporting purposes. In addition, Microvision has research and development tax credits of $2.6 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 annual limitation for losses generated in 1996 is approximately $1.6 million.

Inducement for Conversion 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 362,000 shares of common stock. 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 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, 3.4%, and contractual life five years. $1.3 million of the proceeds were allocated to the warrant and was recorded as an increase to additional paid-in capital.

Subsequent to the relative fair value allocation, the effective 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, resulting in the recognition of a beneficial conversion feature in accordance with Emerging Issues Task Force No 00-27 "Application of Issue No. 98-5 to Certain Convertible Instruments." 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 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) using the effective interest method, over the stated life of the preferred stock, which is three years. During 2005, the Company recorded $280,000 in dividends on the preferred stock and $303,000 in accretion of the beneficial conversion feature of the preferred stock.

In August 2005, the holder of the Company's preferred stock agreed to convert 5,000 shares of the Company's preferred stock into 734,000 shares of common stock. As an inducement to convert the preferred stock the Company issued 124,000 shares of its common stock to the preferred stock holder and adjusted the exercise price from $8.16 to $6.84 per share for the existing warrants to purchase 362,000 shares of common stock issued in connection with the original sale of the Company's preferred stock. The total value of the 124,000 common shares issued of $701,000, the change in the value of the warrants of $62,000 and the amount of unamortized beneficial conversion feature on the preferred stock of $421,000 was recorded as an inducement to convert the preferred stock and charged to common shareholders in 2005. The warrants were valued using the Black Scholes option pricing model with the following assumption: expected volatility 65%, risk free interest rate 4.25% and contractual life 4.1 years.

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.

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 contract 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.

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 was composed of development contracts, including amendments, entered through December 31, 2004.

Product Revenue.

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.

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 was composed of orders for Nomad and Flic received through December 31, 2004.

Cost of Contract Revenue.

Cost of contract revenue decreased by $449,000, or 8%, to $5.5 million from $6.0 million. On a percentage of contract revenue basis, cost of contract revenue increased to 63% from 44% in 2003. The change in cost of contract revenue as a percentage of contract revenue is primarily attributable to changes in the contract costs mix. Total direct costs in 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.

Cost of Product Revenue.

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

Research and Development Expense.

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 required 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 terminated in 2005 after payments of $375,000 were made in quarters ending March 31, 2005 and June 30, 2005. Total payments under the Sponsored Research Agreement were $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.

Sales, Marketing, General and Administrative Expense.

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 was due to the increase in sales and marketing activity related to Nomad and Flic sales. The Company added sales staff, demonstration equipment and promotion materials to support increased sales of Nomad and Flic

Non-Cash Compensation Expense.

Non-cash compensation expense decreased by $38,000 or 2% to $2.1 million from $2.2 million in 2003.

In September 2003, the Company issued two warrants to purchase an aggregate of 70,000 shares of common stock to a third party in exchange for services provided to the Company. 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 vests in three equal tranches on the date of grant, in December 2003, and March 2004. The other warrant grants the holder the right to purchase up to 10,000 shares at a price of $12.00 per share and vests in March 2004. The unvested warrants were subject to remeasurement at each balance sheet date until vested. The deferred compensation related to these warrants was 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 $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 contractual lives used at the measurement dates above were 4 years and 3.9 years, respectively.

In August 2000, the Company issued warrants to purchase an aggregate of 200,000 shares of common stock to two consultants in connection with entering into certain consulting agreements with the Company. One of the consultants subsequently became a director. The warrants grant each of the holders the right to purchase up to 100,000 shares of common stock at a price of $34.00 per share. The warrants to purchase an aggregate of 150,000 shares vested over three years and were subject to remeasurement at each balance sheet date during the vesting period. The remaining warrants to purchase an aggregate of 50,000 shares had a measurement date at the time of grant. The deferred compensation related to these warrants is being amortized to non-cash compensation expense over the five-year period of service under the agreements. The total original value of both warrants were estimated at $5,476,000.

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 and warrants 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 had research and development tax credits of $2.2 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 362,000 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 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.

Liquidity and Capital Resources

Microvision has incurred significant losses since inception. The Company has funded operations to date primarily through the sale of common stock, convertible preferred stock, warrants, the issuance of convertible debt and, to a lesser extent, from development contract revenues and product sales. At December 31, 2005, Microvision had $6.9 million in cash and cash equivalents. In January 2006 the Company raised $10.3 million through the sale of 2.6 million shares of its Lumera common stock equity method investment to a small group of private investors. The Company has sufficient cash to fund its operations through July 2006.

As discussed elsewhere in this report, the Company has received a report from our independent registered public accounting firm regarding the consolidated financial statements for the year ended December 31, 2005 that includes an explanatory paragraph stating that the financial statements have been prepared assuming Microvision will continue as a going concern. The explanatory paragraph states the following conditions, which raise substantial doubt about our ability to continue as a going concern: (i) the Company has incurred operating losses since inception, including a net loss available for common shareholders of $30.3 million for the fiscal year ended December 31, 2005, and the Company has an accumulated deficit of $215.7 million at December 31, 2005 and (ii) the Company anticipates requiring additional financial resources to enable it to fund its operations at least through December 31, 2006.

The Company plans to raise additional cash before July 2006 to fund its operations through the sale of its common stock, preferred stock or through the issuance of debt. The Company has taken the following actions to reduce its use of cash and improve the operations of the Company:

- Made significant changes to it senior management team including appointing a new Chief Executive Officer
- Announced a restructuring and realignment plan that targets a 30% reduction in operating loss
- Begun adding members to the Board of Directors with experience that directly supports the Company's business objectives
- Engaged an investment bank to assist the Company in pursuing financing alternatives

Cash used in operating activities totaled $19.7 million during 2005, compared to $30.8 million during 2004.

The Company had the following material gains and charges and changes in assets and liabilities during the year ended December 31, 2005.

- *"Non cash interest expense, net"* In connection with the issuance of the Company's notes in March 2005 and December 2005 the Company allocated proceeds to the embedded derivative features and the warrants. The aggregate discount to the notes of $7.9 million is amortized to noncash interest expense using the imputed interest method over the life of the notes. At December 31, 2005 the Company has $5.0 million in unamortized discount associated with the notes remaining.

- *"Derivative feature of notes payable"* In connection with the issuance of the Notes, the Company allocated a portion of the proceeds to the embedded derivative features of the Notes. Due to changes in the stock price and remaining life, the fair value of the embedded derivative instrument decreased to $1.4 million at December 31, 2005. The aggregate change in value of $3.3 million for the year ended December 31, 2005 was recorded as a non-operating gain and is included in "Gain on derivative features of note payable, net" in the consolidated statement of operations.

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

  In 2005, Microvision determined that certain of its senior officers may have had insufficient net worth and short-term earnings potential to repay their outstanding loans. As a result, Microvision recorded additional allowances for doubtful accounts for the receivables from senior officers of $1.0 million. The balance of the allowance for doubtful accounts for receivables from senior officers was $1.9 million at December 31, 2005. Two of the officers left the Company in January 2006, in accordance with the terms, the loans issued to these officers will be due in January 2007. Microvision has no plans to forgive any portion of the principal of the outstanding receivable balance.

- "*Equity losses in Lumera*", *"Investment in Lumera"and "Gain on sale of securities of equity subsidiary"* Microvision accounts for its investment in Lumera using the equity method. Microvision records its pro rata share of Lumera's income or loss as an adjustment in the value of its investment in Lumera. Microvision's share in Lumera's losses was $3.2 million for the year ended December 31, 2005 and $1.7 million for the period from July 2004 to December 31, 2004. During 2005, Microvision sold 812,000 shares of its Lumera common stock at prices between $4.04 and $5.00 per share. The total proceeds from the sales were $3,893,000. The aggregate carrying value of the shares sold was $1,192,000. The sales price was higher than the average carrying value of the shares and the Company recognized a gain of $2,700,000 in 2005. In March 2005 and December 2005, the Company issued convertible notes that are secured by 1,750,000 shares Lumera common stock with a book value of $2.2 million at December 31, 2005. The value of the restricted Lumera common stock has been recorded as "Restricted investment in Lumera."

- *"Loss on debt extinguishment"* In July 2005, the Company entered into an agreement to amend the March Notes. In connection with the amendment, the Company issued three year warrants to purchase 750,000 shares of Microvision common stock with an exercise price of $6.84 per share. The conversion price of the amended notes and exercise price of the warrants are subject to anti-dilution adjustments. In addition, the price at which the note holder can convert the March Notes to Microvision common stock was reduced to $5.85 per share, and the price at which the Company can mandatorily convert the March Notes to Microvision common stock was reduced to $10.24. The Company has pledged 1,750,000 shares of its Lumera common stock as collateral for the March Notes. As a result of the amendment, the March Notes are not currently exchangeable into Lumera common stock.

- The Company has concluded that the amendment of March Notes met the criteria of a debt extinguishment and recorded a charge of $3,313,000 for the change in the fair value of the debt in July 2005. The change in the value of the debt was measured as the value of the additional warrants that were issued to the note holders and the change in the price at which the debt could be converted to Microvision common stock. The additional warrants were valued using the Black Scholes option-pricing model with the following assumptions: expected volatility of 75%; expected dividend yield of 0%; risk free interest rate of 3.66%; and contractual life of three years. The warrants were initially valued at $2,295,000. The change in the conversion price was valued using the Black Scholes option-pricing model with the following assumptions: expected volatility of 75%; expected dividend yield of 0%; risk free interest rates ranging from 3.25% to 3.58%; and contractual life equal to the length of the option. The change in the conversion price was valued at $1,018,000.

- *"Accounts receivable" and "Billings in excess of costs and estimated earnings on uncompleted contracts"* In December 2004 the Company recorded a receivable of $3.5 million from a customer for an advance payment in accordance with the terms of the development contract. The Company received the payment in January 2005 and the Company performed work on the contract during 2005.

- *"Inventory"* Inventory decreased by $2.4 million to $759,000 at December 31, 2005 from $ 3.2 million at December 31, 2004. The decrease was primarily attributable to the write off of excess and obsolete inventory. The Company had previously made commitments to purchase certain minimum quantities based on the economic order quantities, sales forecast and the availability of raw materials. The Company values inventory at the lower of cost or market with cost determined on a weighted average cost basis. The following table shows the composition of the inventory at December 31, 2005 and December 31, 2004, respectively:

	December 31, 2005	December 31, 2004
Raw materials	$ 267,000	$ 1,607,000
Work in process	141,000	77,000
Finished goods	351,000	1,483,000
	$ 759,000	$ 3,167,000

Cash provided by investing activities totaled $1.0 million in 2005 compared to $10.0 million in 2004. During 2005, the Company had net purchases of investment securities of $863,000 compared net sales of investment securities of $11.1 million during 2004. The proceeds from the sales of investment securities were used to fund the Company's operations.

The Company used cash of $1.2 million for capital expenditures in 2005, compared to $1.0 million in 2004. Capital expenditures include leasehold improvements to leased office space and computer hardware and software, laboratory equipment and furniture and fixtures to support operations.

Cash provided by financing activities totaled $24.3 million in 2005, compared to $12.8 million in 2004. The following is a list of stock issuances during 2005 and 2004.

- In December 2005, the Company raised $10.0 million, before issuance costs of $134,000, from the issuance of convertible notes ("December Notes"), 838,000 shares of common stock and warrants to purchase 1,089,000 shares of Microvision common stock. The December Notes are convertible on demand by the holders into Microvision common stock at a conversion price of $3.94 per share. The note holders may convert all or a portion of their notes. In addition, upon the request of the note holders, the Company is required to redeem the December Notes for cash upon a change of control or an event of default at a redemption price equal to 125% of the then outstanding balance of the notes. The Company has pledged 1,750,000 shares of its Lumera common stock as collateral for the December Notes and the shares have been classified as a "Restricted investment in Lumera" on the Company's consolidated balance sheet.

  The terms of the December Notes include interest at LIBOR plus 3.0% provided that the interest rate shall not be less than 6% or greater than 8% payable quarterly in cash or Microvision common stock if the stock price is greater than $4.06 per share, at the election of the Company, subject to certain additional conditions. Under certain circumstances the interest rate increases to LIBOR plus 6% but not less than 12% or greater than 15%. If the Company chooses to pay interest in Microvision common stock as opposed to cash, the price will be based on 90% of the arithmetic average of the volume weighted average prices for the 20 trading days prior to the payment date. The December Notes are payable in five equal quarterly installments beginning in March 2006. The Company can elect to make the principal payments in common stock in lieu of cash if the stock price is greater than $4.06 per share, subject to certain other conditions. If the Company elects to pay principal in stock the stock will be issued at a 10% discount to the arithmetic average of the volume weighted average prices for the 15 trading days prior to the payment date. Additionally, the Company can elect to convert the December Notes into Microvision common stock if the stock price exceeds $6.90 per share for 20 out of any 30 consecutive trading days, subject to certain conditions.

The Company concluded that the note holders' right to convert all or a portion of the December Notes into Microvision common stock is an embedded derivative instrument as defined by FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities ("FAS 133")*. Accordingly, $1.1 million of the cash proceeds were allocated to the embedded derivative instrument, which represents the fair value of the instrument on the date of issuance. The value was determined using the Black Scholes option-pricing model with the following assumptions: expected volatility of 58%; expected dividend yield of 0%; risk free interest rate of 4.01% to 4.39%; and contractual life of four to sixteen months, which corresponds to the principal repayment dates. Due to changes in Microvision's stock price and remaining contractual life, the fair value of the embedded derivative feature decreased to $1,038,000 at December 31, 2005. The change in value of $78,000 was recorded as a non-operating gain and included in Gain on derivative features of note payable in the consolidated statement of operations. As of December 31, 2005 total principal payments of $7.0 million remain under the December Notes.

The warrants vested on the date of grant, have an exercise price of $3.94 per share of common stock and expire in December 2010. The warrants met the definition of a derivative instrument that must be accounted for as a liability under the provisions of Emerging Issues Task Force Issue No. 00-19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock,* because the Company cannot engage in certain corporate transactions affecting the common stock unless it makes a cash payment to the holders of the warrants. Accordingly, $2.2 million of the cash proceeds were allocated to the warrants, which represents the fair value of the warrants on the date of issuance and the amount was recorded as a current liability. Subsequent changes in the fair value of the warrants will be recorded in the statement of operations each period. The warrants were valued using the Black Scholes option-pricing model with the following assumptions: expected volatility of 65%; expected dividend yield of 0%; risk free interest rate of 4.35%; and contractual life of five years.

The Microvision common stock was valued at the closing price on the date of closing of $3.60 per share. Aggregate proceeds of $3.0 million were allocated to the common stock. The remaining gross proceeds of $3.7 million were allocated to the December Notes.

- In August and September 2005 the Company raised $7.0 million before issuance costs through the sale of 1,333,000 shares of common stock at a price of $5.25 per share and five-year warrants to purchase 310,000 shares of common stock at a price of $6.50 to a holder of the Company's preferred stock and other investors.

In March 2005, the Company raised $10.0 million, before issuance costs of $423,000, from the issuance of convertible notes ("March Notes") and warrants to purchase an aggregate of 462,000 shares of Microvision common stock. The March Notes are convertible on demand by the holders into Microvision common stock at a conversion price of $6.84 per share of Microvision common stock or Lumera common stock held by the Company at a conversion price of $5.64 per share up to a limit of 1,750,000 shares of Lumera common stock. The right to convert the March Notes into shares of Lumera common stock was removed pursuant to the amendment described below. The note holders may convert all or a portion of their notes. The initial conversion price is subject to adjustment in the event Microvision issues common stock or common stock equivalents at a price per share of common stock below the conversion price of the March Notes. Due to below market issuances of Company's common stock the conversion price of the March Notes at December 31, 2005 was $5.54 per share of common stock. In addition, upon the request of the note holders, the Company is required to redeem the March Notes for cash upon a change of control or an event of default at a redemption price equal to 125% of the then outstanding balance of the March Notes. The Company has pledged 1,750,000 shares of its Lumera common stock as collateral for the March Notes and the December Notes, described above. Those shares have been classified as a "Restricted investment in Lumera" on the Company's consolidated balance sheet.

The terms of the March Notes include interest at LIBOR plus 3.0% payable quarterly in cash or Microvision common stock, at the election of the Company, subject to certain conditions. However, in no case shall the interest rate be less than 6.0% or greater than 8.0%. If the Company chooses to pay interest in Microvision common stock instead of cash, the price will be based on 92% of the arithmetic average of the volume weighted average prices for the 10 trading days prior to the payment date. The March Notes are payable in six equal quarterly installments beginning in December 2005. The Company can subject to certain conditions, elect to make the principal payments in common stock in lieu of cash. Payment in stock will be issued at a 10% discount to the arithmetic average of the volume weighted average prices for the 15 trading days prior to the payment date. Additionally, the Company can elect to convert the March Notes into Microvision common stock if the stock price exceeds $11.97 per share for 20 out of any 30 consecutive trading days, subject to certain conditions.

The Company concluded that the note holders' right to convert all or a portion of the March Notes into Microvision or Lumera common stock is an embedded derivative instrument as defined by FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities ("FAS 133").* Accordingly, $2,955,000 of the cash proceeds were allocated to the embedded derivative instrument, which represents the fair value of the instrument on the date of issuance. The derivative instrument was valued using the higher of the Microvision or Lumera conversion feature. The value was determined using the Black Scholes option-pricing model with the following assumptions: expected volatility of 83%; expected dividend yield of 0%; risk free interest rate of 4.62%; and contractual life of nine months to two years, which corresponds to the principal repayment dates. Due to changes in Lumera and Microvision's stock price and remaining contractual life, the fair value of the embedded derivative feature decreased to $2,463,000 at July 25, 2005 the date of the extinguishment. The changes in value of a decrease of $492,000 for the year ended December 31, 2005 was recorded as a non-operating gain and included in "Gain on derivative features of note payable" in the consolidated statement of operations. As of December 31, 2005 total principal payments of $7.3 million remain under the March Notes.

The warrants vested on the date of grant, have an exercise price of $6.84 per common share and expire in March 2010. The initial exercise price is subject to adjustment in the event Microvision issues common stock or common stock equivalents at a price per share of common stock below the exercise price of the warrant. Due to below market issuances of Company's common stock the exercise price of the warrants issued with the March Notes was adjusted to $6.29 as of December 31, 2005. The warrants met the definition of a derivative instrument that must be accounted for as a liability under the provisions of Emerging Issues Task Force Issue No. 00-19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock,* because the Company cannot engage in certain corporate transactions affecting the common stock unless it makes a cash payment to the holders of the warrants. Accordingly, $1,651,000 of the cash proceeds were allocated to the warrants, which represents the fair value of the warrants on the date of issuance and the amount was recorded as a current liability. Subsequent changes in the fair value of the warrants will be recorded in the statement of operations each period. The warrants were valued using the Black Scholes option- pricing model with the following assumptions: expected volatility of 75%; expected dividend yield of 0%; risk free interest rate of 4.62%; and contractual life of five years. The remaining gross proceeds of $5,394,000 were allocated to the Notes.

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

The Company has concluded that the amendment of the March Notes met the criteria of a debt extinguishment. The Company recorded a non cash charge of $3,313,000 for the change in the fair value of the debt and related consideration. The change in the value was measured as the value of the additional warrants that were issued to the note holders and the change in the price at which the debt could be converted to Microvision common stock. The additional warrants were valued using the Black Scholes option-pricing model with the following assumptions: expected volatility of 75%; expected dividend yield of 0%; risk free interest rate of 3.66%; and contractual life of three years. The additional warrants were initially valued at $2,295,000. The change in the conversion feature was valued using the Black Scholes option-pricing model with the following assumptions: expected volatility of 75%; expected dividend yield of 0%; risk free interest rates ranging from 3.25% to 3.58% and contractual life equal to the length of the option. The change in the conversion price was valued at $1,018,000.

The amended conversion feature continued to meet the definition of a derivative under FAS 133 and accordingly has been recorded at fair value and included within long-term liabilities. The carrying amount of the derivative will be adjusted to fair value at each balance sheet date. An adjustment of $2,712,000 was recorded for the period from July 25, 2005 to December 31, 2005.

In October 2005, the noteholder converted $1.8 million of the March Notes to 310,000 shares of common stock. The value of the embedded derivative feature associated with the converted shares of $439,000 was recorded to additional paid in capital.

The liability for both the initial warrant and the additional warrant are adjusted to the fair market value of $1,273,000 at December 31, 2005. The combined adjustment during the year ended December 31, 2005 was $2,672,000.

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. Due to below market issuances of Company's common stock the conversion price of the Preferred Stock as of December 31, 2005 was $6.36 per share of common 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 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 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 Microvision 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. Due to below market issuances of Company's common stock the exercise price of the warrants issued with the Preferred Stock was adjusted to $6.40 as of December 31, 2005.

The net cash proceeds of $9.9 million 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, 3.4%, and contractual life five 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 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 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.

- In April 2004, Lumera raised $2.3 million from the issuance of convertible promissory notes. The notes accrue interest at a rate of 6.5% per annum and are payable on demand upon the closing of an underwritten public offering of Lumera's common stock. Lumera completed an initial public offering in July 2004. The principal amount and any accrued but unpaid interest in respect of each note is convertible at any time, at the option of the holder, into shares of Lumera's Class A common stock. The conversion price is $6.00 per share of common stock. In connection with the sale of these convertible notes, Lumera also issued warrants to purchase shares of common stock. The number of shares is based on a formula based on the exercise price of the warrant and the face amount of the holder's convertible note. The exercise price of the warrants is equal to $7.20 per share. All of the warrants are exercisable on the date of grant and expire in April 2009. The value of the warrants granted was estimated to be approximately $344,000 using the Black Scholes option pricing model. The relative fair value of the warrants of $299,000 was treated as a debt issuance cost and amortized to interest expense over the one year term of the convertible notes.

- In March 2004 Lumera raised $500,000, before issuance costs, from the sale of 250,000 shares of Series B convertible preferred stock to a group of private investors. Microvision did not participate in the offering.

The Company's investment policy restricts investments to ensure principal preservation and liquidity. Generally, the Company invests cash that it expects to use within approximately sixty days in U.S. treasury-backed instruments. The Company invests the balance of its cash in high quality investment securities. The investment securities portfolio is limited to U.S. government and U.S. government agency debt securities and other high-grade securities generally with maturities of three years or less.

Future operating expenditures and capital requirements will depend on numerous factors, including the following:

- the progress of research and development programs,
- the progress in commercialization activities and arrangements,
- the cost of filing, prosecuting, defending and enforcing any patent claims and other intellectual property rights,
- competing technological and market developments, and
- Microvision's ability to establish cooperative development, joint venture and licensing arrangements.

In order to maintain its exclusive rights under the Company's license agreement with the University of Washington, the Company is obligated to make royalty payments to the University of Washington with respect to the Virtual Retinal Display technology. If the Company is successful in establishing original equipment manufacturer co-development and joint venture arrangements, the Company expects its partners to fund certain non-recurring engineering costs for technology development and/or for product development. Nevertheless, the Company expects its cash requirements to increase at a rate consistent with revenue growth as it expands its activities and operations with the objective of commercializing the scanned beam technology.

The following table lists the Company's contractual obligations (in thousands):

	December 31,				
	2006	2007	2008	2009	2010
Contractual Obligations:					
Open purchase orders *	$ 2,875	$ --	$ --	$ --	$
Minimum payments under senior secured convertable notes including interest	12,202	2,812	--		
Minimum payments under capital leases	41	39	33	27	
Minimum payments under operating leases	741	850	834	837	8
Minimum payments under research, royalty and licensing agreements +	390	390	215	215	1
Total	$ 16,249	$ 4,091	$ 1,082	$ 1,079	$ 1,0

* Open purchase orders represent commitments to purchase inventory, materials, capital equipment and other goods used in the normal course of the Company's business.

\+ License and royalty obligations continue through the lives of the underlying patents, which is currently at least 2017.

Microvision's cash balance at December 31, 2005 was $6.9 million. In addition, Microvision raised $10.3 million in January 2006 through the sale of 2.6 million shares of its Lumera common stock to a small group of investors. To the extent required to implement the Microvision's operating plan, Microvision may sell or pledge as collateral, its unpledged shares of Lumera common stock. As of March 1, 2006, Microvision owns approximately 322,000 shares of Lumera common stock that have not been pledged as collateral for the Company's convertible notes issued as of March 11, 2005 and the notes issued in December 2005. Based on the March 1, 2006 closing price of $4.10, the Lumera shares that have not been pledged as collateral have a market value of approximately $1.2 million. Based on our current operating plan and budgeted cash requirements, we expect to need additional cash to fund our operations in July 2006. Since we hold a large percentage of Lumera's common stock, if an active market is not sustained, it may be difficult for us to sell our shares of Lumera's common stock at a value sufficient to fund our operating plans.

Microvision may also raise financing through future sales of Microvision preferred or common stock, issuance of debt securities or other borrowings. There can be no assurance that other additional financing will be available to Microvision or that, if available, it will be available on terms acceptable to Microvision on a timely basis. If adequate funds are not available to satisfy either short-term or long-term capital requirements, Microvision may be required to limit its operations substantially. This limitation of operations may include reductions in staff and operating costs as well as reductions in capital expenditures and investment in research and development.

Should expenses exceed the amounts budgeted, the Company may require additional capital earlier than July 2006 to further the development of its technology, for expenses associated with product development, and to respond to competitive pressures or to meet unanticipated development difficulties The operating plan also provides for the development of strategic relationships with systems and equipment manufacturers that may require additional investments by the Company. The Company's capital requirements will depend on many factors, including, but not limited to, the rate at which the Company can, directly or through arrangements with original equipment manufacturers, introduce products incorporating the scanned beam technology and the market acceptance and competitive position of such products.

New accounting pronouncements

In December 2004, the Financial Accounting Standards Board ("FASB") issued SFAS No. 123(R), "Share-Based Payment", which is a revision of SFAS No. 123 and supersedes APB Opinion No. 25. SFAS No. 123(R) requires all employee share-based awards granted after the effective date to be valued at fair value, and to be expensed over the applicable vesting period. Pro forma disclosure of the income statement effects of share-based payments is no longer an alternative. SFAS No. 123(R) is effective for all share-based awards granted on or after January 1, 2006. In addition, companies must recognize compensation expense related to any awards that are not fully vested as of the effective date. Compensation expense for the unvested employee awards will be measured based on the fair value of the awards previously calculated in developing the pro forma disclosures in accordance with the provisions of SFAS No. 123. The first reporting period where employee share-based compensation will be recognized is March 31, 2006. Share-based compensation expense in 2006 will be affected by our stock price at the time of grants are awarded, the number and structure of stock-based awards our board of directors may grant during the year, any other actions taken with respect to outstanding options, as well as a number of complex and subjective valuation assumptions. These valuation assumptions include, but are not limited to, the future volatility of our stock price and employee stock option exercise behaviors.

The Company is currently evaluating the alternative methods for implementing SFAS No. 123(R) and there is sufficient uncertainty surrounding future share-based compensation actions and valuation estimates that the Company is not in a position to provide a useful estimate of the financial statement impact of SFAS No. 123(R) in 2006 at this time.

In November 2004 the FASB issued SFAS 151 Inventory Cost - an Amendment of ARP No. 43, chapter 4 ("SFAS 151") which provides clarifies accounting for abnormal manufacturing costs. The Company is required to adopt SFAS 151 for years beginning after June 30, 2005. The Company does not believe that adoption of SFAS 151 will have a material impact on its financial statements.

In March 2005, the Securities and Exchange Commission ("SEC") issued Staff Accounting Bulletin No. 107 ("SAB 107"), "Share Based Payment," which expresses the SEC's views on the interaction between SFAS 123R and certain SEC rules and regulations. The Company is currently assessing the guidance in SAB 107 as part of its evaluation of the adoption of SFAS 123R.

Subsequent Events

In January 2006, the Company raised $10,324,000 from the sale of 2,550,000 shares of Lumera common stock. As a result of the sale, the Company will record a "gain on sale of equity subsidiary" of approximately $7.3 million. Subsequent to the sale, the Company owned 2,072,000 shares, or 12%, of the outstanding shares of Lumera common stock. After January 31, 2006, due to the change in ownership percentage, Microvision will account for its investment in Lumera using the cost method.

In January 2006 the Chief Executive Officer's employment was terminated and the Chief Financial Officer resigned. The Company appointed Alexander Y. Tokman to Chief Executive Officer in January 2006.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Substantially all of the Company's cash equivalents and investment securities are at fixed interest rates and, as such, the fair value of these instruments is affected by changes in market interest rates. Due to the generally short-term maturities of these investment securities, the Company believes that the market risk arising from its holdings of these financial instruments is not significant. The Company's investment policy restricts investments to ensure principal preservation and liquidity. The Company invests cash that it expects to use within approximately sixty days in U.S. treasury-backed instruments. The Company invests cash in excess of sixty days of its requirements in high quality investment securities. The investment securities portfolio is limited to U.S. government and U.S. government agency debt securities and other high-grade securities generally with maturities of three years or less.

The maturities of cash equivalents and investment securities, available-for-sale, as of December 31, 2005, are as follows:

	Amount	Percent
Cash	$ 1,800,000	26.1 %
Less than one year	5,100,000	73.9
	$ 6,900,000	100.0 %

All of the Company's development contract payments are made in U.S. dollars. However, in the future the Company may enter into additional development contracts in foreign currencies that may subject the Company to additional foreign exchange rate risk. The Company intends to enter into foreign currency hedges to offset the exposure to currency fluctuations when it can determine the timing and amounts of the foreign currency exposure.

The Company owns 2.1 million shares of Lumera common stock with a market value of $8.5 million based on the closing price of $4.10 per share on March 1, 2006. Lumera's stock price is subject to fluctuation and may decrease, lowering the value of our investment. The Company owns approximately 12% of Lumera's common stock. Since the Company holds a large percentage of Lumera's common stock, if an active market does not develop or is not sustained, it may be difficult to sell the shares of Lumera's common stock at an attractive price or at all. The likelihood of Lumera's success, and the value of the Company's common stock, 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 the Company's investment, could decrease.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of Microvision, Inc.:

We have completed integrated audits of Microvision's 2005 and 2004 consolidated financial statements and of its internal control over financial reporting as of December 31, 2005and an audit of its 2003 consolidated financial statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Our opinions, based on our audits, are presented below.

Consolidated financial statements and financial statement schedule

In our opinion, the consolidated financial statements listed in the accompanying index, present fairly, in all material respects, the financial position of Microvision Inc. and its subsidiary at December 31, 2005 and

December 31, 2004, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2005 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the accompanying index presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit of financial statements includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

The accompanying consolidated financial statements have been prepared assuming that Microvision, Inc. will continue as a going concern. As more fully described in Note 1, the Company has incurred losses since inception, including a net loss of $30.3 million for the year ended December 31, 2005 and its accumulated deficit was $215.7 million at December 31, 2005. Additionally, the Company anticipates requiring additional financial resources to fund its operations at least through December 31, 2006. These conditions raise substantial doubt about the Company's ability to continue as a going concern. Management's plans as to these matters are also described in Note 1. The financial statements do not include any adjustments to reflect the possible future effects on the recoverability and classification of assets or the amounts and classification of liabilities that may result from the outcome of this uncertainty.

Internal control over financial reporting

Also, in our opinion, management's assessment, included in *Management's Report on Internal Control Over Financial Reporting*

appearing under Item 9A (b) that the Company maintained effective internal control over financial reporting as of December 31, 2005 based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) is fairly stated, in all material respects, based on those criteria. Furthermore, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, based on criteria established in *Internal Control*

- *Integrated Framework* issued by the COSO. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express opinions on management's assessment and on the effectiveness of the Company's internal control over financial reporting based on our audit. We conducted our audit of internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. An audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

PricewaterhouseCoopers LLP

Seattle, Washington
March 15, 2006

Microvision, Inc.

Consolidated Balance Sheets
(in thousands, except share and per share amounts)

	Decem
	2005
Assets	
Current assets	
Cash and cash equivalents	$ 6,860
Accounts receivable, net of allowances of $264 and $193	1,380
Costs and estimated earnings in excess of billings on uncompleted contracts	1,204
Inventory	759
Current resricted cash and investments	1,856
Other current assets	1,512
Total current assets	13,571
Investment in Lumera	3,582
Property and equipment, net	2,902
Restricted investments	1,000
Restricted investment in Lumera	2,184
Other assets	124
Total assets	$ 23,363
Liabilities, Mandatorily Redeemable Convertible Preferred Stock and Shareholders' (Deficit) Equit	
Current liabilities	
Accounts payable	$ 2,328
Accrued liabilities	4,513
Allowance for estimated contract losses	--
Billings in excess of costs and estimated earnings on uncompleted contracts	51
Liability associated with common stock warrants	3,452
Current portion of notes payable	7,896
Current portion of capital lease obligations	32
Current portion of long-term debt	22
Total current liabilities	18,294
Notes payable, net of current portion	1,447
Liability associated with embedded derivative feature	1,368
Capital lease obligations, net of current portion	105
Long-term debt, net of current portion	--
Deferred rent, net of current portion	1,492
Total liabilities	22,706
Commitments and contingencies (note 14)	--
Mandatorily redeemable convertible preferred stock, par value $.001; 25,000 shares authorized; 5 and 10 shares issued and outstanding (liquidation preference of $5,000 and $10,000)	4,166
Shareholders' (Deficit) Equity	

Common stock, par value $.001; 73,000 shares authorized; 25,138 and 21,509 shares issued and outstanding	25
Additonal paid-in capital	212,993
Deferred compensation	(85)
Subscriptions receivable from related parties	--
Receivables from related parties, net	(792)
Accumulated deficit	(215,650)
Total shareholders' (deficit) equity	(3,509)
Total liabilities, mandatorily redeemable convertible preferred stock and shareholders' equity	23,363

The accompanying notes are an integral part of these consolidated financial statements.

Microvision, Inc.

Consolidated Statements of Operations
(in thousands, except per share amounts)

	Ye
	2005
Contract revenue	$ 11,38
Product revenue	3,36
Total revenue	14,74
Cost of contract revenue	6,45
Cost of product revenue	8,63
Total cost of revenue	15,09
Gross margin	(34
Research and development expense (exclusive of non-cash compentsation expense of $0, $548, and $1,006 for 2005, 2004 and 2003, respectively)	6,58
Sales, marketing, general and administrative expense (exclusive of non-cash compensation expense of $429, $1,570 and $1,150 for 2005, 2004 and 2003 respectively)	19,92
Non-cash compensation expense	42
Total operating expenses	26,93
Loss from operations	(27,28
Interest income	26
Interest expense	(3,25
Gain on derivative features of notes payable, net	5,97
Loss on debt extinguishment	(3,31
Other income (expense)	(2
Loss before minority interests and equity in losses of Lumera	(27,64
Minority interests in loss of consolidated subsidiary	-
Equity in losses of Lumera	(3,24
Gain on sale of securities of equity subsidiary	2,70
Net loss	$ (28,18
Less: Stated dividend on mandatorily redeemable convertible preferred stock	(28
Accretion to par value of preferred stock	(63
Inducement for conversion of preferred stock	(1,18
Net loss available for common shareholders	$ (30,28
Net loss per share basic and diluted	$ (1.3
Weighted-average shares outstanding basic and diluted	22,49

The accompanying notes are an integral part of these consolidated financial statements.

Microvision, Inc.

Consolidated Statements of Madatorily Redeemable Convertable Preferred Stock and Stockholders' Equity
(in thousands)

	Mandatorily redeemable convertible preferred stock		Common Stock		
	Shares	Par Value	Shares	Par Value	
Balance at December 31, 2002	--	$ --	15,154	$ --	$
Issuance of options to board members for services					
Issuance of stock, options and warrants to non-employees for services			9		
Exercise of warrants and options			82		
Sales of common stock			6,204		
Revaluations of warrants and options					
Extension of expiring employee options					
Amortization of deferred compensation					
Reclassification of receivables from related parties					
Establishment of par value of common stock				21	
Other comprehensive income					
Net loss					
Balance at December 31, 2003	--	--	21,449	21	
Issuance of options to board members for services					
Issuance of stock, options and warrants to non-employees for services					
Issuance of Lumera options to Microvision employees					
Amortization of deferred compensation					
Exercise of warrants and options			60	1	
Sales of common stock					
Sales of preferred stock and warrants	10	8,590			
Beneficial conversion feature of mandatorily redeemable convertible preferred stock		(1,181)			
Dividend on preferred stock					
Non-cash accretion on mandatorily redeemable convertible preferred stock		238			
Net change in interest gain on Lumera initial public offering					
Other comprehensive income					
Net loss					
Balance at December 31, 2004	10	7,647	21,509	22	
Issuance of stock, options and warrants to non-employees for services			7		
Deferred compensation on stock options					
Amortization of deferred compensation					
Exercise of warrants and options			5	--	
Sales of common stock			2,171	2	
Conversion of preferred stock	(5)	(4,539)	855	1	

Conversion of senior secured exchageable covertible notes			310	--	
Stock received for subscriptions receivable			(28)	--	
Inducement to preferred shareholders					
Issuance of common stock and change in warrant value to preferred shareholders					
Beneficial conversion feature of mandatorily redeemable convertible preferred stock		421			
Issuance of common stock for payment on senior exchangeable convertible notes			258	--	
Issuance of common stock for payment of interest on senior secured exchangeable convertible notes			40	--	
Issuance of common stock on preferred dividend			11	--	
Dividend on preferred stock					
Non-cash accretion on mandatorily redeemable convertible preferred stock		637			
Allowance for doubtful accounts on receivables from related parties					
Net loss					
Balance at December 31, 2005	5	$ 4,166	25,138	$ 25	$

The accompanying notes are an integral part of these consolidated financial statements.

Microvision, Inc.

Consolidated Statemetns of Comprehensive Income
(in thousands)

	Ye
	2005
Net loss	$ (28,18
Other comprehensive loss	
Unrealized loss on investment securities, available-for-sale:	
Unrealized holding loss arising during period	-
Less: reclassification adjustment for gains realized in net loss	-
Net unrealized loss	-
Comprehensive loss	$ (28,18

See accompanying notes to consolidated financial statements.

Microvision, Inc.

Consolidated Statement of Cash Flows
(in thousands)

	Yea
	2005
Cash flows from operating activities	
Net loss	$ (28,183
Adjustments to reconcile net loss to net cash used in operations	
Depreciation	1,602
Loss (gain) on disposal of fixed assets	--
Non-cash expenses related to issuance of stock, warrants, and options, and amortization of deferred compensation	429
Non-cash interest expense, net	2,730
Derivative features of notes payable	(2,659
Inventory write-downs	3,732
Allowance for receivables from related parties	1,031
Realized gain on sale of investment securities	--
Minority interests in loss of consolidated subsidiary	--
Equity in losses of Lumera	3,242
Gain on sale of securities of equity subsidiary	(2,700
Loss on debt extinguishment	3,313
Non-cash deferred rent	(21
Interest on notes payable	--
Allowance for estimated contract losses	(53
Change in	
Accounts receivable	3,847
Intercompany receivable	--
Costs and estimated earnings in excess of billings on uncompleted contracts	(607
Inventory	(1,324
Other current assets	61
Other assets	340
Accounts payable	(1,050
Accrued liabilities	(190
Billings in excess of costs and estimated earnings on uncompleted contracts	(3,267
Notes payable	--
Research liability, current and long-term	--
Net cash used in operating activities	(19,727
Cash flows from investing activities	
Sales of investment securities	1,248
Purchases of investment securities	(1,248
Sales of restricted investment securities	1,238
Purchases of restricted investment securities	(2,101
Increase in restricted cash	(755
Collections of receivables from related parties	--
Sale of long term investment - Lumera	3,893
Purchases of property and equipment	(1,239
Net cash provided by used in investing activities	1,036
Cash flows from financing activities	

Principal payments under capital leases	(46
Proceeds from issuance of short term notes	--
Principal payments under long-term debt	(77
Proceeds from inssuance of notes and warrants	14,148
Payments on notes payable	(1,000
Increase in deferred rent	1,492
Payment of preferred dividend	(173
Net proceeds from inssuance of common stock	9,939
Net proceeds from issuance of preferred stock and warrants	--
Net proceeds from sale of subsidiary's equity to minority interests	--
Net cash provided by financing activities	24,283
Net increase (decrease) in cash and cash equivalents	5,592
Cash and cash equivalents at beginning of period	1,268
Change in cash due to Lumera deconsolidation	--
Cash and cash equivalents at end of period	$ 6,860
Supplemental disclosure of cash flow information	
Cash paid for interest	$ 348
Supplemental schedule of non-cash investing and financing activities	
Property and equipment acquired under capital leases	$ 135
Other non-cash additions to property and equipment	$ 812
Conversion of preferred stock into common stock	$ 4,117
Deferred compensation - warrants, options and stock grants	$ 209
Issuance of common stock for payment of principal and interest on senior secured exchangeable convertible notes	$ 997
Issuance of common stock and warrants for services	$ --

The accompanying notes are an integral part of these financial statements.

1. The Company

The consolidated financial statements include the accounts of Microvision, Inc. ("Microvision"), a Delaware corporation, and Lumera Corporation ("Lumera"), a Delaware corporation, (collectively the "Company"). Prior to July 2004, Lumera was a subsidiary and was consolidated into Microvision. In July 2004, Lumera completed an initial public offering of its common stock and as a result of the change in ownership, ceased to be consolidated and became an equity method investment on Microvision.

Microvision was established to acquire, develop, manufacture and market scanned beam technology, which projects images using a single beam of light. Microvision has entered into contracts with commercial and U.S. government customers to develop applications using the scanned beam technology. Microvision has introduced two commercial products, Nomad, a see through head-worn display, and Flic, a hand-held bar code scanner. In addition, Microvision has produced and delivered various demonstration units using Microvision's display technology. Microvision is working to commercialize additional products for potential medical, defense, industrial, aviation, and consumer applications.

Lumera was established to develop, manufacture and market optical devices using organic non-linear electro-optical chromophore materials. Lumera is working to commercialize the devices for potential wireless networking and optical networking applications.

The accompanying consolidated financial statements have been prepared assuming that the Company continues as a going concern. The financial statements do not include any adjustments to reflect the possible future effects on the recoverability and classification of assets or the amounts and classification of liabilities that may result from the matters discussed above.

The Company's current cash resources are sufficient to fund operations through July 2006. The Company plans to raise additional cash before July 2006 through the sale of its common stock, preferred stock or through the issuance of debt. The Company has taken the following actions to reduce its use of cash and improve the operations of the Company:

- Made significant changes to it senior management team including appointing a new Chief Executive Officer.
- Announced a restructuring and realignment plan that targets a 30% reduction in operating loss
- Begun adding members to the Board of Directors with experience that directly supports the Company's business objectives.
- Engaged an investment bank to assist the Company in pursuing financing alternatives.

The Company's operating plan calls for the addition of sales, marketing, technical and other staff and the purchase of additional laboratory and production equipment. The Company's future expenditures and capital requirements will depend on numerous factors, including the progress of its research and development program, the progress in commercialization activities and arrangements, the cost of filing, prosecuting, defending and enforcing any patent claims and other intellectual property rights, competing technological and market developments and the ability of the Company to establish cooperative development, joint venture and licensing arrangements. There can be no assurance that additional financing will be available to the Company or that, if available, it will be available on terms acceptable to the Company on a timely basis. If adequate funds are not available to satisfy either short-term or long-term capital requirements or planned revenues are not generated, the Company may be required to limit its operations substantially. This limitation of operations may include reduction in capital expenditures and reductions in staff and discretionary costs, which may include non-contractual research costs. The Company's capital requirements will depend on many factors, including, but not limited to, the rate at which the Company can, directly or through arrangements with original equipment manufacturers, introduce products incorporating the scanned beam technology and optical polymer based products and the market acceptance and competitive position of such products.

2

. **Summary of significant accounting policies**

Use of estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. The Company's management has identified the following areas where significant estimates and assumptions have been made in preparing the financial statements: revenue recognition, allowance for uncollectible receivables, management loans, inventory valuation and potential losses from litigation.

Principles of consolidation

The company has historically included both Microvision and Lumera Corporation ("Lumera"), a subsidiary that was consolidated through July 2004. In July 2004, Lumera completed an initial public offering of its common stock.

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 and after July 2004 recorded its share of Lumera income or losses. 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 2004. At December 31, 2004 and 2005, Microvision owned 33% and 28%, respectively, of Lumera's common stock.

Cash, cash equivalents and investment securities

The Company considers all investments that mature within 90 days of the date of purchase to be cash equivalents. At December 31, 2005, all short-term investment securities held by the Company were classified as cash equivalents.

Inventory

Inventory consists of raw material; work in process and finished goods for the Company's Nomad and Flic products. Inventory is recorded at the lower of cost or market with cost determined on the weighted-average method. 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. In addition, Microvision reduces the value of its inventory to its estimated scrap value when management determines that it is not probable that the inventory will be consumed through normal production during the next twelve months.

Restricted cash and investments

As of December 31, 2005, restricted cash and investments includes:

- $1.0 million irrevocable letter of credit as security on a lease agreement for the corporate headquarters building in Redmond, WA. The required letter of credit balance decreases over the term of the lease, which expires in 2013.
- $754,000 cash received in connection with a lease agreement for the corporate headquarters building in Redmond, WA. The use of the cash is restricted to the terms of the tenant improvement agreement associated with the lease.

- $1.1 million certificates of deposit held as collateral for letters of credit issued in connection with a lease agreement for the former corporate headquarters building in Bothell, WA. The balance is required to be maintained for the remaining term of the lease, which expires in April 2006.
- $1.0 million, 1,750,000 shares of Lumera common stock pledged as collateral for the Company's Notes.

Property and equipment

Property and equipment is stated at cost and depreciated over the estimated useful lives of the assets (two to five years) using the straight-line method. Leasehold improvements are depreciated over the shorter of estimated useful lives or the lease term.

Revenue recognition

Revenue has primarily been generated from contracts for further development of the scanned beam technology and to produce demonstration units for commercial enterprises and the United States government. Revenue on such contracts is recorded using the percentage-of-completion method measured on a cost incurred basis. The percentage of completion method is used because the Company can make reasonably dependable estimates of the contract cost. Changes in contract performance, contract conditions, and estimated profitability, including those arising from contract penalty provisions, and final contract settlements, may result in revisions to costs and revenues and are recognized in the period in which the revisions are determined. Profit incentives are included in revenue when realization is assured.

The Company recognizes losses, if any, as soon as identified. Losses occur when the estimated direct and indirect costs to complete the contract exceed unrecognized revenue. The Company evaluates the reserve for contract losses on a contract-by-contract basis.

Revenue from product shipments is recognized in accordance with Staff Accounting Bulletin No. 104 "Revenue Recognition." Revenue is recognized when there is sufficient evidence of an arrangement, the

selling price is fixed and determinable and collection is reasonably assured. Revenue for product shipments is recognized upon acceptance of the product by the customer or expiration of the contractual acceptance period, after which there are no rights of return. Provisions are made for warranties at the time revenue is recorded. Warranty expense was not material for any periods presented.

Concentration of credit risk and sales to major customers

Financial instruments that potentially subject the Company to concentrations of credit risk are primarily cash equivalents, investments and accounts receivable. The Company typically does not require collateral from its customers. The Company has a cash investment policy that generally restricts investments to ensure preservation of principal and maintenance of liquidity.

The United States government accounted for approximately 35%, 42%, and 49% of total revenue during 2005, 2004 and 2003, respectively. Contracts with three commercial customers represented 38%, 25%, and 35% of total revenues during 2005, 2004, and 2003, respectively. At December 31, 2004, one commercial customer accounted for 65% of the accounts receivable balance. The receivable was paid in full in January 2005. The United States government accounted for approximately 41% and 21% of the accounts receivable balance at December 31, 2005 and 2004, respectively. In 2005, 61% of consolidated revenue was earned from development contracts with two customers. In 2004, 11% of consolidated revenue was earned from a development contract with one customer.

Income taxes

Deferred tax assets and liabilities are recorded for differences between the financial statement and tax bases of the assets and liabilities that will result in taxable or deductible amounts in the future, based on enacted tax laws and rates applicable to the periods in which the differences are expected to affect taxable income. Valuation allowances are established when necessary to reduce deferred tax assets to the amount expected to be realized. Income tax expense is recorded for the amount of income tax payable for the period increased or decreased by the change in deferred tax assets and liabilities during the period.

Net loss per share

Basic net loss per share is calculated on the basis of the weighted- average number of common shares outstanding during the periods. Net loss per share assuming dilution is calculated on the basis of the weighted-average number of common shares outstanding and the dilutive effect of all potentially dilutive

securities, including common stock equivalents and convertible securities. Net loss per share assuming dilution for 2005, 2004 and 2003 is equal to basic net loss per share because the effect of dilutive securities outstanding during the periods including options and warrants computed using the treasury stock method, is anti-dilutive. The dilutive securities and convertible securities that were not included in earnings per share were 9,440,000, 6,836,000, and 6,295,000, at December 31, 2005, 2004 and 2003, respectively.

Research and development

Research and development costs are expensed as incurred.

Fair value of financial instruments

The Company's financial instruments include cash and cash equivalents, accounts receivable, accounts payable, accrued liabilities and long-term debt. The carrying amount of long-term debt at December 31, 2005 and 2004 was not materially different from the fair value based on rates available for similar types of arrangements. The carrying value of cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities approximate fair value due to the short maturities. The convertible notes are not publicly traded and it is no practicable for the Company to estimate the fair value of the convertible notes due to the absence of comparable publicly traded financial instruments.

Long-lived assets

The Company evaluates the recoverability of its long-lived assets when an impairment is indicated based on expected undiscounted cash flows and recognizes impairment of the carrying value of long-lived assets, if any, based on the fair value of such assets.

Stock-based compensation

The Company and Lumera each have stock-based employee compensation plans, which are more fully described in Note 13.

The Company accounts for stock-based employee compensation arrangements in accordance with the provisions of Accounting Principles Board Opinion ("APB") No. 25, "Accounting for Stock Issued to Employees" and related amendments and interpretations, including FASB Interpretation Number ("FIN") 44, "Accounting for Certain Transactions Involving Stock Compensation," and complies with the disclosure provisions of SFAS No. 123, "Accounting for Stock-Based Compensation." The Company accounts for equity instruments issued to non-employees in accordance with the provisions of SFAS No. 123 and Emerging Issues Task Force Issue No. 96-18.

Total non-cash stock option expense related to employee and director awards was $94,000, $1,057,000, and $271,000 for the years ended December 31, 2005, 2004 and 2003, respectively. Had compensation cost for employee and director options been determined using the fair values at the grant dates consistent with the methodology prescribed under SFAS 123, the Company's consolidated net loss available to common shareholders and associated net loss per share would have increased to the pro forma amounts indicated below (in thousands):

	Year Ended December 31,		
	2005	2004	2003
Net loss available for common shareholders, as reported	$ (30,284)	$ (33,543)	$ (26,1
Add: Stock-based employee compensation expense included in net loss available for common shareholders, as reported	94	339	2
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards	(1,931)	(5,886)	(8,9
Net loss available for common shareholders, pro forma	$ (32,121)	$ (39,090)	$ (34,8
Net loss per share As reported	$ (1.35)	$ (1.56)	$ (1.
Basic and diluted pro forma	$ (1.43)	$ (1.82)	$ (1.

New accounting pronouncements

In December 2004, the Financial Accounting Standards Board ("FASB") issued SFAS No. 123(R), "Share-Based Payment", which is a revision of SFAS No. 123 and supersedes APB Opinion No. 25. SFAS No. 123(R) requires all employee share-based awards

granted after the effective date to be valued at fair value, and to be expensed over the applicable vesting period. Pro forma disclosure of the income statement effects of share-based payments is no longer an alternative. SFAS No. 123(R) is effective for all share-based awards granted on or after January 1, 2006. In addition, companies must recognize compensation expense related to any awards that are not fully vested as of the effective date. Compensation expense for the unvested employee awards will be measured based on the fair value of the awards previously calculated in developing the pro forma disclosures in accordance with the provisions of SFAS No. 123. The first reporting period where employee share-based compensation will be recognized is March 31, 2006. Share-based compensation expense in 2006 will be affected by our stock price at the time of grants are awarded, the number and structure of stock-based awards our board of directors may grant during the year, any other actions taken with respect to outstanding options, as well as a number of complex and subjective valuation assumptions. These valuation assumptions include, but are not limited to, the future volatility of our stock price and employee stock option exercise behaviors. The Company is currently evaluating the alternative methods for implementing SFAS No. 123(R) and there is sufficient uncertainty surrounding future share-based compensation actions and valuation estimates that the Company is not in a position to provide a useful estimate of the financial statement impact of SFAS No. 123(R) in 2006 at this time.

In November 2004 the FASB issued SFAS 151 Inventory Cost - an Amendment of ARP No. 43, chapter 4 ("SFAS 151") which provides clarifies accounting for abnormal manufacturing costs. The Company is required to adopt SFAS 151 for years beginning after June 30, 2005. The Company does not believe that adoption of SFAS 151 will have a material impact on its financial statements**.**

In March 2005, the Securities and Exchange Commission ("SEC") issued Staff Accounting Bulletin No. 107 ("SAB 107"), "Share Based Payment," which expresses the SEC's views on the interaction

between SFAS 123R and certain SEC rules and regulations. The Company is currently assessing the guidance in SAB 107 as part of its evaluation of the adoption of SFAS 123R.

3. Long-term contracts

Cost and estimated earnings in excess of billings on uncompleted contracts comprises amounts of revenue recognized on contracts that the Company has not yet billed to customers because the amounts were not contractually billable at December 31, 2005 and 2004. The following table summarizes when the Company will be contractually able to bill the balance as of December 31, 2005 and 2004.

	Year Ended December 31, 2005	Year Ended December 31, 2004
Billable within 30 days	$ 686,000	$ 577,000
Billable between 31 and 90 days	3,000	2,000
Billable after 90 days	515,000	18,000
	$ 1,204,000	$ 597,000

"Billable after 90 days" includes $496,000 of unbilled costs related to work on a development contract that are billable upon the completion of a contractual milestone that the Company plans to complete during the second quarter of 2006.

The Company's current contracts with the U.S. government are primarily cost plus fixed fee type contracts. Under the terms of a cost plus fixed fee contract, the U.S. government reimburses the Company for negotiated actual direct and indirect cost incurred in performing the contracted services. The Company is under no

obligation to spend more than the contract value to complete the contracted services. The period of performance is generally one year. Each of the Company's contracts with the United States government can be terminated for convenience by the government at any time.

In June 2005, the Company entered into a $4,359,000 contract with General Dynamics C4 Systems to continue the development of a helmet-mounted display for the Air Warrior Block 3 system. General Dynamics is under contract with the U.S. Army's Product Manager -- Air Warrior in Huntsville, Ala., to develop and integrate the Air Warrior Block 3 system. The Microvision helmet-mounted display is being designed as a full-color, see-through, daylight and night- readable, high-resolution display.

In May 2004, Microvision entered into a $3,900,000 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 $6,200,000 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.

In April 2003, the Company entered into a $2,200,000 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, the Company entered into a $1,600,000 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.

The following table summarizes the costs incurred on the Company's revenue contracts:

	December 31, 2005	December 31, 2004
Costs and estimated earnings incurred on uncompleted contracts	$ 17,325,000	$ 6,410,000
Billings on uncompleted contracts	(16,172,000)	(9,131,000)
	$ 1,153,000	$ (2,721,000)
Included in accompanying balance sheets under the following captions:		
Costs and estimated earnings in excess of billings on uncompleted contracts	$ 1,204,000	$ 597,000
Billings in excess of costs and estimated earnings on uncompleted contracts	(51,000)	(3,318,000)
	$ 1,153,000	$ (2,721,000)

4. Inventory

Inventory consists of the following:

	December 31, 2005	December 31, 2004
Raw materials	$ 267,000	$ 1,607,000
Work in process	141,000	77,000
Finished goods	351,000	1,483,000
	$ 759,000	$ 3,167,000

The inventory at December 31, 2005 and 2004 consisted of raw materials, work in process and finished goods for Nomad and Flic. Inventory is stated at the lower of cost or market, with cost determined on a weighted average basis. 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. In addition, Microvision reduces the value of its inventory to its estimated scrap value when management determines that it is not probable that the inventory will be consumed through the normal course of business during the next twelve months. In 2005, 2004 and 2003, Microvision recorded inventory write-downs of $3,732,000, $2,084,000and $500,000 respectively.

5. Accrued liabilities

Accrued liabilities consist of the following:

	December 31,	
	2005	2004
Bonuses	$ 1,000,000	$ 1,600,000
Payroll and payroll taxes	732,000	763,000
Compensated absences	497,000	475,000
Taxes other than income taxes	12,000	43,000
Facility closing cost	--	253,000
Professional Fees	558,000	371,000
Relocation	166,000	90,000

Consultants	525,000	
Other	1,023,000	943,000
	$ 4,513,000	$ 4,538,000

6. Property and equipment, net

Property and equipment consists of the following:

	December 31,	
	2005	**2004**
Lab and production equipment	$ 2,126,000	$ 4,455,000
Leasehold improvements	3,990,000	2,165,000
Computer hardware and software	6,495,000	3,873,000
Office furniture and equipment	1,124,000	1,057,000
	13,735,000	11,550,000
Less: Accumulated depreciation	(10,833,000)	(9,232,000)
	$ 2,902,000	$ 2,318,000

Depreciation expense was $1,602,000, $2,406,000 and $3,113,000 in 2005, 2004 and 2003 respectively.

7. Receivables from related parties

In 2000, the Board of Directors authorized the Company to provide unsecured lines of credit to each of the Company's three senior officers. The limit of the line of credit is three times the executives' base salary less any amounts outstanding under the Executive Option Exercise Note Plan. In 2002 and 2001, the Board of Directors authorized a $200,000 and $500,000 addition, respectively, to the limit for one senior officer. The

lines of credit carry interest rates of 5.4% to 6.2%. The lines of credit must be repaid within one year of the senior officer's termination or within thirty days of demand by the Company in the event of a plan termination, provided that in the event of such a demand the senior officer may elect to deliver a promissory note with a one-year term in lieu of payment. At December 31, 2005 and 2004, a total of $2,723,000 and $2,723,000, respectively, was outstanding under the lines of credit.

In 2005, the Company determined that certain of its senior officers may have insufficient net worth and short-term earnings potential to repay loans outstanding under the Company's lines of credit. In 2003 and 2002, the Company recorded an allowance for doubtful accounts for receivables from senior officers of $200,000 and $700,000, respectively. In January 2006, two senior officers left the Company. Because the lines of credit are unsecured and collection is uncertain, the Company recorded an additional allowance of $1,031,000 in December 2005. The balance of the allowance for doubtful accounts for receivables from senior officers was $1,931,000 and $900,000 at December 31, 2005 and 2004, respectively.

Under current SEC rules, the Company is prohibited from changing the repayment terms of the lines of credit. No repayments have been made on the outstanding lines of credit. At December 31, 2003, the Company reclassified the loan balance to shareholder's equity under the guidance provided by the SEC for loans to shareholders due to the absence of any repayments of the loans to date. The Company has no plans to forgive the principal balance outstanding under the lines of credit.

In 2000, three executive officers of the Company exercised a total of 128,284 stock options, in exchange for full recourse notes totaling $285,000. These notes bear interest at 4.6% to 6.2% per annum. Each note is payable in full upon the earliest of (1) a fixed date ranging from January 31, 2001 to December 31, 2004 depending on the expiration of the options exercised; (2) the sale of all of the shares acquired with the note; (3) on a pro rata basis upon the partial sale of shares acquired with the note, or (4) within 90 days of the officer's termination of employment. At December 31, 2005 and 2004, a total of $0 and $165,600, respectively, was outstanding under the full recourse notes. The $165,600 plus accrued interest was paid in full in February 2005. The notes are included as subscriptions receivable from related parties in shareholders' equity on the consolidated balance sheet.

The interest on both the lines of credit and the full recourse notes is forgiven if the executive is an employee of the Company at December 31 of the respective year. Compensation expense of $156,000, $163,000 and $163,000 was recognized in 2005, 2004 and 2003, respectively, for interest forgiven.

8. Lumera Subsidiary Equity Transactions

In March 2000, Lumera issued 4,700,000 shares of its Class B common stock to the Company for services provided by the Company to Lumera valued at $94,000. At the same time, Lumera issued 670,000 shares of its Class B common stock to certain Microvision employees for $12,000 in cash.

In January 2001, Lumera issued 802,000 shares of Lumera Class A common stock to the University of Washington ("UW") at a value of $3.75 per share in connection with the research agreement. The valuation of the shares issued to the UW was more than the per share carrying amount of the Company's interest in Lumera. Although the Company's percentage ownership in Lumera was reduced as a result of this transaction, the increased value of Lumera stock on the change in ownership interest resulted in a gain for the Company. The amount of the gain of $3,001,000 resulting from the revaluation of the Company's interest in Lumera was credited to paid-in capital.

In March 2001, Lumera issued 2,400,000 shares of its Series A preferred stock at a price of $10.00 per share. Included in this total were 264,000 shares issued to the Company in repayment of intercompany borrowings.

In October 2002, Lumera paid $200,000 and issued a warrant to purchase 164,000 shares of Lumera Class A Common Stock at an exercise price of $3.65 per share to Arizona Microsystems, Inc. in exchange for a license of certain Arizona Microsystems, Inc. technology. The warrant expires 10 years following the date of grant, and vests 25% on the date of grant and 25% annually from the date of grant. The warrant was valued at the date of grant at $133,000. The total purchase price of $333,000 was recorded as capitalized licensing costs. The fair value of the warrant was estimated using the Black Scholes option pricing model with a stock price of $0.98 per share, dividend yield of zero percent; expected volatility of 100%; risk-free interest rate of 4.0% and expected life of ten years.

In August 2003, Lumera raised $1,900,000, before issuance costs of $34,000, from the sale of 944,000 shares of Series B convertible preferred stock to Microvision and other purchasers. Microvision purchased 434,000 of these shares for an aggregate purchase price of $868,000. In October 2003, Lumera raised $782,000 before issuance costs of $32,000, from the sale of 391,000 shares of Series B convertible preferred stock. Microvision did not purchase additional shares of Series B preferred stock in the October 2003 offering.

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 certain 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 were subject to remeasurement at each balance sheet date during the vesting period. The deferred compensation and liability related to these options was amortized to non-cash compensation expense over the two year period of service under the agreements. The aggregate value of both options was estimated at $136,000 at the grant date and December 31, 2003. Total non-cash compensation expense was $315,000 for the period from January 1, 2004 through July 2004, and $32,000 for the year ended December 31, 2003. The fair values of the options were estimated at the grant date and December 31, 2003, using the Black Scholes option pricing model with the following weighted-average assumptions: underlying security fair market value of $0.98, dividend yield of zero percent; expected volatility of 100% for both measurement dates; risk-free interest rates of 4.4% and 4.3%; and expected lives of 10 and 9.7 years, respectively.

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.

In July 2004, Lumera completed an initial public offering of its common stock. As a result of the offering, Microvision's ownership interest in Lumera was reduced to 33%. As a result of the reduction in ownership, Microvision changed to the equity method of accounting for its investment in Lumera. Microvision recorded a non-cash change in interest gain of $13.7 million during the third quarter. Because of uncertainty surrounding the ultimate realizability of the gain, the gain was recorded as an increase to stockholders' equity as a component of additional paid-in capital. As of December 31, 2005, Microvision owned 4,622,000 shares or 28% of Lumera's common stock.

During the period from inception to July 2004, losses in Lumera were first allocated to the holders of the common stock and then to the holders of the preferred shareholders pro rata in accordance with their respective ownership interest. Losses were not allocated to the options and warrants until exercised.

Lumera common stock, Series A preferred stock and Series B preferred stock were eliminated in consolidation with Microvision interests in Lumera common stock, Series A preferred stock, Series B preferred stock and options and warrants to purchase equity in Lumera held by investors other than the Company, and are presented as minority interests on the Company's consolidated balance sheet.

A reconciliation of the changes in ownership interests through Lumera's initial public offering is as follows (in thousands):

	Minority Interests				
	Common	Preferred	Total	Microvision	Total
Balance at December 31, 2002	$ 308	$ 6,915	$ 7,223	$ (440)	$ 6,783
Issuance of preferred stock, net	--	1,735	1,735	868	2,603
Options and warrants	14	--	14	--	14
Loss allocation for 2003	--	(7,125)	(7,125)	(958)	(8,083)
Balance at December 31, 2003	322	1,525	1,847	(530)	1,317
Issuance of preferred stock, net	--	500	500	--	500
Preferred stock reallocation	--	413	413	(413)	
Options and warrants	342	--	342		342
Loss allocation for 2004		(2,438)	(2,438)	(1,286)	(3,724)
Balance at July 2004	$ 664	$ --	$ 664	$ (2,229)	$ (1,565)

As a result of the Series B stock issuance, the allocations of Lumera losses changed between Microvision and other minority interests and resulted in an additional $413,000 of losses being allocated to minority interest during 2004, with a resultant change in interest loss allocated to Microvision. In July 2004, Microvision's ownership interest in Lumera was reduced to 33% as a result of Lumera completing an initial public offering of its common stock. As a result of the reduction in ownership, Microvision changed to the equity method of accounting for its investment in Lumera. Microvision recorded a non-cash change in interest gain of $14,138,000 during the third quarter as a result of the change to the equity method. The net change in interest gain for 2004 was $13,727,000. Because of uncertainty surrounding the ultimate realizability of the gain; the gain was recorded as an increase to stockholders' equity as a component of additional paid-in capital.

The following table shows the Lumera balances included in the consolidated balance sheet immediately prior to the change in interest and the reconciliation to the investment account shown at December 31, 2005.

Cash and cash equivalents	$ 657
Costs and estimated earnings in excess of billings on uncompleted contracts	117
Other current assets	1,077
Property and equipment, net	2,369
Other assets	33
Accounts payable	(434)
Accrued liabilities	(1,315)
Current portion of research liability	(78)
Notes payable - current	(2,386)
Other long-term liabilities	(245)
Net Assets	(205)
Less minority interest options and warrants	(664)
Cumulative losses in excess of investment	(1,360)
	(2,229)
Gain on change in interest	14,138
Investment losses from July 2004 to December 31, 2004	(1,708)
Investment in Lumera at December 31, 2004	10,201
Investment losses from January 1, 2005 to December 31, 2005	(3,242)
Sales of Lumera Stock	(1,193)
Investment in Lumera at December 31, 2005	$ 5,766

The difference between the amount at which an investment is carried at December 31, 2005 and the amount of underlying equity in net assets of Lumera is a result of equity transaction of Lumera for which Microvision does not recognize any change in interest gains or losses.

9. Long-term Notes

The following table summarizes the activity related to the issuance of convertible notes in 2005:

	Notes	**Warrants**	**Embedded derivative feature**	**s**
March 10, 2005 issuance	$ 5,395	$ 1,650	$ 2,955	$
Debt restructuring at July 25, 2005		2,295	1,018	

Conversion of debt to common stock at October 11, 2005	(1,398)		(439)	
December 1, 2005 issuance	3,667	2,200	1,116	
Principal payments on notes	(867)			
Discount accretion for the year ended December 31, 2005	2,546			
Changes in market value for the year ended December 31, 2005		(2,693)	(3,282)	
Balances at December 31, 2005	$ 9,343	$ 3,452	$ 1,368	$

December Notes

In December 2005, the Company raised $10,000,000, before issuance costs of $134,000, from the issuance of notes ("December Notes"), 838,000 shares of common stock and warrants to purchase an aggregate of 1,089,000 shares of Microvision common stock. The December Notes are convertible on demand by the holders into Microvision common stock at a conversion price of $3.94 per share. The note holders may convert all or a portion of their December Notes. In addition, upon the request of the note holders, the Company is required to redeem the notes for cash upon a change of control or an event of default at a redemption price equal to 125% of the then outstanding balance of the December Notes. The Company has pledged 1,750,000 shares of its Lumera common stock as collateral for the December Notes and the notes issued as of March 2005 ("March Notes") described below. Those shares have been classified as a "Restricted investment in Lumera" on the Company's consolidated balance sheet.

The terms of the December Notes include interest at LIBOR plus 3.0%, provided that the interest rate shall not be less than 6% or greater than 8%payable quarterly in cash or Microvision common stock if the stock price is greater than $4.06 per share, at the election of the Company, subject to certain additional conditions. Under certain circumstances the interest rate increase to LIBOR plus 6% but not less than 12% or greater than 15%. If the Company chooses to pay interest in Microvision common stock as opposed to cash, the price will be based on 90% of the arithmetic average of the volume weighted average prices for the 20 trading days prior to the payment date. The December Notes are payable in five equal quarterly installments beginning in March 2006. The Company can elect to make the principal payments in common stock in lieu of cash if the stock price is greater than $4.06 per share, subject to certain other conditions. If the Company elects to pay principal in stock the stock will be issued at a 10% discount to the arithmetic average of the volume weighted average prices for the 15 trading days prior to the payment date. Additionally, the Company can elect to convert the December Notes into Microvision common stock if the stock price exceeds $6.90 per share for 20 out of any 30 consecutive trading days, subject to certain conditions.

The Company concluded that the note holders' right to convert all or a portion of the December Notes into Microvision common stock is an embedded derivative instrument as defined by FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities ("FAS 133"). Accordingly, $1.1 million of the cash proceeds were allocated to the embedded derivative instrument, which represents the fair value of the instrument on the date of issuance. The value was determined using the Black Scholes option-pricing model with the following assumptions: expected volatility of 58%; expected dividend yield of 0%; risk free interest rates ranging from 4.01%to 4.39%; and contractual life of four to sixteen months , which corresponds to the principal repayment dates. Due to changes in Microvision's stock price and remaining contractual life, the fair value of the embedded derivative feature decreased to $1,038,000 at December 31, 2005. The change in value of $78,000 was recorded as a non-operating gain and included in Gain on derivative features of note payable in the consolidated statement of operations. At December 31, 2005 total principal payments of $7.0 million remain under the December Notes.

The warrants issued with the December Notes vested on the date of grant, have an exercise price of $3.94 per share of common stock share and expire in December 2010. The warrants met the definition of a derivative instrument that must be accounted for as a liability under the provisions of Emerging Issues Task Force Issue No. 00-19, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock, because the Company cannot engage in certain corporate transactions affecting the common stock unless it makes a cash payment to the holders of the warrants. Accordingly, $2.2 million of the cash proceeds were allocated to the warrants, which represents the fair value of the warrants on the date of issuance and the amount was recorded as a current liability. Subsequent changes in the fair value of the warrants will be recorded in the statement of operations each period. The warrants were valued using the Black Scholes option-pricing model with the following assumptions: expected volatility of 65%; expected dividend yield of 0%; risk free interest rate of 4.35%; and contractual life of five years.

The Microvision common stock was valued at the closing price on the date of closing of $3.60 per share. Aggregate proceeds of $3.0 million were allocated to the common stock. The remaining gross proceeds of $3.7 million were allocated to the notes.

March Notes

In March 2005, the Company raised $10,000,000, before issuance costs of $423,000, from the issuance of convertible March Notes ("March Notes") and warrants to purchase an aggregate of 462,000 shares of Microvision common stock. The March Notes are convertible on demand by the holders into Microvision common stock at a conversion price of $6.84 per share of Microvision common stock or Lumera common stock held by the Company at a conversion price of $5.64 per share up to a limit of 1,750,000 shares of Lumera common stock. The right to convert the March Notes into shares of Lumera common stock was removed pursuant to the amendment described below. The initial conversion price is subject to adjustment in the event Microvision issues common stock or common stock equivalents at a price per share of common stock below the conversion price of the March Notes. Due to below market issuances of Company's common stock the conversion price of the March Notes at December 31, 2005 was $5.54 per share of common stock. In addition, upon the request of the Note holders, the Company is required to redeem the March Notes for cash upon a change of control or an event of default at a redemption price equal to 125% of the then outstanding balance of the March Notes. The Company has pledged 1,750,000 shares of its Lumera common stock as collateral for the March Notes and the December Notes described above. Those shares have been classified as a "Restricted investment in Lumera" on the Company's consolidated balance sheet.

The terms of the March Notes include interest at LIBOR plus 3.0% payable quarterly in cash or Microvision common stock, at the election of the Company, subject to certain conditions. However, in no case shall the interest rate be less than 6.0% or greater than 8.0%. If the Company chooses to pay interest in Microvision common stock as opposed to cash, the price will be based on 92% of the arithmetic average of the volume weighted average prices for the 10 trading days prior to the payment date. The March Notes are payable in six equal quarterly installments beginning in December 2005. The Company can subject to certain conditions, elect to make the principal payments in common stock in lieu of cash. If the Company elects to pay principal in common stock, the Note holders can elect to receive Microvision or Lumera common stock. Payment in stock will be issued at a 10% discount to the arithmetic average of the volume weighted average prices for the 15 trading days prior to the payment date. Additionally, the Company can elect to convert the March Notes into Microvision common stock if the stock price exceeds $11.97 per share for 20 out of any 30 consecutive trading days, subject to certain conditions.

The Company concluded that the note holders' right to convert all or a portion of the March Notes into Microvision or Lumera common stock is an embedded derivative instrument as defined by FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities ("FAS 133"). Accordingly, $2,955,000 of the cash proceeds were allocated to the embedded derivative instrument, which represents the fair value of the instrument on the date of issuance. The derivative instrument was valued using the higher of the Microvision or Lumera conversion feature. The value was determined using the Black Scholes option-pricing model with the following assumptions: expected volatility of 83%; expected dividend yield of 0%; risk free interest rate of 4.62%; and contractual life of nine months to two years, which corresponds to the principal repayment dates. Due to changes in Lumera and Microvision's stock price and remaining contractual life, the fair value of the embedded derivative feature decreased to $2,463,000 at July 25, 2005 the date of the deemed extinguishment described below. The decrease in the fair value of $492,000 for the period from issuance to extinguishment was recorded as a non-operating gain and included in "Gain on derivative features of note payable" in the consolidated statement of operations. At December 31, 2005 total principal payments of $7.3 million remain under the March Notes.

The warrants issued with the March Notes vested on the date of grant, have an exercise price of $6.84 per common share and expire in March 2010. The initial exercise price is subject to adjustment in the event Microvision issues common stock or common stock equivalents at a price per share of common stock below the exercise price of the warrant. Due to below market issuances of Company's common stock the exercise price of the warrants issued with the March Notes was adjusted to $6.29 as of December 31, 2005.

The warrants met the definition of a derivative instrument that must be accounted for as a liability under the provisions of Emerging Issues Task Force Issue No. 00-19, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock, because the Company cannot engage in certain corporate transactions affecting the common stock unless it makes a cash payment to the holders of the warrants. Accordingly, $1,651,000 of the cash proceeds were allocated to the warrants, which represents the fair value of the warrants on the date of issuance and the amount was recorded as a current liability. Subsequent changes in the fair value of the warrants will be recorded in the statement of operations each period. The warrants were valued using the Black Scholes option-pricing model with the following assumptions: expected volatility of 75%; expected dividend yield of 0%; risk free interest rate of 4.62%; and contractual life of five years. The remaining gross proceeds of $5,394,000 were allocated to the Notes.

In July 2005, the Company entered into an agreement to amend the March Notes. In connection with the amendment, the Company issued three year warrants to purchase 750,000 shares of Microvision common stock at an exercise price of $6.84 per share. The conversion price of the amended March Notes and exercise price of the warrants are subject to anti-dilution adjustments, subject to conditions. In addition, the price at which the note holders can convert the March Notes to Microvision common stock was reduced to $5.85 per share, and the price at which the Company can mandatorily convert the March Notes to Microvision common stock was reduced to $10.24. The note holders may convert all or a portion of their March Notes. As a result of the amendment, the March Notes are no longer exchangeable into Lumera common stock.

The Company has concluded that the amendment of the Notes met the criteria of a debt extinguishment. The Company recorded a charge of $3,313,000 for the change in the fair value of the debt and related consideration between the original and the amended March Notes. The change in the value was measured as the value of the additional warrants that were issued to the note holders and the change in the price at which the debt could be converted to Microvision common stock. The additional warrants were valued using the Black Scholes option-pricing model with the following assumptions: expected volatility of 75%; expected dividend yield of 0%; risk free interest rate of 3.66%; and contractual life of three years. The additional warrants were initially valued at $2,295,000. The change in the conversion feature was valued using the Black Scholes option-pricing model with the following assumptions: expected volatility of 75%; expected dividend yield of 0%; risk free interest rates ranging from 3.25% to 3.58% and contractual life equal to the length of the option. The change in the conversion price was valued at $1,018,000.

The amended conversion feature continued to meet the definition of a derivative under FAS 133 and accordingly has been recorded at fair value and included within long-term liabilities. The carrying amount of the derivative will be adjusted to fair value at each balance sheet date. An adjustment of in fair value $2,712,000 was recorded for the period from July 25, 2005 to December 31, 2005.

In October 2005, the noteholder converted $1.8 million of the March Notes to 310,000 shares of common stock. The value of the embedded derivative feature associated with the converted shares of $439,000 was recorded to additional paid in capital.

The liability for both the initial warrant and the additional warrant are adjusted to the fair market value of $1,273,000 at December 31, 2005. The combined adjustment during the year ended December 31, 2005 was $2,672,000.

10. Convertible Preferred Stock

In August 2005, the holder of the Company's preferred stock agreed to convert 5,000 shares of the Company's preferred stock into 734,000 shares of common stock. As an inducement to convert the preferred stock the Company issued 124,000 shares of its common stock to the preferred stock holder and adjusted the exercise price from $8.16 to $6.84 per share for the existing warrants to purchase 362,000 shares of common stock issued in connection with the original sale of the Company's preferred stock. The value of the common shares issued of $701,000, the change in the value of the warrants of $62,000 and the amount of unamortized beneficial conversion feature on the preferred stock of $421,000 was recorded as an inducement to convert the preferred stock and charged to common shareholders in 2005.

In September 2004, Microvision raised $10,000,000 before issuance costs of $90,000 from the sale of 10,000 shares of convertible preferred stock and a warrant to purchase 362,000 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. Due to below market issuances of Company's common stock the conversion price of the Preferred Stock as of December 31, 2005 was $6.36 per share of common 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 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 stock price exceeds $12.09 per share, subject to certain conditions. The warrant was 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 Microvision 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. Due to below market issuances of Company's common stock the exercise price of the warrants issued with the Preferred Stock was adjusted to $6.40 as of December 31, 2005.

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 of 75%, risk free interest rate of 3.4%, and contractual life of five years. Proceeds of $1.3 million 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 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 resulting in the recognition of a beneficial conversion feature in accordance with Emerging Issues Task Force No 00-27 "Application of Issue No. 98-5 to Certain Convertible Instruments.". This beneficial conversion feature was measured as $1,181,000 which represents the difference between the fair value of the common stock and the effective 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.

During 2005, the Company recorded $280,000 in dividends on the preferred stock and $303,000 in accretion of the beneficial conversion feature of the preferred stock.

11. Common stock

In August and September 2005, the Company raised $7,000,000, before issuance costs, through the sale of 1,333,000 shares of common stock at a price of $5.25 per share and five-year fully exercisable warrants to purchase 301,000 shares of common stock at an exercise price of $6.50 per share to a holder of the Company's preferred stock and other investors. The holder of the Company's preferred stock also agreed to convert 5,000 shares of the Company's preferred stock into 734,000 shares of common stock. (See Note 10).

In November 2003, the Company raised $22,250,000, before issuance costs of $1,454,000, from the sale of 3,560,000 shares of common stock to a group of private investors.

In August 2003, the Company issued 8,600 fully vested shares of Microvision common stock to a professional services firm in connection with consulting services provided to the Company. The shares were valued at $7.28, the closing price on the date of issuance, and the full value of the shares, $63,000, was charged to non-cash compensation at the time of issuance.

In March 2003, the Company raised $12,560,000, before issuance costs of $970,000, from the sale of 2,644,000 shares of common stock and warrants to purchase 529,000 shares of common stock at an exercise price of $6.50 per share. Each share of common stock and accompanying partial warrant was sold for $4.75. The warrants are first exercisable in September 2003 and expire in March 2008. The exercise price of the warrants was greater than the fair market value of the common stock on the date of issue.

12. Warrants

In September 2003, the Company issued two warrants to purchase an aggregate of 70,000 shares of common stock to a third party in exchange for services provided to the Company. 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 vests in three equal tranches on the date of grant, in December 2003, and March 2004. The other warrant grants the holder the right to purchase up to 10,000 shares at a price of $12.00 per share and vests in March 2004. The unvested warrants were subject to remeasurement at each balance sheet date until vested. The deferred compensation related to these warrants was 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 $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 contractual lives used at the measurement dates above were 4 years and 3.9 years, respectively.

In August 2000, the Company issued warrants to purchase an aggregate of 200,000 shares of common stock to two consultants in connection with entering into certain consulting agreements with the Company. One of the consultants subsequently became a director. The warrants grant each of the holders the right to purchase up to 100,000 shares of common stock at a price of $34.00 per share. The warrants to purchase an aggregate of 150,000 shares vested over three years and were subject to remeasurement at each balance sheet date during the vesting period. The remaining warrants to purchase an aggregate of 50,000 shares had a measurement date at the time of grant. The deferred compensation related to these warrants is being amortized to non-cash compensation expense over the five-year period of service under the agreements. The total original value of

both warrants were estimated at $5,476,000.

On June 7, 2003, the warrants became fully vested and the value of both warrants was fixed. Total non-cash amortization expense was $270,000, $447,000, and $595,000 for the years ended December 31, 2005, 2004 and 2003, respectively. The fair values of the warrants were estimated at June 7, 2003 and December 31, 2002 using the Black Scholes option-pricing model with the following weighted- average assumptions: dividend yield of zero percent, and expected volatility of 83% for all measurement dates; risk-free interest rates of 4.0%, and 5.0% and expected lives of 7.4 and 8.1 years.

The following summarizes activity with respect to Microvision common stock warrants during the three years ended December 31, 2005:

	Warrants to purchase common Shares	Weighted-average excercise price
Outstanding at December 31, 2002	975,000	$ 18.10
Granted:		
Exercise price greater than fair value	539,000	6.60
Exercise price less than fair value	60,000	7.50
Exercised	--	--
Canceled/expired	--	--
Outstanding at December 31, 2003	1,574,000	13.76
Granted:		
Exercise price greater than fair value	362,000	8.16
Exercised	(22,000)	6.50
Canceled/expired	(196,000)	18.41
Outstanding at December 31, 2004	1,718,000	12.14
Granted:		
Exercise price greater than fair value	2,602,000	5.59
Exercise price equal to fair value	7,000	5.32
Exercised	--	--
Canceled/expired	(207,000)	25.14
Outstanding at December 31, 2005	4,120,000	$ 6.99
Exercisable at December 31, 2005	4,120,000	$ 6.99

The following table summarizes information about the weighted-average fair value of Microvision common stock warrants granted:

	Year Ended December 31,		
	2005	2004	2003
Exercise price greater than fair value	$ 2.74	$ 4.07	$ 1.69
Exercise price equal to fair value	3.24		
Exercise price less than fair value	--		4.10

The following table summarizes information about Microvision common stock warrants outstanding and exercisable at December 31, 2005:

	Warrants outstanding and exercisable		
Range of exercise prices	Number outstanding at December 31, 2005	Weighted average remaining contractual life	Weighted average excercise price
		(years)	
$3.94	1,090,000	4.92	$ 3.94
$4.80-$5.32	241,000	1.64	4.81
$6.10-$6.29	1,513,000	3.47	6.25
$6.40-$6.56	1,006,000	2.65	6.47
$7.50-$12.00	70,000	1.70	8.14
$34.00	200,000	4.61	34.00
$3.94-$34.00	4,120,000		

The fair value of the Microvision common stock warrants granted was estimated on the date of grant using the Black Scholes option-pricing model with the following weighted-average assumptions used for grants in 2005, 2004 and 2003, respectively: dividend yield of zero percent for all years; expected volatility of 70%, 75% and 83%; risk-free interest rates of 4.2%, 3.4%, and 2.1% and expected lives of 4, 5 and 3 years, respectively.

13. Options

The Company has several stock option plans ("Option Plans") that provide for granting incentive stock options ("ISOs") and nonqualified stock options ("NSOs") to employees, directors, officers and certain non-employees of the Company as determined by the Board of Directors, or its designated committee ("Plan Administrator"). The Company deems the fair market value of its stock on any given trading day to be the closing price of its stock on the NASDAQ National Market on that date.

In June 2005, shareholders approved an amendment to the Director Option Plan, increasing the number of shares reserved for the plan by 400,000, to 900,000 shares.

In June 2004, the Company granted its independent directors options to purchase an aggregate of 90,000 shares of common stock at an exercise price of $8.35. The exercise price of the options was less than the fair market value of the shares at the date of grant. The Company recorded $81,000 of deferred compensation expense related to these options in June 2004. The deferred compensation was amortized to non cash compensation expense over the one-year vesting period of the grants. Deferred compensation expense of $35,000 and $46,000 was recorded in 2005 and 2004, respectively.

In December 2003, the Board of Directors authorized extending the original expiration date for all outstanding employee options with original expiration terms of less than 10 years. Under terms of the offer, employees could extend the life of options that had original lives less than ten years by five years from the original expiration date. No other terms of the options were amended. All options were fully vested on the offer date. The extensions were voluntary and, in total, holders elected to extend 263,000 of the 264,000 eligible shares. At the time of the extensions the Company recorded $145,000 in non-cash compensation expense for the excess of the fair market value of the common stock over the relevant exercise prices of the options on the modification date.

In November 2002, the Company offered to exchange most of its outstanding options to purchase common stock for new options scheduled to be granted on or after June 11, 2003. All eligible options that were properly submitted for exchange were accepted and cancelled effective December 10, 2002. Employees tendered options to purchase an aggregate of 2,521,714 shares of the Company's common stock. Under the terms of the exchange program, the Company granted new options to purchase an aggregate of 1,731,825 shares of the Company's common stock on June 13, 2003. The exercise price of the new options was $7.00 per share.

In May 2002, shareholders approved an amendment to the 1996 Stock Option Plan, increasing the number of shares reserved for the Plan by 2,500,000 to 8,000,000. The shareholders also approved amendments to the

Independent Director Stock Option Plan ("Director Option Plan") that increased the total shares reserved for the Plan by 350,000 to 500,000 shares; established a fully vested option grant to purchase 15,000 shares to each independent director upon initial election or appointment to the Board of Directors; increased the number of shares granted in the annual initial and reelection grants from 5,000 to 15,000; granted a one-time option to each independent director to purchase 10,000 shares; and, authorized the Board of Directors to make discretionary grants.

For Option Plan grants, other than non-discretionary grants to directors, the date of grant, option price, vesting period and other terms specific to options granted are determined by the Plan Administrator. The specific terms of Mandatory Director Grants are specified by the plan document.

Stock options issued under the Option Plans, other than the Director Option Plan, generally have vesting ranges from three years to four years; expirations of 10 years; and exercise prices greater than or equal to the fair market value of the Company's stock on the date of grant.

The Director Option Plan provides for two types of Mandatory Grants: a fully vested option to purchase 15,000 shares of common stock to each independent director upon initial election or appointment to the Board of Directors, and an additional initial or annual reelection option to purchase 15,000 shares of common stock, which the earlier of one year or no later than the Company's subsequent regularly scheduled annual shareholders' meeting. For both types of Mandatory Grants, the exercise prices are set equal to the closing price of the Company's common stock as reported on the NASDAQ National Market on the date of grant and have ten year terms. Upon leaving the Board, the director's grants remain exercisable until their expiration dates.

The following table summarizes activity with respect to Microvision common stock options for the three years ended December 31, 2005:

	Shares	Weighted-average excercise price
Outstanding at December 31, 2002	3,076,000	$ 16.03
Granted:		
Exercise price greater than fair value	1,935,000	7.15
Exercise price equal to fair value	378,000	6.76
Exercise price less than fair value	197,000	6.93
Exercised	(82,000)	6.60
Forfeited	(783,000)	10.06
Outstanding at December 31, 2003	4,721,000	12.43

Granted:		
Exercise price greater than fair value	177,000	7.55
Exercise price equal to fair value	487,000	6.76
Exercise price less than fair value	90,000	8.35
Exercised	(38,000)	6.25
Forfeited	(319,000)	12.03
Outstanding at December 31, 2004	5,118,000	11.72
Granted:		
Exercise price greater than fair value	--	--
Exercise price equal to fair value	274,000	5.34
Exercise price less than fair value	300,000	5.32
Exercised	(5,000)	4.03
Forfeited	(367,000)	10.99
Outstanding at December 31, 2005	5,320,000	$ 11.09
Exercisable at December 31, 2005	4,515,000	$ 11.90

The following table summarizes information about the weighted-average fair value of Microvision common stock options granted:

	Year Ended December 31,		
	2005	2004	2003
Exercise price greater than fair value	$ --	$ 3.19	$ 3.19
Exercise price equal to fair value	3.21	3.33	4.26
Exercise price less than fair value	3.66	4.58	2.69

The following table summarizes information about Microvision common stock options outstanding and exercisable at December 31, 2005:

	Options outstanding			**Options exercisable**	
Range of exercise prices	**Number outstanding December 31, 2005**	**Weighted average aremaining contractualife**	**Weighted average excercise price**	**Number excercisable December 31, 2005**	**Weighted average excercise price**
		(years)			
$3.25-$5.32	558,000	9.05	$ 5.09	133,000	$ 4.89
$5.33-6.99	549,000	7.70	6.13	474,000	6.18
$7.00-7.07	1,582,000	7.46	7.00	1,574,000	7.00
$7.19-10.00	561,000	7.14	7.82	354,000	7.91
$10.20-14.94	565,000	5.69	11.58	475,000	11.66
$15.00-15.16	874,000	5.81	15.00	874,000	15.00
$15.63-60.75	631,000	4.72	27.99	631,000	27.99
$3.25-$60.75	5,320,000			4,515,000	

Fair Value Disclosures

The fair values of Microvision common stock options granted were estimated on the date of each grant using the Black Scholes option pricing model with the following weighted average assumptions used for grants in 2005, 2004 and 2003, respectively: dividend yield of zero percent for all years; expected volatility of 70%, 76% and 83%; risk free interest rates of 4.0%, 3.0%, and 2.2%; and expected lives of 5, 3 and 3 years. Actual forfeitures of 7.2%, 6.8% and 25.4% were used for the years ended December 31, 2005, 2004, and 2003 respectively. Excluding shares cancelled under the voluntary extension for grants with terms less than ten years, the actual forfeiture rate for 2003 was 16.3%.

14. Commitments and contingencies

Agreements with the University of Washington

In October 1993, the Company entered into a Research Agreement and an exclusive license agreement ("License Agreement") with the UW. The License Agreement grants the Company the rights to certain intellectual property, including the technology being subsequently developed under the Microvision research agreement ("Research Agreement"), whereby the Company has an exclusive, royalty-bearing license to make, use and sell or sublicense the licensed technology. In consideration for the license, the Company agreed to pay a one-time nonrefundable license issue fee of $5,134,000. Payments under the Research Agreement were credited to the license fee. In addition to the nonrefundable fee, which has been paid in full, the Company is required to pay certain ongoing royalties. Beginning in 2001, the Company is required to pay the UW a nonrefundable license maintenance fee of $10,000 per quarter, to be credited against royalties due.

Litigation

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.

Lease commitments

The Company leases its office space and certain equipment under noncancelable capital and operating leases with initial or remaining terms in excess of one year. The Company entered into a facility lease that commenced in April 1999, which includes extension and rent escalation provisions over the seven-year term of the lease. Rent expense is recognized on a straight-line basis over the lease term.

The Company entered into a 90 month facility lease that commenced in February 2006. The lease includes extension and rent escalation provisions over the 90 month term of the lease. Rent expense will be recognized on a straight-line basis over the lease term.

Future minimum rental commitments under capital and operating leases for years ending December 31 are as follows:

	Capital leases	Operating leases
2006	$ 41,000	$ 741,000
2007	39,000	850,000
2008	33,000	834,000
2009	27,000	837,000
2010	20,000	867,000
Thereafter	--	2,400,000

Total minimum lease payments	160,000	$ 6,529,000
Less: Amount representing interest	(23,000)	
Present value of capital lease obligations	137,000	
Less: Current portion	(32,000)	
Long-term obligation at December 31, 2005	$ 105,000	

Operating lease commitments amounts do not include the impact of contractual sublease receipts of $79,000 for the year ended December 31, 2006.

The capital leases are collateralized by the related assets financed and by security deposits held by the lessors under the lease agreements. The cost and accumulated depreciation of equipment under capital leases was $1,309,000, and $1,140,000, respectively at December 31, 2005 and $1,175,000 and $1,053,000, respectively, at December 31, 2004.

Net rent expense was $1,435,000, $1,689,000, and $2,302,000 for 2005, 2004 and 2003, respectively. Rent expense in 2003 includes $540,000 for the closure of the Company's facility in San Mateo, California. Sub- lease income of $575,000, $363,000 and $226,000 for 2005, 2004, and 2003 respectively was included as a reduction in rent expense.

Long-term debt

During 1999, the Company entered into a loan agreement with the lessor of the Company's corporate headquarters to finance $420,000 in tenant improvements. The loan carries a fixed interest rate of 10% per annum, is repayable over the initial term of the lease, which expires in 2006, and is secured by a letter of credit. The balance of the loan was $22,000 and $99,000 at December 31, 2005 and 2004 respectively.

15. Income taxes

A provision for income taxes has not been recorded for 2005, 2004 or 2003 due to valuation allowances placed against the net operating losses and deferred tax assets arising during such periods. A valuation allowance has been recorded for all deferred tax assets because based on the Company's history of losses since inception, the available objective evidence creates sufficient uncertainty regarding the realizability of the deferred tax assets.

At December 31, 2005, Microvision has net operating loss carry forwards of approximately $191 million, for federal income tax reporting purposes. In addition, Microvision has research and development tax credits of $2,559,000. The net operating loss carry forwards and research and development credits available to offset future taxable income, if any, will expire in varying amounts from 2008 to 2025 if not previously utilized. In certain circumstances, as specified in the Internal Revenue Code, a 50% or more ownership change by certain combinations of the Company's stockholders during any three-year period would result in limitations on the Company's ability to utilize its net operating loss carry-forwards. The Company has determined that such a change occurred during 1995 and the annual utilization of loss carry-forwards generated through the period of that change will be limited to approximately $761,000. An additional change occurred in 1996; and the limitation for losses generated in 1996 is approximately $1,600,000.

Deferred tax assets are summarized as follows:

	December 31,	
	2005	**2004**
Net operating loss carry forwards Microvision	$ 65,006,000	$ 57,112,000

R&D credit carry forwards Microvision	2,559,000	2,218,000
Other	3,463,000	4,642,000
	71,028,000	63,972,000
Less: Valuation allowance	(71,028,000)	(63,972,000)
Deferred tax assets	$ --	$ --

The valuation allowance and the research and development credit carry forwards account for substantially all of the difference between the Company's effective income tax rate and the Federal statutory tax rate of 34%.

Certain net operating losses arise from the deductibility for tax purposes of compensation under nonqualified stock options equal to the difference between the fair value of the stock on the date of exercise and the exercise price of the options. For financial reporting purposes, the tax effect of this deduction when recognized is accounted for as a credit to shareholders' equity.

16. Retirement savings plan

The Company has a retirement savings plan ("the Plan") that qualifies under Internal Revenue Code Section 401(k). The Plan covers all qualified employees. Contributions to the Plan by the Company are made at the discretion of the Board of Directors.

In February 2000, the Board of Directors approved a plan amendment to match 50% of employee contributions to the Plan up to 6% of the employee's per pay period compensation, starting on April 1, 2000. During 2005, 2004 and 2003, the Company contributed $321,000, $337,000 and $392,000 respectively, to the Plan under the matching program.

17. Segment Information

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

The accounting policies used to derive reportable segment results are described in Note 2, "Summary of Significant Accounting Policies."

A portion of each segments' administration expenses arise from shared services and infrastructure that Microvision has provided to both segments in order to realize economies of scale and to efficiently use resources. These efficiencies include costs of certain legal, accounting, human resources and other Microvision corporate and infrastructure costs. These expenses are allocated to the segments and the allocation has been 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.

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

At December 31, 2005 and 2004, Lumera was a significant unconsolidated equity investment of Microvision. For 2005 Lumera revenue was $1,509,000, Gross profit was $587,000, Loss from operations was $11,108,000 and Net loss was $10,453,000 For the period that Lumera was an unconsolidated investment in 2004 (July 2004 through

December 31, 2004) Lumera revenue was $303,000, Gross profit was $85,000, Loss from operations was $5,205,000 and Net loss was $5,199,000. At December 31, 2005 Lumera had Current assets of $22,384,000, Noncurrent assets of $1,322,000, Current liabilities of $1,552,000 and Shareholders equity of $22,154,000 At December 31, 2004 Lumera had Current assets of $19,623,000, Noncurrent assets of $13,263,000, Current liabilities of $1,493,000 and Shareholders equity of $31,393,000.

The following tables reflect the results of the Company's reportable segments under the Company's management system. The performance of each segment is measured based on several metrics. These results are 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

18. Quarterly Financial Information (Unaudited)

The following table presents the Company's unaudited quarterly financial information for the years ending December 31, 2005 and 2004:

	Year Ended December 31, 2005			
	December 31,	September 30,	June 30,	March 31,
Revenue	$ 2,709,000	$ 3,330,000	$ 4,725,000	$ 3,982,000
Gross Margin	(1,756,000)	(434,000)	840,000	1,004,000
Net loss available for common shareholde	(5,566,000)	(12,571,000)	(4,968,000)	(7,179,000

Net loss per share basic and diluted	(0.23)	(0.56)	(0.23)	(0.33

	Year Ended December 31, 2004			
	December 31,	September 30,	June 30,	March 31,
Revenue	$ 3,317,000	$ 2,729,000	$ 2,398,000	$ 2,974,000
Gross Margin	76,000	263,000	568,000	1,104,000
Net loss	(8,247,000)	(10,094,000)	(8,512,000)	(6,690,000
Net loss per share basic and diluted	(0.38)	(0.47)	(0.40)	(0.31

19. Subsequent Event

In January 2006, the Company raised $10,324,000 from the sale of 2,550,000 shares of Lumera common stock. As a result of the sale, the Company will record a "gain on sale of equity subsidiary" of approximately $7.3 million. Subsequent to the sale, the Company owned 2,072,000 shares, or 12%, of the outstanding shares of Lumera common stock. After January 31, 2006, due to the change in ownership percentage, Microvision will account for its investment in Lumera using the cost method.

In January 2006 the Chief Executive Officer's employment was terminated and the Chief Financial Officer resigned. The Company appointed Alexander Y. Tokman to Chief Executive Officer in January 2006.

MICROVISION, INC.
VALUATION AND QUALIFYING ACCOUNTS AND RESERVES
(in thousands)

Description	Balance at beginning of fiscal period	Additions: Charges to costs and expenses	Additions: Charges to other accounts	
Year Ended December 31, 2003				
Allowance for receivables from related parties	$ 700	$ 200	$ --	$
Tax valuation allowance	52,059	--	11,454	
Year Ended December 31, 2004				
Allowance for receivables from related parties	900	--	--	
Tax valuation allowance	63,513	--	11,015	
Year Ended December 31, 2005				
Allowance for receivables from related parties	900	1,031	--	
Tax valuation allowance	63,972	--	7,056	

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

There have been no changes in or disagreements with accountants in accounting or financial disclosure matters during the Company's fiscal years ended December 31, 2005 and 2004.

ITEM 9A. CONTROLS AND PROCEDURES

(a) *Evaluation of disclosure controls and procedures.* The Chief Executive Officer and the Principal Financial Officer evaluated our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities and Exchange Act of 1934 (the "Exchange Act") prior to the filing of this annual report. Based on that evaluation, they concluded that, as of the end of the period covered by this annual report, our disclosure controls and procedures were, in design and operation is effective and such information is accumulated and communicated to management as appropriate to allow timely decisions regarding required disclosure.

(b) *Management's Report on Internal Control Over Financial Reporting.* Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rule 13a-15(f). Our management conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on its evaluation under the framework in *Internal Control - Integrated Framework,* our management concluded that our internal control over financial reporting was effective as of December 31, 2005.

Our management's assessment of the effectiveness of our internal control over financial reporting as of December 31, 2005 has been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm, as stated in their report which is included in Item 8 of this Annual Report on Form 10-K.

(c) *Changes in internal controls over financial reporting.* There have not been any changes in the Company's internal control over financial reporting during the quarter ended December 31, 2005 which have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

ITEM 9B. OTHER INFORMATION

None

PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT.

Set forth below are the name, position held and age of each of the directors and executive officers of the Company. The principal occupation and recent employment history of each of the directors and executive officers are described below:

Name	Age	Position
Alexander Y. Tokman	44	President and Chief Executive Officer, Director
Richard A. Cowell (1)(2)(3)*	57	Director
Slade Gorton(1)(2)(3)*	77	Director
Marc Onetto (1) (2) (3)*	55	Director
Richard F. Rutkowski	49	Director
Ian D. Brown	43	Vice President Sales and Marketing
Todd R. McIntyre	44	Vice President of Global Strategic Marketing and Bu
Thomas M. Walker	41	Vice President, General Counsel and Secretary
Stephen R. Willey	52	President, Marketing and Sales, Asia
Jeff T. Wilson	45	Chief Finanicial Officer

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* Independent Directors

(1)

Member of the Compensation Committee

(2)

Member of the Audit Committee

(3)

Member of the Nominating and Corporate Governance Committee

Alexander Tokman, has served as President, Chief Executive Officer and a director of Microvision since January 2006. Mr. Tokman served as Microvision's President and Chief Operating Officer from July 2005 to January 2006. From April 1995 to July 2005, Mr. Tokman served in various cross-functional and cross-business leadership positions at GE Healthcare, a subsidiary of General Electric most recently as a General Manager of its Global Molecular Imaging and Radiopharmacy unit from May 2003 to June 2005. From November 1989 to March 1995 Mr. Tokman served as technical programs lead and a head of I&RD at Tracor Applied Sciences a subsidiary of then Tracor, Inc. Mr. Tokman has both a M.S. and B.S. in Electrical Engineering from the University of Massachusetts, Dartmouth. He also is a certified Six Sigma & DFSS Black Belt and Master Black Belt.

Ian D. Brown, age 43, has served as Vice President, Sales and Marketing of Microvision since February 2006. Prior to joining Microvision, from March 1994 to February 2006, Mr. Brown served in various Sales and Marketing positions with General Electric Healthcare, Americas. Most recently from April 2004 to February 2006 Mr. Brown served as the Sales and Marketing Manager - Nuclear Medicine. From April 1989 to March 1994 Mr. Brown served as Technical Author - Nuclear Medicine Operator Documentation with IGE Medical Systems, Radlett, UK. Mr. Brown holds Ordinary & Higher National Certificates in Medical Physics & Physiological Measurements from Paddington College, London, Post Graduate Diploma in Management studies, University of Hertfordshire. He also holds a Six Sigma Black Belt.

Todd R. McIntyre, age 44, has served as Senior Vice President of Global Strategic Marketing and Business Development of Microvision since January 2006. Mr. McIntyre served as Senior Vice President of Business Development from November 2003 until January 2006, and Vice President of Business Development of Microvision from January 1996 to November 2003. Mr. McIntyre's experience in emerging markets includes business development and marketing with development stage companies in a variety of technology segments including wireless telecommunications products and services, internet software products, and digital and print media. Mr. McIntyre holds an M.B.A. from Stanford University and a B.A. from Hendrix College.

Thomas M. Walker, age 41, joined Microvision in May 2002 and serves as Vice President, General Counsel and Secretary. Prior to joining Microvision, Mr. Walker served as Senior Vice President, General Counsel and Secretary of Advanced Radio Telecom Corp., a publicly held technology and services company where he managed domestic and international legal affairs from April 1996 to April 2002. Prior to that, Mr. Walker advised publicly and privately held businesses while practicing in the Los Angeles offices of the law firms of Pillsbury Winthrop and Buchalter, Nemer Fields and Younger. Mr. Walker holds a B.A. from Claremont McKenna College and a J.D. from the University of Oregon.

Stephen R. Willey has served as President, Marketing and Sales, Asia of Microvision since January 2006. Mr. Willey served as President, Consumer Solutions from July 2005 to January 2006, as Microvision's Executive Vice President from October 1995 to August 2002 and as a director from June 1995 to April 2006. Prior to that, he served as an outside consultant to the company through The Development Group (DGI) a business and technology consulting firm that he founded. As principal of DGI, Willey had also provided senior management consulting services to CREO Products, Inc., an electro-optics equipment manufacturer, between June 1989 and December 1992. In 1993, Willey co-founded PRO.NET Communications, Inc., an Internet service company. Willey holds an M.B.A. from the University of California, Los Angeles, and an M.A.Sc. in Electronics from the University of British Columbia, Vancouver. He earned a B.Sc., Engineering (Physics) from McMaster University, Hamilton.

Jeff T. Wilson, age 45, has served as Chief Financial Officer of Microvision since April 2006, Vice President, Accounting of Microvision from April 2002 to April 2006, Principal Financial Officer since January 2006 and Principal Accounting Officer of Microvision since August 1999 and as Director of Accounting of Microvision from August 1999 to March 2002. Prior to joining Microvision, from 1991 to 1999 Mr. Wilson served in various accounting positions for Siemens Medical Systems, Inc., a developer and manufacturer of medical imaging equipment. Prior to 1991, Mr. Wilson served as a manager with the accounting firm Price Waterhouse (currently PricewaterhouseCoopers LLP). Mr. Wilson is a Certified Public Accountant. Mr. Wilson holds a B.S. in Accounting from Oklahoma State University.

Colonel Richard A. Cowell, USA, (Ret.) has served as a director of the Company since August 1996. Colonel Cowell is a Principal at Booz Allen Hamilton, Inc. where he is involved in advanced concepts development and technology transition, joint and service experimentation, and the interoperability and integration of command and control systems for Department of Defense and other agencies. Prior to joining Booz Allen Hamilton, Inc. in March of 1996, Colonel Cowell served in the United States Army for 25 years. Immediately prior to his retirement from the Army, Colonel Cowell served as Director of the Louisiana Maneuvers Task Force reporting directly to the Chief of Staff, Army. Colonel Cowell has authored and received awards for a number of documents relating to the potential future capabilities of various services and agencies.

Slade Gorton joined the company as a director in September 2003. Mr. Gorton is currently Of Counsel at the law firm of Preston Gates & Ellis LLP. Prior to joining the firm, he represented Washington State in the United States Senate for 18 years. Mr. Gorton began his political career in 1958 as a Washington State Representative and went on to serve as State House Majority Leader. In 1968 he was elected Attorney General of Washington State where he served until 1980. Mr. Gorton also served on the President's Consumer Advisory Council (1975-77), the Washington State Criminal Justice Training Commission (1969-1981), the National Commission on Federal Election Reform (2001), and was chairman of the Washington State Law & Justice Commission (1969-76). Mr. Gorton also served in the U.S. Army, U.S. Air Force, and the U.S. Air Force Reserves. Mr. Gorton was a Commissioner on the National Commission on Terrorist Attacks upon the United States ("9-11 Commission").

Marc Onetto has served as a director of Microvision since March 2006. Since 2003, Mr. Onetto has served as Executive Vice President of Worldwide Operations for Solectron, a global provider of electronics manufacturing and integrated supply-chain services. Prior to joining Solectron, Mr. Onetto served 15 years with GE, most recently as Vice President of GE Corporate European operations. From 1992-2002 Mr. Onetto held several senior leadership positions at GE Medical Systems as head of its global supply chain and operations, global quality, and global process engineering. He was one of GE's Six Sigma pioneers and led the quality culture transformation across GE Medical Systems. Prior to GE, Mr. Onetto served 12 years with Exxon Corporation in supply operations, information systems and finance.

Richard F. Rutkowski has served as a director since August 1995. Mr. Rutkowski also served as the Company's Chief Executive Officer from September 1995 to January 2006 and President from July 1996 to August 2002. From November 1992 to May 1994, Mr. Rutkowski served as Executive Vice President of Medialink Technologies Corporation (formerly Lone Wolf Corporation), a developer of high-speed digital networking technology for multimedia applications in audio-video computing, consumer electronics, and telecommunications. From February 1990 to April 1995, Mr. Rutkowski was a principal of Rutkowski, Erickson, Scott, a consulting firm. Mr. Rutkowski also serves as a director of Lumera Corporation and CMT Crimble Microtest.

The Audit Committee

The Board of Directors has an Audit Committee which assists the Board of Directors by monitoring and overseeing: (1) the accounting and financial reporting processes of the Company and the audits of the financial statements of the Company, (2) the integrity of the financial statements of the Company, (3) compliance by the Company with legal and regulatory requirements, and (4) the performance of the Company's internal finance and accounting personnel and its independent auditors. Messrs. Cowell, Gorton and Onetto currently serve on the Audit Committee, with Mr. Cowell serving as Chairman.

Audit Committee Financial Expert

The "audit committee financial expert" designated by our Board is Col. Richard A. Cowell (Ret.), an Independent Director. Col. Cowell holds a degree in accounting and has served for seven years as Chair of the Company's Audit Committee. During his twenty-five years of service in the United States Army, Col. Cowell oversaw and actively supervised various complex governmental projects that involved government accounting with a breadth and level of complexity comparable to accounting issues raised by the Company's financial statements, including issues relating to estimates, accruals, and reserves. Since retiring from the Army, Col. Cowell has served as a Principal at Booz Allen Hamilton, where he provides consulting services relating to significant government projects and grants which involve significant and complex accounting issues.

Section 16(a) Beneficial Ownership Reporting Compliance

Section 16(a) of the Securities Exchange Act of 1934 requires that our directors, executive officers, and greater-than 10% shareholders file reports with the SEC relating to their initial beneficial ownership of the Company's securities and any subsequent changes. They must also provide us with copies of the reports.

Based on copies of reports furnished to us, we believe that all of these reporting persons complied with their filing requirements during 2005, except that Mr. Tokman, an executive officer of the Company, belatedly filed an Initial Statement of Beneficial Ownership of Securities on Form 3, reporting 1 transaction; and Mr. Willey, an executive officer of the Company, belatedly filed one Statement of Changes of Beneficial Ownership of Securities on Form 4 reporting 1 transaction.

Code of Ethics

The Company has adopted a code of ethics applicable to the Company's principal executive officer, principal financial officer, and principal accounting officer, known as the Code of Ethics for Microvision Executives. The Company has also adopted a code of conduct applicable to the Company's directors, officers, and employees, known as the Code of Conduct. The Code of Ethics for Microvision Executives and the Code of Conduct are available on the Company's website. In the event we amend or waive any of the provisions of the Code of Ethics for Microvision Executives applicable to our principal executive officer, principal financial officer, and principal accounting officer, we intend to disclose the same on the Company's website at

www.microvision.com.

ITEM 11. Executive Compensation.

The following table sets forth the compensation awarded or paid to or earned by the person who served as Chief Executive Officer during 2005 and the next four most highly compensated persons who served as executive officers during 2005 (the "Named Executive Officers"):

Summary Compensation Table

		Annual Compensation		Long-term Compensation Awards	
Name and Principal Position (3)	**Fiscal Year**	**Salary ($)**	**Bonus (2) ($)**	**Securities Underlying Options (#)**	**A s**
Richard F. Rutkowski	2005	377,104	--	--	
Former Chief Executive Officer and Director	2004	364,000	50,000	80,000	
	2003	353,000	10,000	361,751	
Stephen R. Willey	2005	326,340	387	--	
President, Marketing and Sales, Asia	2004	315,000	40,000	130,000	
	2003	284,000	85,000	305,002	
Richard A. Raisig	2005	281,792	--	--	
Former Chief Financial Officer	2004	272,000	30,000	70,000	
	2003	263,000	68,000	232,613	
Vilakkudi Veeraraghavan	2005	239,144	88	--	
Former Senior Vice President,	2004	235,000	20,000	--	
Research & Product Development	2003	220,000	50,000	111,000	
Todd R. McIntyre	2005	210,000	70,000	--	

Senior Vice President,	2004	200,000	50,000	30,000
Global Strategic Marketing and Business Development	2003	166,061	40,000	182,627

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(1) All Other Compensation amounts for 2005 include contributions of $1,500, $6,169, $6,300, $6,300 and $6,008 to the accounts of Messrs. Rutkowski, Willey, Raisig, Veeraraghavan and McIntyre, respectively, under the Company's qualified 401(k) Retirement Plan. The amounts also include forgiveness of $95,632, $22,181, and $37,749 of interest for Messrs. Rutkowski, Willey, Raisig, respectively, under one or both of the Company's Executive Option Exercise Note Plan and Executive Loan Plan. For a description of the two plans, see "Executive Loan Plans" below. No Options, Restricted Stock Awards or Long-Term Incentive Plan payments were made as of December 31, 2005.

(2) Bonus amounts for 2005 include Patent Incentive Program bonuses of $387 and $88 for Messrs. Willey and Veeraraghavan respectively.

(3) Richard F. Rutkowski, Richard A. Raisig and Vilakkudi Veeraraghavan are no longer employed by the Company.

Stock Option Grants in the Last Fiscal Year

The Company did not grant any options to acquire common stock to its named executive officers during 2005.

Aggregated Option Values as of Year End 2005

The following table provides information regarding the aggregate number of options exercised during the fiscal year ended December 31, 2005, by each of the Named Executive Officers and the number of shares subject to both exercisable and unexercisable stock options as of December 31, 2005.

Aggregated Option Exercises in Last Fiscal

Year and FY-End Option Values

			Number of Securities Underlying Unexercised Options at/SARS at December 31, 2005		Value of Unexercised In-the-Money Options at December 31, 2005 (1)	
Name	**Shares Acquired On Exercise**	**Value Realized ($)**	**Exercisable**	**Unexercisable**	**Exercisable ($)**	**Unexercisable ($)**
Richard F. Rutkowski	--	--	873,791	--	--	--
Stephen R. Willey	--	--	555,013	--	--	--
Richard A. Raisig	--	--	444,823	--	--	--
Vilakkudi Veeraraghavan	--	--	180,454	--	--	--
Todd R. McIntyre	--	--	239,430	--	--	--

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(1) The value of unexercised in-the-money options is based on the difference between $3.60 (the fair market value of the Company's common stock as reflected by the closing price of the common stock on the Nasdaq National Market as of December 31, 2005) and the exercise price of such options multiplied by the number of shares issuable upon exercise thereof. As of December 31, 2005, the exercise price of all options held by named executive officers was greater than $3.60.

Executive Loan Plans

The Company previously adopted two loan plans under which Richard F. Rutkowski, Stephen Willey, and Richard Raisig were able to borrow funds from the Company. At the end of each year, the Company will forgive the interest that accrued under the loans if the executive remains employed by the Company. In 2005, the Company forgave $95,632, $22,181, and $37,749 of interest for Messrs. Rutkowski, Willey, and Raisig, respectively. No additional loans have been made under either the Executive Option Exercise Loan Plan or the Executive Loan Plan since July 2002, and the Company does not intend to make any additional loans under these plans. The Company also has no plans to forgive the principal balance outstanding of the lines of credit. On February 16, 2005, Stephen Willey transferred 28,844 shares of the Company's common stock in full repayment of an existing loan and accrued interest thereon, which had become due on December 31, 2004. For additional details regarding loan balances and terms, see Item 13.

Certain Tax Considerations Related to Executive Compensation

As a result of Section 162(m) of the Internal Revenue Code of 1986, as amended, in the event that compensation paid by the Company to the Named Executive Officers in a year were to exceed an aggregate of $1,000,000, the Company's deduction for such compensation could be limited to $1,000,000.

Director Compensation

Pursuant to the Independent Director Stock Option Plan (the "Director Plan"), each Independent Director is granted a nonstatutory option to purchase 15,000 shares of common stock on the date on which he or she is first elected or appointed to the Board of Directors. These options are fully vested and immediately exercisable upon the date of grant. Each Independent Director also receives, upon his or her initial appointment or election and upon each subsequent reelection to the Board of Directors, an option to purchase 15,000 shares that will vest in full on the earlier of (i) the day prior to the date of the Company's annual meeting of shareholders next following the date of grant, or (ii) one year from the date of grant, provided the Independent Director continues to serve as a director on the vesting date. If an Independent Director ceases to be a director for any reason other than death or disability before his or her term expires, then any outstanding unvested options issued under the Director Plan to such Independent Director will be forfeited. Options vested as of the date of termination for any reason other than death or disability are exercisable through the date of expiration. The exercise price for each option is equal to the closing price of the Company's common stock as reported on the Nasdaq National Market on the date of grant. The options generally expire on the tenth anniversary of the date of grant.

In addition, each Independent Director receives the following cash compensation for his or her service as a director:

- A fee of $20,000 that accrues as of the date of appointment or election to the Board of Directors, and as of the date of each subsequent reelection;
- A fee of $3,000 for the Board chair or $2,000 per director for each Board meeting attended by the director; and
- A fee of $3,000 for the committee chair or $2,000 per committee member for each committee meeting attended by the director that is held on a day other than a day on which a Board meeting is held.

All directors are reimbursed for reasonable travel and other out-of-pocket expenses incurred in attending meetings of the Board of Directors.

Compensation Committee Interlocks And Insider Participation

The Compensation Committee is composed entirely of the following Independent Directors: Slade Gorton, Richard Cowell and Mark Onetto. Dennis Reimer, who resigned from the Board of Directors on April 10, 2006, also served on the Compensation Committee during 2005.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The following table shows as of April 11, 2006, the number of shares of common stock held by all persons we know to beneficially own at least 5% of the Company's common stock, the Company's directors, the Named Executive Officers, and all directors and executive officers as a group.

Name and Address of Beneficial Owner	**Number of Shares (1)**	**Percentage of Common Stock (2)**
Alexander Y. Tokman (3) c/o Microvision, Inc. 6222 185th Avenue NE Redmond, WA 98052	60,000	*
Richard F. Rutkowski (4) 3125 E. Laurelhurst Dr. NE Seattle, WA 98105-5332	876,163	3.4%
Stephen R. Willey (5) c/o Microvision, Inc. 6222 185th Avenue NE Redmond, WA 98052	725,404	2.8%
Richard A. Raisig (6) 4881 Birch Street Newport Beach, CA 92660	494,640	1.9%
Todd R. McIntyre (7) c/o Microvision, Inc. 6222 185th Avenue NE Redmond, WA 98052	239,930	*
Vilakkudi Veeraraghavan (8) 2406 246th Place NE Redmond, WA 98074	180,454	*
Richard Cowell (9) c/o Microvision, Inc. 6222 185th Avenue NE Redmond, WA 98052	85,067	*
Slade Gorton (10) c/o Microvision, Inc. 6222 185th Avenue NE Redmond, WA 98052	46,000	*
Marc Onetto (11) c/o Microvision, Inc. 6222 185th Avenue NE Redmond, WA 98052	15,000	*
All executive officers and directors as a group (12 persons) (12)	2,993,297	10.7%

* Less than 1% of the outstanding shares of common stock.

(1) Beneficial ownership is determined in accordance with the rules of the Securities and Exchange Commission (the "SEC") and generally includes voting or investment power with respect to securities. Shares of common stock subject to options or warrants that are currently exercisable or convertible or may be exercised or converted within sixty days are deemed to be outstanding and to be beneficially owned by the person holding these options or warrants for the purpose of computing the number of shares beneficially owned and the percentage of ownership of the person holding these securities, but are not outstanding for the purpose of computing the percentage ownership of any other person or entity. Subject to community property laws where applicable, the Company believes that each shareholder named in this table has sole voting and investment power with respect to the shares indicated as beneficially owned thereby.

(2) Percentage of common stock is based on 25,243,026 shares of common stock outstanding as of April 11, 2006.

(3) Includes 60,000 shares issuable upon exercise of options.

(4) Includes 873,791 shares issuable upon exercise of options.

(5) Includes 585,013 shares issuable upon exercise of options.

(6) Includes 444,823 shares issuable upon exercise of options.

(7) Includes 239,430 shares issuable upon exercise of options.

(8) Includes 180454 shares issuable upon exercise of options and warrants.

(9) Includes 78,867 shares issuable upon exercise of options.

(10) Includes 45,000 shares issuable upon exercise of options.

(11) Includes 15,000 shares issuable upon exercise of options.

(12) Includes 2,793,017 shares issuable upon exercise of options.

EQUITY COMPENSATION PLAN INFORMATION

The following table shows the number of shares of common stock that could be issued upon exercise of outstanding options and warrants, the weighted average exercise price of the outstanding options and warrants and the remaining shares available for future issuance as of December 31, 2005.

	Equity Compensation Plan Information		
Plan Category	**Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)**	**Weighted-average exercise price of outstanding options, warrants and rights (b)**	**Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)**
Equity compensation plans approved by shareholders	4,982,000	$ 10.79	3,131,000
Equity compensation plans not approved by shareholders	615,000	20.53	--

Total	5,597,000	$ 11.86	3,131,000

As of December 31, 2005, there were non-plan options to purchase a total of 338,000 shares of Microvision common stock outstanding. 329,000 of these were options approved by the Board of Directors and issued in October 2001, with exercise prices in excess of the fair value of Microvision common stock on the date of grant. The October 2001 options have a $15.00 exercise price and vested 25% on the grant date and 25% at six-month intervals thereafter. The remaining 9,000 non-plan options were granted at fair values on the dates of grant and vest 25% at each annual anniversary date of the grants.

All non-plan options are non-qualified options with 10 year terms granted to non-executive employees. The options are administered by the Compensation Committee of the Board of Directors or its authorized agents. Options surrendered, exchanged for another option, canceled or terminated without having been exercised in full will again be available for issuance by the Company. The options are not transferable other than by will or the laws of descent and distribution. Each option is exercisable during the lifetime of the optionee only by such optionee, upon its vest date and thereafter through the expiration date, subject to the termination of employment provisions. Following termination of employment by the Company other than for cause, resignation in lieu of dismissal, disability or death, an option holder may exercise options, vested as of the date of termination, within three months before the options will automatically expire, and any unvested options will automatically expire upon the termination date. The number and class of shares covered by the options and the exercise price per share shall be proportionately adjusted for any change in the number of issued shares of common stock of the Company resulting from a stock split, stock dividend or consolidation of shares or any like capital stock adjustment. In the event of a merger, consolidation or plan of exchange to which the Company is a party or a sale of all or substantially all of the Company's assets, the Board of Directors may elect to treat the options in one of the following ways: (i) outstanding options would remain in effect in accordance with their terms; (ii) outstanding options would be converted into options to purchase stock in the surviving or acquiring corporation in the transaction; or (iii) outstanding options would be exercised within a period determined by the Board of Directors prior to the consummation of the transaction, after which time the options automatically expire. The Board may accelerate the vesting of the options so they are exercisable in full.

In August 2000, the Company issued two non-plan warrants to purchase an aggregate of 200,000 shares of Microvision common stock to two consultants in connection with entering into certain consulting agreements with the Company. Subsequently, one of the consultants was elected to the Board of Directors by shareholders. The warrants were fully outstanding as of December 31, 2005. The warrants have an exercise price of $34.00 per share and are exercisable prior to their expiration in August 2010. As of the date of grant, all but 25,000 of the underlying shares of common stock issuable to each consultant upon exercise of the warrants were subject to lock- up restrictions that prevent the holder from transferring such shares. The number of shares subject to the lock-up restrictions is reduced by 25,000 for each consultant on each June 7 subsequent to the grant date. Rather than issue shares of common stock upon exercise of the warrants, the Company may elect to redeem the warrants if, in the opinion of the Board of Directors upon advice of counsel, it would be unlawful to issue the underlying securities. The warrants are transferable upon prior written approval of the Company. The Company cannot unreasonably withhold such approval with respect to transfers of warrants to purchase at least 10,000 shares that are not subject to the lock-up restrictions. If the Company terminates the consulting agreement due to the consultant's failure to provide consulting services during the first three years of the agreement, the consultant must return to the Company a pro-rata portion of the 75,000 warrants initially subject to the lock-up restrictions based on the number of calendar days remaining in the initial three year period. The number, class and price of securities for which the warrants may be exercised are subject to adjustment for certain changes in the Company's capital structure. The number of securities and exercise price per share will be proportionately adjusted if outstanding shares of the Company's common stock are divided into a greater number of shares or combined into a smaller number of shares, or a stock dividend is paid on the common stock. In the event of a change in the common stock from a merger, consolidation, reclassification, reorganization, partial or complete liquidation, or other change in the capital structure of the Company, the Company will, as a condition of the change in capital structure, make provision for the warrant holder to receive upon the exercise of the warrants the kind and amount of shares of stock, other securities or property to which the holder would have been entitled if, immediately prior to the change in capital structure, the warrant holder had held the number of shares of common stock obtainable upon the exercise of the warrants, and the exercise price will be proportionately adjusted.

The Company has two warrants outstanding to purchase an aggregate of 70,000 shares of Microvision common stock that were issued in September 2003 to a third party for services. The first warrant for 60,000 shares has an exercise price of $7.50 per share and vests in three equal tranches. The first tranche vests on the issue date, the second and third tranches vest three and six months following the issue date, respectively. The second warrant for 10,000 shares has an exercise price of $12.00 per share and vests six months after the issue date. The Company may cancel unvested tranches or the second warrant prior to their respective vest dates if it determines in good faith, and notifies the holder, that it is not satisfied with the holder's performance under the agreement. Vested warrants are exercisable prior to their expiration in September 2007. The warrant holder may transfer any portion or all of the warrant shares by delivering the original warrant certificate and a form of assignment to the Company. The number and price of securities for which the warrant may be exercised are subject to adjustment for certain changes in the Company's capital structure. Where the outstanding shar