Vuzix Corp
Form 10-Q
August 15, 2011

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

FORM 10-Q

þ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the Quarterly Period Ended June 30, 2011

OR

¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

Commission file number 000-53846

VUZIX CORPORATION
(Exact name of registrant as specified in its charter)

Delaware State or other jurisdiction of incorporation or organization	04-3392453 (I.R.S. Employer Identification No.)
75 Town Centre Drive Rochester, New York (Address of principal executive offices)	14623 (Zip Code)

Registrant's telephone number, including area code: (585) 359-5900

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ¨ No ¨

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of "large accelerated filer", "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer ¨	Accelerated filer ¨	Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company þ

Indicate by check mark whether the registrant is a shell company (as defined in rule 12b-2 of the Exchange Act). Yes ¨ No þ

As of August 15, 2011, there were 263,600,274 shares of the registrant's common stock outstanding.

Vuzix Corporation

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Part 1: FINANCIAL INFORMATION

Item 1: Condensed Consolidated Financial Statements

VUZIX CORPORATION

CONSOLIDATED BALANCE SHEETS

	(Unaudited) June 30, 2011	December 31, 2010
Current Assets		
Cash and Cash Equivalents	$ 639,376	$ 2,636,819
Accounts Receivable, Net	1,188,722	1,358,905
Inventories, Net (Note 3)	3,826,389	3,748,664
Prepaid Expenses and Other Assets	64,983	158,817
Total Current Assets	5,719,470	7,903,205
Tooling and Equipment, Net	596,669	562,085
Patents and Trademarks, Net	718,880	726,892
Total Assets	$ 7,035,019	$ 9,192,182
Current Liabilities		
Accounts Payable	$ 3,091,067	$ 4,128,842
Lines of Credit (Note 4)	450,000	96,040
Current Portion of Long-term Debt, net of discount	727,925	118,943
Current Portion of Capital Leases	95,100	99,523
Customer Deposits (Note 5)	895,699	1,289,592
Current Portion of Deferred Trade Payables	793,651	691,680
Accrued Expenses (Note 6)	236,291	288,798
Income Taxes Payable	4,850	9,100
Total Current Liabilities	6,294,583	6,722,518
Long-Term Liabilities		
Accrued Compensation (Note 8)	745,096	645,096
Long Term Portion of Term Debt, net of discount (Note 9)	3,184,870	3,479,843
Long Term Portion of Deferred Trade Payables (Note 9)	862,461	1,233,703
Long Term Portion of Capital Leases	93,043	102,071
Accrued Interest	475,478	420,448
Total Long-Term Liabilities	5,360,948	5,881,161
Total Liabilities	11,655,531	12,603,679
Stockholders' Equity		
	—	—

Series C Preferred Stock — $.001 Par Value, 500,000 Shares Authorized; (Refer to Note 14 for Series A, Series B and Unauthorized Preferred Stock) 0, Shares Issued and Outstanding at June 30, and December 31				
Common Stock — $.001 Par Value, 700,000,000 Shares Authorized; 263,600,274, Shares Issued and Outstanding at June 30 and December 31, Respectively		263,600		263,600
Additional Paid-in Capital		19,280,631		19,141,802
Accumulated (Deficit)		(23,937,407)		(22,589,563)
Subscriptions Receivable		(227,336)		(227,336)
Total Stockholders' Equity		(4,620,512)		(3,411,497)
Total Liabilities and Stockholders' Equity	$	7,035,019	$	9,192,182

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

VUZIX CORPORATION

CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

	For Three Months Ended June 30,		For Six Months Ended June 30,	
	2011 (Unaudited)	2010 (Unaudited)	2011 (Unaudited)	2010 (Unaudited)
Sales of Products	$ 1,712,784	$ 1,870,817	5,551,289	3,839,642
Sales of Engineering Services	615,865	44,542	850,469	137,676
Total Sales	2,328,649	1,915,359	6,401,758	3,977,318
Cost of Sales — Products	989,323	1,497,590	3,245,385	2,947,090
Cost of Sales — Engineering Services	262,662	25,144	382,310	77,718
Total Cost of Sales	1,251,985	1,522,734	3,627,695	3,024,808
Gross Profit	1,076,664	392,625	2,774,063	952,510
Operating Expenses:				
Research and Development	534,728	457,864	1,069,449	951,864
Selling and Marketing	406,458	518,066	902,219	1,135,252
General and Administrative	647,493	588,243	1,331,766	1,337,909
Depreciation and Amortization	111,052	113,990	222,149	224,256
Total Operating Expenses	1,699,731	1,678,163	3,525,583	3,649,281
Loss from Operations	(623,067)	(1,285,538)	(751,520)	(2,696,771)
Other Income (Expense)				
Interest and Other (Expense) Income	295	330	961	744
Foreign Exchange Gain (Loss)	(5,529)	(4,341)	(1,815)	(9,515)
Amortization of Senior Term Debt Discount	(62,975)	—	(125,259)	—
Interest Expenses	(234,307)	(91,971)	(448,979)	(183,278)
Total Other Income (Expense)	(302,516)	(95,982)	(575,092)	(192,049)
Loss Before Provision for Income Taxes	(925,583)	(1,381,520)	(1,326,612)	(2,888,820)
Provision (Benefit) for Income Taxes	1,956	4,388	21,232	5,263
Net Loss	(927,539)	$ (1,385,908)	(1,347,844)	(2,894,083)
Basic and Diluted Loss per Share	$ (0.0035)	$ (0.0053)	(0.0051)	(0.0110)

Weighted-average Shares Outstanding — Basic and Diluted	263,600,274	263,600,274	263,600,274	263,600,274

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

VUZIX CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Six Months Ended June 30, 2011	Six Months Ended June 30, 2010
Cash Flows from Operating Activities		
Net Loss	$ (1,347,844)	$ (2,894,083)
Non-Cash Adjustments		
Depreciation and Amortization	222,149	224,256
Stock-Based Compensation Expense	138,829	124,044
Amortization of Senior Term Debt Discount	125,259	—
Accrued Interest Added to Term Debt Principal	240,000	—
Warrants Issued for Credit Line	—	1,798
(Increase) Decrease in Operating Assets		
Accounts Receivable	170,183	344,267
Inventories	(77,725)	(17,734)
Prepaid Expenses and Other Assets	93,834	5,211
Increase (Decrease) in Operating Liabilities		
Accounts Payable	(1,037,776)	(1,023,720)
Accrued Expenses	(52,507)	53,158
Customer Deposits	(393,893)	1,445,787
Income Taxes Payable	(4,250)	(1,817)
Accrued Compensation	100,000	100,000
Accrued Interest	55,030	131,109
Net Cash Flows Used in Operating Activities	(1,768,711)	(1,507,724)
Cash Flows from Investing Activities		
Purchases of Tooling and Equipment	(178,439)	(83,083)
Investments in Patents and Trademarks	(26,022)	(48,497)
Net Cash Used in Investing Activities	(204,461)	(131,580)
Cash Flows from Financing Activities		
Net Change in Lines of Credit	353,960	(78,105)
Repayment of Capital Leases	(57,713)	(31,057)
Repayment of Notes Payable	(320,518)	(621,417)
Net Cash Flows Provided (Used) by Financing Activities	(24,271)	(730,579)
Net Increase (Decrease) in Cash and Cash Equivalents	(1,997,443)	(2,369,883)
Cash and Cash Equivalents — Beginning of Year	2,636,819	2,500,523
Cash and Cash Equivalents — End of Period	$ 639,376	$ 130,640

Supplemental Disclosures		
Interest Paid	235,409	52,169
Income Taxes Paid	25,482	7,080
Non-Cash Investing Transactions		
Equipment Acquired Under Capital Lease	44,261	29,645

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

VUZIX CORPORATION AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 — Basis of Presentation

The accompanying unaudited Consolidated Financial Statements of Vuzix Corporation and Subsidiary (“the Company") have been prepared in accordance with generally accepted accounting principles in the United States of America for interim financial information (“GAAP”) and with the instructions to Form 10-Q and Article 8 of Regulation S-X of the Securities and Exchange Commission. Accordingly, the Consolidated Financial Statements do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments considered necessary for a fair presentation have been included. The accompanying Consolidated Financial Statements should be read in conjunction with the audited Consolidated Financial Statements of the Company as of December 31, 2010, as reported in the Company’s Annual Report on Form 10-K filed with the Securities and Exchange Commission.

The results of the Company’s operations for any interim period are not necessarily indicative of the results of the Company’s operations for any other interim period or for a full fiscal year. Certain prior year amounts have been reclassified to conform to the current year presentation.

Note 2 — Liquidity and Going Concern Issues

The Company’s independent registered public accounting firm’s report issued on the consolidated financial statements for the year ended December 31, 2010 included an explanatory paragraph describing the existence of conditions that raise substantial doubt about the Company’s ability to continue as a going concern, including continued operating losses and the potential inability to pay currently due debts. The Company incurred a net loss of $927,539 for the three months ended June 30, 2011 and has an accumulated deficit of $23,937,407 as of June 30, 2011. The Company’s losses for the first six month period of 2011 and the prior two fiscal years have had a significant negative impact on the Company’s financial position and liquidity.

The Company’s cash requirements are primarily for funding operating losses, working capital, research, principal and interest payments on debt obligations, and capital expenditures. Historically, these cash needs have been met by borrowings of notes and convertible debt and the sales of securities. There can be no assurance that the Company will be able to borrow or sell securities in the future, which raises substantial doubt about the ability of the Company to continue as a going concern. The consolidated financial statements do not include any adjustments relating to the recoverability and classification of assets carrying amounts or the amount of and classification of liabilities that may result should the Company be unable to continue as a going concern.

In late December 2010, the Company closed on a Convertible, Senior Secured Term loan in the principal amount of $4,000,000 with interest payable at the rate of 12% per annum (the "Senior Loan"). No payments of principal are required in first 12 months of the loan. Interest is due and payable semi-annually commencing June 23, 2011. Beginning on January 13, 2012, the Company is required to make 24 equal monthly principal payments of $141,666. A final principal payment of $600,000 is due on December 23, 2014. In connection with the Senior Loan, four existing secured lenders that were owed an aggregate of $2,320,980 in principal and accrued interest agreed to subordinate their security interests in favor of the security interest granted to secure the Senior Loan and to extend the period for repayment of their loans for periods ranging from 24 to 36 months following closing of the Senior Loan transaction. The holder of the Senior Loan has agreed to defer payments of $240,000 in accrued interest due in June 2011 and to add that amount to the principal of the Senior Loan, payable upon maturity of the loan on

December 23, 2014. The Senior Loan agreement contains certain covenants, including a covenant requiring the Company to meet quarterly and annual EBITDA targets. The lender waived the Company's compliance with the EBIDTA covenant for the second quarter ended June 30, 2011. If the Company fails to meet its sales and margin forecasts for the remainder of 2011, it may not achieve its quarterly EBITDA covenant targets for the third and fourth quarter of 2011 or its annual target for 2011. It is uncertain whether the lender will waive that covenant in connection with any future failure to meet EBITDA targets.

On March 22, 2011 the Company entered into an agreement with a bank for a $2 million secured credit facility to support on-going working capital needs. The credit facility is an accounts receivable formula based line of credit, which matures on March 22, 2013. Under the agreement, the Company may borrow up to 80% of Company's eligible accounts receivable generated by sales to customers based in the United States and, in addition, approved international accounts on a case-by-case basis. The bank credit agreement contains certain covenants, including a covenant requiring the Company to meet quarterly and annual EBITDA targets and the maintenance of minimum asset coverage ratios. The Company cannot predict with any certainty the amount of credit that will be available to it under this facility at any time or whether the application of that formula will require that the Company repay previous borrowings at any time.

Together these new loans and existing debt restructurings have improved the Company's liquidity position and working capital. The Company's business plan for fiscal year 2011 projects an improvement in cash flow, including EBITDA levels that will meet the minimum requirements of the Senior Loan and bank credit facility. However, there is no assurance that the Company will achieve the sales, margin or cash flow projected in its business plan.

Note 3 — Inventories, Net

Inventories are stated at the lower of cost (determined on the first-in, first-out or specific identification method) or market and consisted of the following as at June 30, 2011 and December 31, 2010:

	June 30, 2011	December 31, 2010
Purchased Parts and Components	$ 2,089,946	$ 2,219,918
Work in Process	554,673	751,794
Finished Goods	1,181,770	776,952
Net	$ 3,826,389	$ 3,748,664

Note 4 – Bank Lines of Credit

The Company entered into an agreement with a bank for a $2 million credit facility to support its on-going working capital needs. The credit facility is an accounts receivable formula based line of credit, which matures on March 22, 2013. Under the agreement, the Company may borrow up to 80% of the Company's eligible accounts receivable generated by sales to customers based in the United States and, in addition, approved international accounts on a case-by-case basis. The Bank has been granted a first position security interest in all of the Company's current and future assets, with the exception of Intellectual Property in which its position is second to the lien of the holder of the Senior Loan described in Note 2. All other secured debt is subordinate to the Bank credit facility.

The borrowing rate for credit the facility is the Bank's Prime Rate plus 1.25%, with a floor of 3.25%. As of June 30, 2011 the effective interest rate was 4.5%. Interest is payable monthly and principal is due at maturity. As of June 30, 2011 the outstanding loan balance was $450,000.

The loan agreement relating to this facility requires the Company to maintain an asset coverage ratio (ACR) of at least 1.5 to 1.00 on a monthly basis, and it must also maintain quarterly earnings before interest, taxes, depreciation, and amortization (EBITDA) losses and non-cash compensation or expense, which are measured monthly on a trailing 90 days, not to exceed minus $(150,000), with annual EBITDA to be a minimum of $1 million. ACR is defined as the sum of unrestricted cash, which the Company holds at the Bank, plus eligible accounts receivable divided by all Bank indebtedness. The Company was not in compliance with the EBITDA covenant as its losses for the second quarter exceeded minus $(150,000), however the Bank issued a waiver on not meeting the EBIDTA covenant for the second quarter ending June 30, 2011.

Note 5 — Customer Deposits

Customer deposits of $895,699 as of June 30, 2011 represent advance payments made by customers when they place major orders for customer specific defense products. These deposits range from 20 to 40% of the total order amount. These deposits are credited to the customer against product deliveries or at the completion of their order. During the six months ending June 30, 2011 total deposit credits issued were $1,814,694 based on actual product deliveries. During the six months ended June 30, 2011 additional deposits totaling $1,420,801 were received.

Note 6 — Accrued Expenses

Accrued expenses consisted of the following:

	June 30, 2011	December 31, 2010
Accrued Wages and Related Costs	$ 66,108	$ 68,954
Accrued Professional Services	67,667	91,000
Accrued Warranty Obligations	95,669	99,257
Other Accrued Expenses	6,847	29,587
Total	$ 236,291	$ 288,798

The Company has warranty obligations in connection with the sale of certain of its products. The warranty period for its products is generally one year except in certain European countries where it is two years. The costs incurred to provide for these warranty obligations are estimated and recorded as an accrued liability at the time of sale. The Company estimates its future warranty costs based on product-based historical performance rates and related costs to repair. The changes in the Company's accrued warranty obligations for the three and six months ended June 30, 2011 were as follows:

	2011
Accrued Warranty Obligations at December 31, 2010	$ 99,257
Reductions for Settling Warranties	(58,475)
Warranties Issued During Period	63,495
Adjustments to Pre-Existing Warranties	-
Accrued Warranty Obligations at March 31	$ 104,277
Reductions for Settling Warranties	(50,336)
Warranties Issued During Period	41,728
Adjustments to Pre-Existing Warranties	-
Accrued Warranty Obligations at June 30, 2011	$ 95,669

Note 7 – Earnings (Loss) Per Share

Basic earnings (loss) per share is computed by dividing net income or loss by the weighted average number of common shares outstanding for the period. Due to the net loss incurred in the three and six months ended June 30, 2011 and 2010, the assumed exercise of stock options and warrants and the conversion of debt are anti-dilutive, therefore basic and diluted loss per share are reported as being the same for both periods.

Note 8 — Accrued Compensation

Accrued compensation represents amounts owed to officers of the Company for services. The amount is not subject to a fixed repayment schedule. Interest on the outstanding balances is payable at 8% per annum, compounding monthly from and after the completion of the Company's initial public offering. A total of $50,000 in compensation was accrued for the three months and $100,000 for the six months ended June 30, 2011.

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Note 9 — Long-Term Debt

Long-term debt consisted of the following as of:

	June 30, 2011	December 31, 2010
Note payable to an officer of the Company. The principal is not subject to a fixed repayment schedule, bears interest at 8% per annum and is secured by a subordinated position in all of the assets of the Company	$209,208	$ 209,208
Note payable to an officer of the Company. The principal and interest is subject to a fixed blended repayment schedule of 36 months, commencing January 31, 2011. The loan bears interest at 12% per annum and is secured by a subordinated position in all the assets of the Company	227,976	258,658
Convertible, Senior Secured Term Debt. The principal is subject to a fixed repayment schedule beginning in December 2011 through to December 2014, bears interest at 12% per annum, which is due and payable semi-annually, beginning June 23, 2011. The loan is secured by a first security position in all the Intellectual Property assets of the Company and a security interest in all of the other assets of the Company that is subordinate only to the security interest that secures the Company's working capital credit line	4,240,000	4,000,000
Unamortized debt discount related to Warrants issued pursuant to Senior Term Debt net of $62,284 and $5,536 in recognized interest expense in 2011 and 2010	(879,584)	(1,004,843)
Long-term secured deferred trade payable	1,656,112	1,925,384
Note payable for which the principal and interest is subject to a fixed blended repayment schedule of 36 months, commencing January 31, 2011. The loan bears interest at 12% per annum and is secured by a subordinated position in all the assets of the Company	115,195	135,763
	$5,568,907	$ 5,524,170
Less: Amount Due Within One Year	1,521,576	810,623
Amount Due After One Year	$4,047,331	$ 4,713,547

On December 23, 2010, an aggregate amount of $2,320,980 in principal and accrued interest on certain current Notes Payable and secured deferred trade payables was deferred and added to Long-term debt and is included in the above table.

Interest on the Convertible, Senior Secured Term Debt in the amount of $240,000 due June 23, 2011 has been deferred and added to the principal of the loan and is due upon the maturity of the loan on December 23, 2014. The same lender also provided the Company with a waiver on not complying with the debt's EBIDTA covenant for the second quarter ending June 30, 2011.

Note 10 — Income Taxes

The Company's effective income tax rate is a combination of federal, state and foreign tax rates and differs from the U.S. statutory rate due to taxes on foreign income, permanent differences including tax-exempt interest, and the resolution of tax uncertainties, offset by a valuation allowance against U.S. deferred income tax assets.

At December 31, 2010, the Company had unrecognized tax benefits totaling $4,244,000, which would have a favorable impact on the Company's provision (benefit), if recognized.

In the six months ended June 30, 2011 and 2010, the Company generated federal and state net operating losses for income tax purposes. These federal and state net operating loss carry forwards total approximately $19,800,000 at June 30, 2011 and begin to expire in 2018, if not utilized. Of the Company's tax credit carry forwards, $1,272,000 expires between 2017 and 2018, if not utilized.

Note 11 — Stock Warrants

A summary of the changes in outstanding warrants during the six-month period ended June 30, 2011 is as follows.

	Number of Shares
Warrants Outstanding at December 31, 2010	65,604,786
Exercised During the Period	—
Issued During the Period	—
Expired During the Period	(133,896)
Warrants Outstanding, June 30, 2011	65,470,890

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The outstanding warrants as of June 30, 2011 expire on various dates from December 31, 2011 to May 21, 2015. The weighted average remaining term of the warrants is 2.9 years. The weighted average exercise price is $0.1439 per share.

Note 12 — Stock Option Plans

A summary of stock option activity for the six months ended June 30, 2011 is as follows.

	Number of Shares	Weighted Average Exercise Price	Exercise Price Range
Outstanding at December 31, 2010	15,435,674	$ 0.1182	$0.0061 – $ 0.2334
Granted	5,512,690	$ 0.1500	$ 0.1500
Exercised	—	$ —	$ —
Expired or Forfeited	(302,152)	$ 0.1230	$0.0289 – $ 0.2334
Outstanding at June 30, 2011	20,646,212	$ 0.1263	$0.0061 – $ 0.2334

As of June 30, 2011, there were 14,826,119 options that were fully vested and exercisable at a weighted average exercise price of $0.1149 per share. The weighted average remaining contractual term on the vested options is 4.5 years.

As of June 30, 2011 there were 5,820,093 unvested options exercisable at a weighted average exercise price of $0.1500 per share. The weighted average remaining contractual term on the unvested options is 9.0 years.

No cash was received from option exercises for the six months ended June 30, 2011.

The table below summarizes the impact of outstanding stock options on the results of operations for the six months ended June 30, 2011 and 2010:

	Three Months Ended June 30, 2011	Three Months Ended June 30, 2010	Six Months Ended June 30, 2011	Six Months Ended June 30, 2010
Stock-based compensation expense: - - Stock Options	$ 69,349	$ 62,022	$ 138,829	$ 124,044
Income tax benefit	—	—	—	—
Net Decrease in Net Income	$ 69,349	$ 62,022	$ 138,829	$ 124,044
Per share increased in Loss Per Share:				
Basic and Diluted	$ 0.0003	$ 0.0002	$ 0.0005	$ 0.0005

The weighted average fair value of option grants was calculated using the Black-Scholes-Merton option pricing method. At June 30, 2011, the Company had approximately $355,502 of unrecognized stock compensation expense, which will be recognized over a weighted average period of approximately 1.6 years.

Note 13 — Litigation

The Company is not subject to any legal proceedings or claims.

Note 14 — Product Revenue

The following table represents the Company’s total sales classified by product category for the three and six months ended June 30, 2011 and 2010:

	Three Months Ended June 30, 2011	Three Months Ended June 30, 2010	Six Months Ended June 30, 2011	Six Months Ended June 30, 2010
Consumer Video Eyewear	$ 718,382	$ 1,002,174	$ 1,367,089	$ 2,228,064
Defense Products	994,403	868,643	4,184,200	1,611,578
Engineering Services	615,864	44,542	850,469	137,676
Total	$ 2,328,649	$ 1,915,359	$ 6,401,758	$ 3,977,318

Note 15 — Recent Accounting Pronouncements

There are no recent accounting pronouncements that have a material impact on the condensed consolidated financial statements.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

You should read the following discussion and analysis of financial condition and results of operations in conjunction with the financial statements and related notes appearing elsewhere in this interim report. In addition to historical information, the matters discussed in Management's Discussion and Analysis of Financial Condition and Results of Operations and elsewhere in this Form 10-Q include forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, and are subject to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Actual results could differ materially from those discussed in the forward-looking statements.

As used in this report, unless otherwise indicated, the terms "Company," "Vuzix" "management," "we," "our," and "us" refer t Vuzix Corporation and its subsidiary.

Critical Accounting Policies and Significant Developments and Estimates

The discussion and analysis of our financial condition and results of operations are based on our financial statements and related notes appearing elsewhere in this quarterly report. The preparation of these statements in conformity with generally accepted accounting principles requires the appropriate application of certain accounting policies, many of which require us to make estimates and assumptions about future events and their impact on amounts reported in our financial statements, including the statement of operations, balance sheet, cash flow and related notes. Since future events and their impact cannot be determined with certainty, the actual results will inevitably differ from our estimates. Such differences could be material to the financial statements.

We believe that our application of accounting policies, and the estimates inherently required therein, are reasonable. These accounting policies and estimates are periodically reevaluated, and adjustments are made when facts and circumstances dictate a change. Historically, we have found our application of accounting policies to be appropriate, and actual results have not differed materially from those determined using necessary estimates.

Our accounting policies are more fully described in the notes to our financial statements included in this quarterly report and our annual report on Form 10-K for the year ended December 31, 2010. In reading our financial statements, you should be aware of the factors and trends that our management believes are important in understanding our financial performance. The critical accounting policies, judgments and estimates that we believe have the most significant effect on our financial statements are:

- valuation of inventories;
- carrying value of long-lived assets;
- valuation of intangible assets;
- revenue recognition;
- product warranty;
- research & development;
- stock-based compensation; and
- income taxes.

Valuation of Inventories

Inventory is stated at the lower of cost or market, with cost determined on a first-in, first-out method. Inventory includes purchased parts and components, work in process and finished goods. Provisions for excess, obsolete or slow moving inventory are recorded after periodic evaluation of historical sales, current economic trends, forecasted sales, estimated product lifecycles and estimated inventory levels. Purchasing practices, electronic component obsolescence, accuracy of sales and production forecasts, introduction of new products, product lifecycles, product support and foreign regulations governing hazardous materials are the factors that contribute to inventory valuation risks. Exposure to inventory valuation risks is managed by maintaining safety stocks, minimum purchase lots, managing product and end-of-life issues brought on by aging components or new product introductions, and by utilizing certain inventory minimization strategies such as vendor-managed inventories. The accounting estimate related to valuation of inventories is considered a “critical accounting estimate” because it is susceptible to changes from period-to-period due to the requirement for management to make estimates relative to each of the underlying factors, ranging from purchasing, to sales, to production, to after-sale support. If actual demand, market conditions or product lifecycles differ from estimates, inventory adjustments to lower market values would result in a reduction to the carrying value of inventory, an increase in inventory write-offs and a decrease to gross margins.

Carrying Value of Long-Lived Assets

If facts and circumstances indicate that the value of a long-lived asset, including a product’s mold tooling and equipment, may be impaired, the carrying value is reviewed in accordance with FASB ASC Topic 360-10. If this review indicates that the carrying value of the asset will not be recovered as determined based on projected undiscounted cash flows related to the asset over its remaining life, the carrying value of the asset is reduced to its estimated fair value. To date, no impairment on long-lived assets has been booked. Impairment losses in the future will be dependent on a number of factors such as general economic trends and major technology advances, and thus could be significantly different than historical results.

Valuation of Intangible Assets

We perform a valuation of intangible assets when events or circumstances indicate their carrying amounts may be unrecoverable, in whole or in part. We have not treated as impaired the value of certain intellectual property, such as patents and trademarks, which were valued (net of accumulated amortization) at $718,880 as of June 30, 2011, because management believes that its value is recoverable.

We recorded an impairment charge of $49,956 representing cost of $89,151, less accumulated amortization of $39,195 in 2010 regarding our abandoned patents and trademarks. The value of the remaining intellectual property, such as patents and trademarks, were valued (net of accumulated amortization) at $726,892 as of December 31, 2010.

Revenue Recognition

Revenue from product sales is recognized in accordance with FASB ASC Topic 605, Revenue Recognition   Product sales represent the majority of our revenue. We recognize revenue from these product sales when persuasive evidence of an arrangement exists, delivery has occurred or services have been provided, the sale price is fixed or determinable, and collectability is reasonably assured. Additionally, we sell our products on terms which transfer title and risk of loss at a specified location, typically shipping point. Accordingly, revenue recognition from product sales occurs when all factors are met, including transfer of title and risk of loss, which typically occurs upon shipment by us. If these conditions are not met, we will defer the revenue recognition until such time as these conditions have been satisfied. We collect and remit sales taxes in certain jurisdictions and report revenue net of any associated sales taxes. We also sell certain products through distributors who are granted limited rights of return for stock balancing against purchases made within a prior 90-day period, including price adjustments downwards on any existing inventory. The provision for product returns and price adjustments is assessed for adequacy both at the time of sale and at each quarter end and is based on recent historical experience and known customer claims.

Revenue from any engineering consulting and other services is recognized at the time the services are rendered. For our longer-term development contracts, which to date have all been firm, fixed-priced contracts, we recognize revenue on the percentage-of-completion method. Under this method income is recognized as work on contracts progresses, but estimated losses on contracts in progress are charged to operations immediately. To date, all of our longer-term development contracts have been less than one calendar year in duration. We generally submit invoices for our work under these contracts on a monthly basis. The percentage-of-completion is determined using the cost-to-cost method.

The accounting estimate related to revenue recognition is considered a “critical accounting estimate” because terms of sale can vary, and judgment is exercised in determining whether to defer revenue recognition. Such judgments may materially affect net sales for any period. Judgment is exercised within the parameters of GAAP in determining when contractual obligations are met, title and risk of loss are transferred, sales price is fixed or determinable and collectability is reasonable assured.

Product Warranty

Warranty obligations are generally incurred in connection with the sale of our products. The warranty period for these products is generally one year, but can be 24 months in certain countries if required by law. Warranty costs are accrued, to the extent that they are not recoverable from third party manufacturers, for the estimated cost to repair or replace products for the balance of the warranty periods. We provide for the costs of expected future warranty claims at the time of product shipment or over-builds to cover replacements. The adequacy of the provision is assessed each quarter end and is based on historical experience of warranty claims and costs. The costs incurred to provide for these warranty obligations are estimated and recorded as an accrued liability at the time of sale. Future warranty costs are estimated based on historical performance rates and related costs to repair given products. The accounting estimate related to product warranty is considered a “critical accounting estimate” because judgment is exercised in determining future estimated warranty costs. Should actual performance rates or repair costs differ from estimates, revision to the estimated warranty liability would be required.

Research and Development

Research and development costs, are expensed as incurred consistent with the guidance of FASB ASC Topic 730, “Research and Development,” and include employee related costs, office expenses, third party design and engineering services, and new product prototyping costs.

Stock-Based Compensation

Our board of directors approves grants of stock options to employees to purchase our common stock. A stock compensation expense is recorded based upon the estimated fair value of the stock option at the date of grant. The accounting estimate related to stock-based compensation is considered a “critical accounting estimate” because estimates are made in calculating compensation expense including expected option lives, forfeiture rates and expected volatility. The fair market value of our common stock on the date of each option grant is determined based on the most recent quoted sales price on the TSX-V Exchange.

Income Taxes

We have historically incurred operating losses for both financial reporting and tax return purposes. Accordingly, we record deferred income tax assets and liabilities based on the estimated future tax effects of differences between the financial and tax bases of assets and liabilities based on currently enacted tax laws. A valuation allowance is established for deferred tax assets in amounts for which realization is not considered more likely than not to occur. The accounting estimate related to income taxes is considered a “critical accounting estimate” because judgment is exercised in estimating future taxable income, including prudent and feasible tax planning strategies, and in assessing the need for any valuation allowance. To date we have determined that a 100% valuation allowance is required and accordingly no amounts for the value of our deferred tax asset have been reflected in our consolidated financial statements. In the event that it should be determined that all or part of a deferred tax asset in the future is in excess of the amount currently recorded, an adjustment of the valuation allowance would increase income to be recognized in the period such determination was made.

In addition, the calculation of our tax liabilities involves dealing with uncertainties in the application of complex tax regulations. As a result we recognize liabilities for uncertain tax positions based on a two-step process. The first step is to evaluate the tax position for recognition by determining whether the weight of available evidence indicates that it is more likely than not that the position will be sustained on audit, including resolution of related appeals or litigation processes, if any. The second step requires us to estimate and measure the tax benefit as the largest amount that is more than 50% likely of being realized upon ultimate settlement. It is inherently difficult and subjective to estimate such amounts, as this requires us to determine the probability of various possible outcomes. We re-evaluate these uncertain tax positions on a quarterly basis. This evaluation is based on factors including, but not limited to, changes in facts or circumstances, changes in tax law, effectively settled issues under audit and new audit activity. Such a change in recognition or measurement would result in the recognition of a tax benefit or an additional charge to the tax provision in the period.

Finally, any future recorded value of our deferred tax assets will be dependent upon our ability to generate future taxable income in the jurisdictions in which we operate.

Our deferred tax assets consist of research credit carry-forwards, capital and net operating loss carry-forwards and the future tax effect of temporary differences between balances recorded for financial statement purposes and for tax return purposes. It will require future pre-tax earnings in excess of $19,800,000 in order to fully realize the value of our unrecorded deferred tax assets. If we were to sustain future net losses, it may be necessary to record valuation allowances against such deferred tax assets in order to recognize impairments in their estimated future economic value.

Off Balance Sheet Arrangements

We do not have any off-balance sheet arrangements that have, or are reasonably likely to have, an effect on our financial condition, financial statements, revenues or expenses.

Recent Accounting Pronouncements

There are no recent accounting pronouncements that have a material impact on the condensed consolidated financial statements.

Key Performance Indicators

We believe that a key indicator for our business is the trend for the volume of orders received from customers, especially those orders related to night-vision electronic modules. During weak economic periods, customers' ability to forecast their requirements deteriorates causing delays in the placement of orders. Forward-looking visibility on customer orders is at an all time low. Our major night-vision electronics modules customers (Kopin and DRS Technologies, Inc.) are placing orders for product only when they have orders in hand from their governmental customer. Total shipments of night vision electronics modules for the three months ended June 30, 2011 and 2010 were $223,321 and $152,625, respectively. Total shipments of night vision electronics modules for the six months ended June 30, 2011 and 2010 were $1,570,301 and $152,625, respectively.

Results of Operations

Comparison of Three Months Ended June 30, 2011 and June 30, 2010

Sales. Our sales were $2,328,649 for the second quarter of 2011 compared to $1,915,359 for the same period in 2010. This represents a 21.6% increase for the same three month period in 2011 as compared to 2010. Our sales from defense products increased to $994,403 or 42.7% of our total sales in the second quarter of 2011 compared to $868,643 or 45.4% of total sales in the same period of 2010, an increase of $125,760 or 14.5%. The growth primarily resulted from increased shipments of night vision electronics in the second quarter of 2011 which were $223,321 as compared to $152,625 in the same period of 2010 as well as $99,839 in sales of optics modules as compared to Nil for the same period in 2010. Sales of our Tac-Eye Video Eyewear decreased by $44,775 or 6.3% in the second quarter as compared to the same period in 2010. Sales from our primarily defense-related engineering programs for the second quarter of 2011, increased to $615,864 or 26.4% of total sales compared to $44,542 or 2.3% of total sales in same quarter 2010. The $571,322 increase resulted from commencement of three new engineering programs during the second quarter of 2011 versus only one engineering service program in the same quarter in 2010. Consumer Video Eyewear product sales decreased to $718,382 or 30.8% of total sales for the second quarter of 2011 compared to $1,002,174 or 52.3% of our total sales for the second quarter of 2010. We believe that the decreased revenues from our consumer products in Japan and the UK resulted from slowed economic growth and natural disasters in these regions and to the fact that many of our customers appear to be waiting for the new Wrap 1200 products and therefore are not purchasing our current products. Offsetting the slowed demand for our general consumer Video Eyewear, is a continued demand for our Augmented Reality (AR) video eyewear products, which were not available in the prior year's second quarter of 2010.

Cost of Sales and Gross Profit. Gross profit increased to $1,076,664 for the second quarter of 2011 from $392,625 for the same period in 2010, an increase of $684,039 or 174%. As a percentage of net sales, gross profit increased to 46.2% for the second quarter of 2011 compared to 20.5% for the same period in 2010. This increase was the primarily the result of our higher margin earned on selling our defense engineering services, which were over 26.4% of total sales versus 2.3% in the prior period and the high margins we are currently earning on sales of our AR Video Eyewear.

Research and Development. Our research and development expenses increased by $76,864 or 16.8% in the second quarter of 2011, to $534,728 compared to $457,864 in the same period of 2010. This increase was primarily the result of ongoing development work on our new Wrap 1200 video eyewear models. Research and development expenses we incur under government funded engineering programs are included in costs of goods sold.

Selling and Marketing. Selling and marketing expenses were $406,458 for the second quarter of 2011 compared to $518,066 for the same period in 2010, a decrease of $111,608 or 21.5%. The decreases were mainly attributable to lower catalog advertising costs and reduced external public relations consulting fees as compared to the prior year, partially as a result of the delay in the introduction of the new Wrap 1200.

General and Administrative. General and administrative expenses were $647,493 for the second quarter costs of 2011 as compared to $588,243 for the same period in 2010, an increase of $59,250 or 10.1%. The higher general and administrative costs related to increased wages costs, additional spending on legal and accounting expenses as well as increased investor relations outreach as compared to the prior period in 2010.

Depreciation and Amortization. Our depreciation and amortization expense for the second quarter of 2011 was $111,052 as compared to $113,990 in the same period in 2010. The decrease reflects reduced capital expenditures in the prior year and the achievement of full depreciation of certain tooling and equipment.

Other Income (Expense). Total other expenses was $(302,516) in the second quarter of 2011 compared to $(95,982) in the same period in 2010. The increase in expenses was primarily attributable to interest costs of $234,307 for the quarter on our new senior debt as compared to interest costs of $91,971 in the prior year's comparable period, and $62,975 in costs related to the amortization of senior term debt discount.

Provision for Income Taxes. The provision for income taxes for the second quarter of 2011 was $1,956 compared to $4,388 for the same period in 2010.

Net (Loss) and (Loss) per Share. Our net loss was $(927,539) or $(0.0035) per share in the second quarter of 2011, a decreased loss of $458,369, or 33.1%, from $(1,385,908) or $(0.0053) per share in the same period in 2010.

Comparison of Six Months Ended June 30, 2011 and June 30, 2010

Sales. Our sales were $ 6,401,758 for the six months ended June 30, 2011 compared to $ 3,977,318 for the same period in 2010. This represents a 61.0% increase. Our sales from defense products increased to $4,184,200 or 65.4% of our total sales in the first six months of 2011 compared to $1,611,578 or 40.5% of total sales in the same period of 2010, an increase of $2,572,622 or 159.6%. A major portion of the increase resulted from $1,570,301 in sales of night vision electronics in the first six-month period of 2011 as compared to sales of $152,625 for those products in the same period of 2010. Of those sales for the first six months of 2011, sales of a new defense night vision display modules that are included in this category were $382,124 for the six month period in 2011 versus Nil in the prior year. Sales of our Tac-Eye video eyewear products, also included in this product category increased to $2,231,776 for the six month period in 2011 as compared to $1,458,953 for the same period in 2010, a 53% increase. Revenues from our defense-related engineering programs for the first six months of 2011, increased to $850,469 or 13.3% of total sales compared to $137,676 or 3.5% of total sales for the same period in 2010. In the first six months of 2010 we had revenues from only one active program whereas in the first six months of 2011 we were working on four programs. Consumer Video Eyewear product sales decreased to $1,367,090 or 21.4% of total sales for the first six months of 2011 compared to $2,228,064 or 56.0% of our total sales for the same six month period of 2010. We believe that the revenues from our consumer products in Japan and the UK resulted from slowed economic growth and natural disasters in these regions and to the fact that many of our customers may be waiting for our new Wrap 1200 product and therefore not purchasing our current products. Offsetting the slowed demand for our general consumer Video Eyewear, is a continued demand for our Augmented Reality (AR) video eyewear products, which was not available in the first six months of 2010.

Cost of Sales and Gross Margin. Gross margin increased to $2,774,063 for the first six months of 2011 from $952,510 for the same period in 2010, an increase of $1,821,553. As a percentage of net sales, gross margin increased to 43.3% for the first six months of 2011 compared to 23.9% for the same period in 2010. This increase was primarily the result of higher margin earned on defense engineering services, which were over 13.3% of total sales versus 3.5% in the prior period and the high margins we are currently earning on sales of our new AR Video Eyewear.

Research and Development. Our research and development expenses increased to $1,069,449 in the first six months of 2011, as compared to $951,864 in the same period of 2010. The $117,585 or 12.4% increase in the 2011 period versus 2010 was primarily the result of ongoing development work on our new Wrap 1200 Video Eyewear models and an enhanced Tac-Eye product model. We expect to introduce both products in the second half of 2011. Research and development expenses we incur under government funded engineering programs are included in costs of goods sold.

Selling and Marketing. Selling and marketing expenses were $902,219 for the first six months of 2011 compared to $1,135,252 for the same period in 2010, a decrease of $233,033 or 20.5%. The decrease was primarily attributable to lower catalog advertising costs and reduced external public relations consulting fees due to delays in our new product introductions.

General and Administrative. General and administrative expenses were $1,331,766 for the first six months of 2011 as compared to $1,337,909 for the same period in 2010, an decrease of $6,143.

Depreciation and Amortization. Our depreciation and amortization expense for the first six months of 2011 was $222,149, compared to $224,256 in the same period in 2010. The decrease reflects reduced capital expenditures in the prior year and the achievement of full depreciation during the prior year of certain tooling and equipment.

Other Income (Expense). Total other expenses, consisting primarily of interest expense, was $(575,092) in the first six months of 2011 compared to $(192,049) in the same period in 2010. The increase in expenses was primarily attributable to interest costs of $448,979 for the current period on our new senior debt as compared to interest costs of $183,278 in the prior year's period. Additionally we amortized as part of interest expense, $125,259 of the new senior term debt discount, whereas in the same period in 2010 the comparable amount was Nil.

Provision for Income Taxes. The provision for income taxes for the first six months of 2011 was $21,232 compared to $5,263 for the same period in 2010. The balance of each period's tax provision was primarily for franchise taxes payable to the State of Delaware, our state of incorporation and branches taxes in Japan.

Net (Loss) and (Loss) per Share. Our net loss was $(1,347,844) or $(0.0051) per share in the first six months of 2011, a decreased loss of $1,546,239, or 53.4%, from $(2,894,083) or $(0.0110) per share in the same period in 2010.

Liquidity and Capital Resources

As of June 30, 2011, we had cash and cash equivalents of $639,376 a decrease of $1,997,443 from $2,636,819 as of December 31, 2010.

Operating Activities. Cash (used in) operating activities was $(1,768,711) for the six months ended June 30, 2011 and $(1,507,724) in the same period in 2010. Changes in non-cash operating assets and liabilities were $(1,147,104) for the six months ended June 30, 2011 and $1,036,261 in the same period in 2010. The major non-cash operating items for the first 6 months of 2011 were a $(1,037,776) reduction in accounts payable and a $(393,893) reduction in customer deposits. In the comparable period for the prior year, the major components resulting in positive changes in non-cash working capital were the receipt of $1,445,787 in new customer deposits and a $344,267 reduction in accounts receivable, net of a $1,023,720 reduction in accounts payable.

Investing Activities. Cash (used in) investing activities was $(204,461) during the six months ended June 30, 2011 and $(131,580) in the same period in 2010. Cash used for investing activities in the first half of 2011 related primarily to the purchase of computer equipment and tooling additions for the Wrap 1200 product. The costs of registering our intellectual property rights, included in the investing activities totals described above, were $(26,022) in the second quarter of 2011 and $(48,497) in the same period in 2010.

Financing Activities. Cash used by financing activities was $(24,271) during the six months ended June 30, 2011, whereas in the same period in 2010, our net financing activities used $(730,579). During the first six months of 2011, the primary source of cash was $353,960 in draws under our bank operating line of credit before payments of $(320,518) and $(57,713) on Notes payable and Capital leases, respectively.

Capital Resources. As of June 30, 2011, we had a cash balance of $639,376. We had $287,000 available under our bank lines of credit. The outstanding balance under our line of credit as of June 30, 2011 was $450,000. The bank credit agreement contain various restrictions on indebtedness, liens, guarantees, redemptions, mergers, acquisitions or sale of assets, loans, transactions with any affiliates, and investments. It also prohibits us from declaring and paying cash dividends without the bank's prior consent. The credit facility is an accounts receivable formula based line of credit, which matures on March 22, 2013. Under the agreement, the Company may borrow up to 80% of the Company's eligible accounts receivable generated by sales to customers based in the United States and, in addition, approved international accounts on a case-by-case basis. The maximum borrowings under the bank credit facility is $2,000,000. The lender has been granted a first position security interest in all of Company's current and future assets, with the exception of Intellectual Property in which it has a second position security interest. All secured debt other than that secured by Intellectual Property is subordinated to the bank credit facility.

The following discussion and analysis should be read in conjunction with the condensed consolidated financial statements, including Note 2 thereto, and the related notes appearing in our annual report on Form 10-K for the year ended December 31, 2010. We have been unable to generate cash flows sufficient to support our operations and have been dependent on term debt financing and equity financings. There can be no assurance that we will be able to raise cash from those sources in the future. Our independent auditors issued a going concern explanatory paragraph in their reports for the years ended December 31, 2010 and 2009. With our current level of funding and ongoing losses from operations, doubt exists about our ability to continue as a going concern.

We have the intent and believe that we have the ability to take actions necessary to continue as a going concern, as discussed herein, and accordingly our condensed consolidated financial statements have been prepared assuming that we will continue as a going concern. The consolidated financial statements do not include any adjustments that might result from the adverse outcome of this uncertainty.

Our cash requirements depend on numerous factors, including new product development activities, our ability to commercialize our products, their timely market acceptance, selling prices and gross margins, and other factors. To the extent we have sufficient operating funds, we expect to carefully devote capital resources to continue our research and development programs, hire and train additional staff if needed, and undertake new product marketing activities. Assuming we are able to increase our projected sales and achieve our planned gross margins, we anticipate that we will also experience growth in our operating expenses for the foreseeable future. Further future net operating losses, product tooling expenses, and related working capital investments will be the principal use of our cash.

Without successfully achieving our current operating plan, our existing working capital may not be sufficient to fund our planned operating expenses, capital expenditures, and working capital requirements through December 31, 2011 without additional sources of cash and/or the deferral, reduction or elimination of significant planned expenditures on new products, tooling, R&D, and marketing. A shortfall from projected sales levels could have a material adverse effect on our ability to continue operations at current levels. If this were to occur, we would be forced to liquidate certain assets where possible, and/or to suspend or curtail certain of our operations. Any of these actions could harm our business, results of operations and future prospects. To guard against this risk, we may need to seek additional debt, equity or equity-based financing. We can give no assurance that we will be able to obtain additional financing on favorable terms or at all. If we raise additional funds by selling additional shares of our capital stock, or securities convertible into shares of our capital stock, the ownership interest of our existing shareholders will be diluted. The amount of dilution could be increased by the issuance of warrants or securities with other dilutive characteristics, such as anti-dilution clauses or price resets. If we need additional funding for operations and we are unable to raise it, we may be forced to liquidate assets and/or curtail or cease operations or to obtain funds through entering into additional collaborative agreements or other arrangements that may be on unfavorable terms.

We also at times rely on credit lines from our key suppliers and customer deposits in managing our liquidity. As a result, if our trade creditors were to impose unfavorable terms on us or customers decline to make advance deposits for their orders, it would negatively impact our ability to obtain products and services on acceptable terms and operate our business.

These factors raise substantial doubt about the Company’s ability to continue as a going concern. The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. This basis of accounting contemplates the recovery of the Company’s assets and the satisfaction of liabilities in the normal course of business. In addition, these financial statements do not include any adjustments to the specific amounts and classifications of assets and liabilities, which might be necessary should the Company be unable to continue as a going concern.

The closing in late December 2010 of the Convertible, Senior Secured Term loan of $4,000,000 and the restructuring of $2,320,980 in deferred trade accounts payable and other notes decreased the Company’s material working capital deficiency. On March 22, 2011 the Company entered into an agreement with a bank for up to $2 million in credit facilities to support on-going working capital needs, which matures on March 22, 2013. The credit facility is an accounts receivable formula based line of credit, and our ability to use the credit facility is dependent upon our ability to generate qualifying accounts receivable. There can be no assurance that we will be able to do so. Under the agreement, the Company may borrow up to 80% of eligible North American accounts receivable and, in addition, approved international accounts on a case-by-case basis. These financings have improved our working capital position. However due to our continued operating losses we have negative working capital. If we meet our 2011 sales and margin forecasts, we expect to achieve our quarterly and annual EBITDA covenant targets with our lenders, but there can be no assurance that we will do so, and, if we do not meet those targets we will require additional waivers from our lenders and there can be no assurance they would provide them.

Additionally we plan to manage our liquidity under an operational plan that contemplates, among other things:

- managing our working capital through better optimization of inventory levels;
- focusing on selling higher gross margin products, which will mean a greater emphasis on defense versus consumer products; the phasing out of our low resolution Video Eyewear models for which we earn a lower gross margin; and the introduction of see-through and new high resolution Video Eyewear;
- restructuring and reengineering our organization and processes to increase efficiency and reduce our operating costs wherever possible;
- reducing public relations expenses;
- minimizing our capital expenditures by eliminating, delaying or curtailing discretionary and non-essential spending on Capital items;

- reducing and deferring some research and development and delaying some planned product and new technology introductions if required; and

- exploring our options with respect to new debt borrowings and equity financings;

We currently have $3.8 million in open orders for our defense products and ongoing engineering services programs. Most will be fulfilled by the end of 2011. The majority of our orders for consumer products have historically been received in the second half of the year. The delay in the introduction of our new Wrap 1200 Video Eyewear models is resulting in postponements of orders for consumer products and fewer orders for our existing products which we expect may adversely affect our sales in the second half of 2011. Another factor that we expect to adversely affect our sales for consumer products in the second half of 2011 is that orders for such products are generally placed only against our customers' short-term plans so our ability to react to unplanned new orders may be limited due to component and manufacturing lead times.

We will also be affected by the change in market demand which is rapidly moving towards higher resolution portable displays, partially driven by the larger higher resolution displays available on mobile devices such as the Apple iPad. Although our new Wrap 1200 products will better address consumer demand for higher resolution Video Eyewear, we do not intend to introduce our first HD Video Eyewear until the second half of 2012, with that target subject to the availability of working capital for new product tooling and development.

We cannot make assurances as to whether any of these actions can be effected on a timely basis, on satisfactory terms or maintained once initiated, and even if successful, whether certain of our operational and strategic initiatives designed to grow our business over the long term will be limited by the availability of capital.

We cannot make assurances that we will be able to generate sufficient cash flow from operations to service our indebtedness or fund our operations. These factors raise substantial doubt about our ability to continue as a going concern.

Forward Looking Statements

This quarterly report includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934 (the “Exchange Act”). The Private Securities Litigation Reform Act of 1995 (the “Reform Act”) provides a “safe harbor” for forward-looking statements. Certain written and oral statements made by management of Vuzix Corporation include forward-looking statements intended to qualify for the safe harbor from liability established by the Reform Act. These statements are based on our management’s beliefs and assumptions and on information currently available to our management. Forward-looking statements include statements concerning:

- Our possible or assumed future results of operations;
- Our business strategies;
- Our ability to attract and retain customers;
- Our ability to sell additional products and services to customers;
- Our cash needs and financing plans;
- Our competitive position;

- Our industry environment;
- Our potential growth opportunities;
- Expected technological advances by us or by third parties and our ability to leverage them;
- The effects of future regulation; and
- The effects of competition.

All statements in this quarterly report that are not historical facts are forward-looking statements. We may, in some cases, use terms such as “anticipates,” “believes,” “could,” “estimates,” “expects,” “intends,” “may,” “plans,” “potential,” “pre “projects,” “should,” “will,” “would” or similar expressions that convey uncertainty of future events or outcomes to identify forward-looking statements.

The outcome of the events described in these forward-looking statements are subject to known and unknown risks, uncertainties and other factors that may cause our actual results, performance or achievements to be materially different from any future results, performances or achievements expressed or implied by the forward-looking statements. These important factors include our financial performance and the other important factors set forth in our annual report on Form 10-K for the year ended December 31, 2010 and in other filings with the Securities and Exchange Commission.

All such forward-looking statements are subject to certain risks and uncertainties and should be evaluated in light of important risk factors. These risk factors include, but are not limited to, those that are described in “Risk Factors” under Item 1A and elsewhere in our 2010 annual report on Form 10-K and the following: business and economic conditions, rapid technological changes accompanied by frequent new product introductions, competitive pressures, dependence on key customers, inability to gauge order flows from customers, fluctuations in quarterly and annual results, the reliance on a limited number of third party suppliers, limitations of the Company’s manufacturing capacity and arrangements, the protection of the Company’s proprietary technology, the effects of pending or threatened litigation, the dependence on key personnel, changes in critical accounting estimates, potential impairments related to investments, foreign regulations, and potential material weaknesses in internal control over financial reporting. In addition, during weak or uncertain economic periods, customers’ visibility deteriorates causing delays in the placement of their orders. These factors often result in a substantial portion of the Company’s revenue being derived from orders placed within a quarter and shipped in the final month of the same quarter.

Any of these factors could cause our actual results to differ materially from its anticipated results. For a more detailed discussion of these factors, see the "Risk Factors" discussion in Item 1A in our 2010 annual report. We caution readers to carefully consider such factors. Many of these factors are beyond our control. In addition, any forward-looking statements represent our estimates only as of the date they are made, and should not be relied upon as representing our estimates as of any subsequent date. While we may elect to update forward-looking statements at some point in the future, we specifically disclaim any obligation to do so, even if our estimates change.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Not applicable

Item 4. Controls and Procedures

Disclosure Controls and Procedures

Our management, including our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this quarterly report as required by Rule 13a-15 under the Securities Exchange Act of 1934 (the “Exchange Act”). Based on that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of the period covered by this quarterly report, our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Exchange Act) were not effective as discussed below, in all material respects, to ensure that information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

Management’s Interim Report on Internal Control Over Financial Reporting

Our internal control over financial reporting includes those policies and procedures that (a) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of our assets; (b) provide reasonable assurance that transactions are recorded as necessary to permit preparation of consolidated financial statements in accordance with US GAAP, and that our receipts and expenditures are being made only in accordance with authorizations of our management and directors; and (c) provide reasonable assurance regarding prevention or timely detection of unauthorized use, acquisition, or disposition of our assets that could have a material effect on the consolidated financial statements.

A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting such that there is a reasonable possibility that a material misstatement of our annual or interim financial statements will not be prevented or detected on a timely basis. As a result of this evaluation, we concluded that our internal control over financial reporting was not effective as of June 30, 2011 because of the material weaknesses set forth below.

During our last fiscal quarter, there were no changes in our internal control over financial reporting. The following is a summary of our material weaknesses as of June 30, 2011:

Financial Reporting and Close Process

Our current financial close process does not ensure accurate financial reporting on a timely basis. We also did not maintain effective controls over the period-end financial close and reporting processes in relation to the consolidation of our subsidiary’s financial information. The specific deficiencies contributing to this material weakness related (a) to inadequate policies and procedures, (b) ineffective procedures and controls over journal entries, accruals and reserves, (c) inadequate controls and procedures related to the timely preparation and review of account reconciliations, (d) inadequate segregation of duties, (e) inadequate controls over cut-off procedures, (f) deficiencies in end-user computing controls of critical spreadsheets, and (g) an insufficient complement of personnel with appropriate levels of knowledge and experience. Due to the actual and potential errors on financial statement balances and disclosures, management has concluded that these deficiencies in internal controls over the period-end financial close and reporting processes constituted a material weakness in internal control over financial reporting. We intend to establish and document financial close processes and procedures including responsibilities and due dates. We also intend to commence utilizing a closing checklist to ensure all procedures are performed and appropriate reviews are completed on a timely basis each quarter and year-end period. Additionally, we intend to implement controls over critical spreadsheets, including change control, input control, access and data security and appropriate review procedures. Further, we intend to seek additional resources with strong accounting and reporting experience when financial resources are available.

Segregation of Duties

There is limited segregation of duties which could result in a material misstatement in our financial statements. Given our staff levels, certain duties within the accounting and finance department cannot be properly segregated. However, we believe that none of these segregation of duty deficiencies resulted in material misstatement to the financial statements as we rely on certain compensating controls, including periodic review of the financial statements by the Chief Executive Officer, Chief Financial Officer, Audit Committee and Board of Directors.

Monitoring of Subsidiaries

We have not designed adequate monitoring controls related to our European subsidiary or Japanese branch sales office, such that we can be assured that a material misstatement of financial results would be prevented or detected on a timely basis.

Inventory

We have identified weaknesses in our inventory controls as follows:

- Documented processes and controls are insufficient and are not working effectively for several key inventory processes including inventory adjustments and reserves for excess, defective and obsolete inventory.
- Inventory valuation processes and controls are not sufficiently documented and are not working effectively including costs to be expensed versus inventoried and maintenance of adequate supporting documentation for current unit costs and bill of materials.

Warranty Reserve

Controls to ensure valuation and adequacy of our warranty reserve were not operating effectively. Specifically, we do not have an adequate process to properly analyze average length of period of return for use in establishing an adequate reserve.

Intangible Asset Impairment Assessment

We have not established adequate controls to properly evaluate intangible assets for impairment consistently on an annual basis or identify when indicators for impairment are present requiring an evaluation.

Internal Controls Procedures and Risk Assessment Program

We have concluded that formal written internal control policies and procedures do not currently exist for all areas within our operations. A well-established and documented internal control structure is pertinent to our ability to maintain accurate books and records, prevent and detect fraud, maintain segregation of duties, report timely financial results and to properly comply with management's requirements to report on the effectiveness of internal controls over financial reporting pursuant to the Sarbanes-Oxley Act. In determining key controls and appropriate internal controls for us management needs to further develop its risk assessment process, including a fraud risk assessment and monitoring program, that is appropriate for our size and complexity, to assess the risks of material misstatement in the significant accounts and disclosures and related assertions and to ensure implementation of controls to prevent or detect errors or fraud that could result in material misstatements.

Part II. OTHER INFORMATION

Item 1. Legal Proceedings

There are no material legal proceedings pending to which we or any of our subsidiaries is a party or of which any of our property is subject. To our knowledge, there are no material legal proceedings to which any our directors, officers or affiliates, or any beneficial owner of more than five percent of our common stock, or any associate of any of the foregoing, is a party adverse to us or any of our subsidiaries or has a material interest adverse to us or any of our subsidiaries.

Item 1A. Risk Factors

In addition to the other information set forth in this report and the risk factor set forth below, you should carefully consider the factors discussed in Part I, Item 1A. "Risk Factors" in our annual report on Form 10-K for the year ended December 31, 2010. The risks discussed in our 2010 annual report could materially affect our business, financial condition and future results. The risks described in our 2010 annual report are not the only risks facing us. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially and adversely affect our business, financial condition or operating results. There are no material changes to the Risk Factors described in Item 1A in our 2010 annual report.

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

Sale of Unregistered Securities – none

Purchase of Equity Securities - none

Item 3. Defaults Upon Senior Securities

None, except those that have been waived, as described above.

Item 4. Reserved

Item 5. Other Information

None

Item 6. Exhibits

Exhibit No	Description
31.1	Certification of the Chief Executive Officer of the Registrant pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of the Chief Financial Officer of the Registrant pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of the Chief Executive Officer of the Registrant pursuant to 18 U.S.C. Section 1350 adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of the Chief Financial Officer of the Registrant pursuant to 18 U.S.C. Section 1350 adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101.INS*	XBRL Instance Document
101.SCH*	XBRL Taxonomy Extension Schema
101.CAL*	XBRL Taxonomy Calculation Linkbase
101.DEF*	XBRL Taxonomy Definition Linkbase
101.LAB*	XBRL Taxonomy Label Linkbase
101.PRE*	XBRL Taxonomy Presentation Linkbase

* Furnished, not filed.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

	VUZIX CORPORATION (Registrant)	
Date: August 15, 2011	By:	/s/ Paul J. Travers Paul J. Travers President, Chief Executive Officer (Principal Executive Officer)
Date: August 15, 2011	By:	/s/ Grant Russell Grant Russell Executive Vice President and Chief Financial Officer (Principal Financial and Accounting Officer)