

Vuzix Corp
Form 10-Q
November 14, 2014

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended September 30, 2014

OR

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

Commission file number 001-35955

VUZIX CORPORATION

(Exact name of registrant as specified in its charter)

| | |
|--|----------------------------|
| Delaware | 04-3392453 |
| State or other jurisdiction of | (I.R.S. Employer |
| incorporation or organization | Identification No.) |
| 2166 Brighton Henrietta Townline Rd | 14623 |

Rochester, New York
(Address of principal executive offices) (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 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 Smaller reporting company
(Do not check if a smaller reporting company)

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

As of November 14, 2014, there were 11,150,274 shares of the registrant's common stock outstanding.

Vuzix Corporation

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Part 1: FINANCIAL INFORMATION**Item 1: Condensed Consolidated Financial Statements (Unaudited)****VUZIX CORPORATION****CONDENSED CONSOLIDATED BALANCE SHEETS****(Unaudited)**

| | September 30, 2014 | December 31, 2013 |
|---|-----------------------|----------------------|
| ASSETS | | |
| Current Assets | | |
| Cash and Cash Equivalents | \$ 564,302 | \$ 310,140 |
| Accounts Receivable, Net | 117,479 | 214,920 |
| Inventories, Net (Note 4) | 1,081,439 | 953,627 |
| Prepaid Expenses and Other Assets | 233,086 | 200,936 |
| Total Current Assets | 1,996,306 | 1,679,623 |
| Tooling and Equipment, Net | 415,009 | 446,329 |
| Patents and Trademarks, Net | 524,547 | 495,608 |
| Software Development Costs, Net | 884,351 | 240,561 |
| Debt Issuance Costs, Net | 124,228 | — |
| Total Assets | \$ 3,944,441 | \$ 2,862,121 |
| LIABILITIES AND STOCKHOLDERS' DEFICIT | | |
| Current Liabilities | | |
| Accounts Payable | \$ 1,741,994 | \$ 2,420,571 |
| Notes Payable (Note 5) | 89,677 | 278,467 |
| Current Portion of Long-term Debt, net of discount (Note 9) | 98,106 | 99,320 |
| Current Portion of Capital Leases | 21,792 | 24,670 |
| Customer Deposits (Note 6) | 177,261 | 170,777 |
| Accrued Interest | 64,800 | 36,935 |
| Accrued Expenses (Note 7) | 634,308 | 554,264 |
| Other Taxes Payable | 46,800 | 75,851 |
| Total Current Liabilities | 2,874,738 | 3,660,855 |
| Long-Term Liabilities | | |
| Long Term Derivative Liability (Note 8) | 9,920,807 | 12,035,816 |
| Long Term Portion of Term Debt, net of discount (Note 9) | 1,067,827 | 170,496 |

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| | | |
|---|---------------|---------------|
| Long Term Portion of Capital Leases | — | 16,882 |
| Long Term Portion of Accrued Interest | 54,257 | 16,365 |
| | | |
| Total Long-Term Liabilities | 11,042,891 | 12,239,559 |
| | | |
| Total Liabilities | 13,917,629 | 15,900,414 |
| Commitments and Contingencies (Note 13 and Note 14) | — | — |
| | | |
| Stockholders' Deficit | | |
| Preferred Stock — \$.001 Par Value, 5,000,000 Shares Authorized; 0 Shares Issued and Outstanding in Each Period | — | — |
| Common Stock — \$.001 Par Value, 100,000,000 Shares Authorized September 30, 2014 and 700,000,000 Shares Authorized December 31, 2013; 10,816,363 Shares Issued and Outstanding September 30, 2014 and 9,600,453 Shares Issued and Outstanding on December 31, 2013 | 10,817 | 9,600 |
| Additional Paid-in Capital | 27,858,832 | 23,244,639 |
| Accumulated (Deficit) | (37,842,837) | (36,292,532) |
| | | |
| Total Stockholders' Deficit | (9,973,188) | (13,038,293) |
| | | |
| Total Liabilities and Stockholders' Deficit | \$ 3,944,441 | \$ 2,862,121 |

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

VUZIX CORPORATION

CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

| | For Three Months Ended September 30, | | For Nine Months Ended September 30, | |
|---|---|----------------|--|--------------|
| | 2014 | 2013 | 2014 | 2013 |
| Sales of Products | \$624,586 | \$301,076 | \$1,883,891 | \$1,421,598 |
| Sales of Engineering Services | 40,000 | 37,740 | 302,371 | 356,597 |
| Total Sales | 664,586 | 338,816 | 2,186,262 | 1,778,195 |
| Cost of Sales — Products | 444,234 | 177,361 | 1,251,690 | 774,653 |
| Cost of Sales — Engineering Services | 16,000 | 12,666 | 121,032 | 159,382 |
| Total Cost of Sales | 460,234 | 190,027 | 1,372,722 | 934,035 |
| Gross Profit | 204,352 | 148,789 | 813,540 | 844,160 |
| Operating Expenses: | | | | |
| Research and Development | 484,510 | 470,302 | 1,177,484 | 1,209,023 |
| Selling and Marketing | 336,099 | 193,650 | 957,422 | 756,134 |
| General and Administrative | 592,914 | 585,260 | 1,605,112 | 1,604,011 |
| Depreciation and Amortization | 59,680 | 95,595 | 260,823 | 284,556 |
| Loss from Operations | (1,268,851) | (1,196,018) | (3,187,301) | (3,009,564) |
| Other Income (Expense) | | | | |
| Other Taxes | (9,747) | (24,288) | (56,282) | (41,225) |
| Foreign Exchange Gain (Loss) | (3,473) | 4,671 | (3,710) | (5,075) |
| Gain (Loss) on Derivative Valuation (Note 8) | (1,698,940) | 259,426 | 2,124,878 | (35,122) |
| Amortization of Senior Term Debt Discount (Note 9) | (253,977) | (592,970) | (294,191) | (639,989) |
| Interest Expenses | (66,333) | (307,521) | (133,699) | (718,759) |
| Total Other Income (Expense) | (2,032,470) | (660,682) | 1,636,996 | (1,440,170) |
| Loss from Before Provision for Income Taxes | (3,301,321) | (1,856,700) | (1,550,305) | (4,449,734) |
| Provision (Benefit) for Income Taxes | — | — | — | — |
| Net Loss | (3,301,321) | \$(1,856,700) | (1,550,305) | (4,449,734) |
| Basic and Diluted Loss per Share (Note 3) | \$(0.31) | \$(0.26) | \$(0.15) | \$(0.93) |
| Weighted-average Shares Outstanding Basic and Diluted | 10,556,420 | 7,191,649 | 10,276,447 | 4,773,042 |

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

VUZIX CORPORATION**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(Unaudited)**

| | For the Nine Months Ended September 30, | |
|--|---|---------------|
| | 2014 | 2013 |
| Cash Flows from Operating Activities | | |
| Net Loss | \$(1,550,305) | \$(4,449,734) |
| Non-Cash Adjustments | | |
| Depreciation and Amortization | 260,823 | 284,556 |
| Stock-Based Compensation Expense | 201,671 | 139,926 |
| Amortization and Write-off of Term Debt Discount | 294,191 | 639,989 |
| Amortization of Debt Issuance Costs | 15,112 | 257,692 |
| (Gain) Loss on Derivative Valuation | (2,124,878) | 35,122 |
| (Increase) Decrease in Operating Assets | | |
| Accounts Receivable | 97,441 | 6,794 |
| Inventories | (127,812) | 41,887 |
| Prepaid Expenses and Other Assets | 138,763 | 2,604 |
| Increase (Decrease) in Operating Liabilities | | |
| Accounts Payable | (678,576) | (501,802) |
| Accrued Expenses | 7,928 | 92,427 |
| Customer Deposits | 6,484 | 11,653 |
| Income and Other Taxes Payable | (29,051) | 8,692 |
| Accrued Compensation | 72,116 | 116,667 |
| Accrued Interest | 65,757 | 459,029 |
| Net Cash Flows Used in Operating Activities | (3,350,336) | (2,854,498) |
| Cash Flows from Investing Activities | | |
| Purchases of Tooling and Equipment | (189,558) | (98,723) |
| Investments in Software Development | (643,790) | — |
| Investments in Patents and Trademarks | (68,884) | (38,925) |
| Net Cash Used in Investing Activities | (902,232) | (137,648) |
| Cash Flows from Financing Activities | | |
| Proceeds from Exercise of Warrants | 1,928,241 | — |
| Issuance of Common Stock | — | 8,050,000 |
| Repayment of Capital Leases | (19,760) | (48,601) |
| Direct Offering Associated Costs | — | (1,633,641) |
| Net Change in Lines of Credit | — | (112,500) |

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| | | |
|--|---------------|-----------------|
| Repayment of Long-Term Debt and Notes Payable | (262,411) | (1,952,327) |
| Proceeds from Senior Convertible Debt | 3,000,000 | 1,000,000 |
| Issuance Costs on Senior Convertible Debt | (139,340) | (191,088) |
| Proceeds from Notes Payable | — | 382,884 |
| Net Cash Flows Provided by Financing Activities | 4,506,730 | 5,494,727 |
| Net Increase in Cash and Cash Equivalents | 254,162 | 2,502,581 |
| Cash and Cash Equivalents — Beginning of Period | 310,140 | 66,554 |
| Cash and Cash Equivalents — End of Period | \$564,302 | \$2,569,135 |
| Supplemental Disclosures | | |
| Interest Paid | \$67,942 | \$460,083 |
| Common Stock Issued For Services, Classified as Prepaid Expense | 170,913 | — |
| Conversion of Accrued Interest into Common Stock | — | 1,076,250 |
| Warrant Derivative Liability of Common Stock Offering and Debt Conversions | — | 8,446,271 |
| Conversion of Accrued Compensation and Term Debt into Common Stock | 600,000 | 2,882,333 |
| Unamortized Discount upon Conversion of Term Debt | 214,536 | — |
| Discount on senior convertible debt attributed to embedded conversion price adjustment option | 1,938,988 | — |
| Warrants granted for senior convertible debenture issuance costs | — | 66,603 |
| Reclassification of Derivative Liability to Additional Paid-In Capital upon Note Conversions and Warrant Exercises | \$1,927,120 | \$— |

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

VUZIX CORPORATION AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 1 — Basis of Presentation

The accompanying unaudited Condensed Consolidated Financial Statements of Vuzix Corporation and Subsidiaries ("the Company") have been prepared in accordance with generally accepted accounting principles in the United States of America ("GAAP") for interim financial information and with the instructions to Form 10-Q and Article 8 of Regulation S-X of the Securities and Exchange Commission. Accordingly, the unaudited Condensed 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 condensed consolidated balance sheet as of December 31, 2013 was derived from the audited Consolidated Financial Statements in Form 10-K.

The accompanying Condensed Consolidated Financial Statements should be read in conjunction with the audited Consolidated Financial Statements of the Company as of December 31, 2013, 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.

Note 2 — Liquidity and Going Concern Issues

The Company's independent registered public accounting firm's report issued on our consolidated financial statements for the years ended December 31, 2013 and 2012 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 net loss from operations for the first nine months of 2014 was \$3,187,301. The Company has incurred a net loss from continuing operations consistently over the last 2 years. The Company incurred annual net losses from its continuing operations of \$10,146,228 in 2013 and \$4,747,387 in 2012, and has an accumulated deficit of \$37,842,837 as of September 30, 2014. The Company's ongoing losses have had a significant negative impact on the Company's financial position and liquidity. As at September 30, 2014 the Company had a working capital deficit of \$878,432.

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, the Company has met these cash needs by borrowings under notes, sales of convertible debt, the sales of equity securities and the sale of assets.

Since the closing of the Company's public stock offering on August 5, 2013 and the related debt conversions and repayments, the Company has had the financial resources to better execute on its business plan. However the Company's continued operating losses and large composition of past due accounts payable with certain vendors continue to affect the efficient operations of the Company and slow new product development.

During the first nine months of 2014, holders of the warrants issued in our public offering which closed on August 5, 2013 exercised for cash warrants for the purchase of 856,996 shares of common stock and the Company received proceeds of \$1,928,241 from such warrant exercises. During the fourth quarter period running from October 1, 2014 to November 14, 2014, we received further warrant exercises to purchase 322,800 shares of common stock for which the Company received net proceeds of \$726,300.

On June 3, 2014, we entered into and closed a securities purchase agreement (the "June 2014 Purchase Agreement") with various accredited investors (the "June 2014 Investors") pursuant to which we issued and sold to the June 2014 Investors a total of \$3,000,000 principal amount of 5% Senior Secured Convertible Notes (the "June 2014 Notes"). The June Notes are secured by a first security interest in all the assets of the Company. There are no scheduled payments on the June 2014 Notes, which are due on June 3, 2017, prior to maturity. Interest on the June 2014 Notes accrues at the rate of 5% per year, compounded annually, and is payable at maturity in cash, or (provided certain conditions are met) in shares of common stock valued at the then effective conversion price. The June 2014 Notes are convertible into common stock at an initial conversion price of \$2.25 per share, subject to adjustment in the event of stock splits, stock dividends, and similar transactions, and in the event of subsequent sales of common stock or securities convertible or exercisable for common stock, at a price per share lower than the then effective conversion price, subject to certain exceptions. The Company is not permitted to prepay any portion of the principal amount of the June 2014 Notes without the prior written consent of the June 2014 Investors unless certain conditions are met.

The June 2014 Note financing and cash warrant exercise proceeds have provided the Company sufficient capital to implement its current operating plan and planned new product development activities for 2014 thus far.

The Company's 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 the Company has sufficient operating funds, it expects to carefully devote capital resources to the development of new products and to continue its waveguide and HD display engine development programs, hire additional staff, and undertake new product marketing activities. Such expenditures, along with further future net operating losses, product tooling expenses, software development costs, and related working capital investments, will be the principal uses of cash. The Company must grow its business significantly to become profitable and self-sustaining on a cash flow basis or it will be required to raise new capital.

The Company's management intends 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 condensed consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty. Management's plans concerning these matters and managing our liquidity includes among other things:

- managing working capital through better optimization of inventory levels;
- focusing on selling higher gross margin products, which will mean a greater emphasis on augmented reality and smart glasses products;
 - the introduction of see-through binocular waveguide and new higher resolution Video Eyewear;
 - reducing operating costs wherever possible;
 - minimizing capital expenditures by eliminating, delaying or curtailing discretionary and non-essential spending;
 - deferring some research and development and delaying some planned new products based on new technology;
 - exploring options with respect to new equity financings or debt borrowings; and
 - exploring the licensing of our IP.

The Company and its management 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 our liquidity plan will limit certain of our operational and strategic initiatives designed to grow the business over the long term or whether such initiatives will be limited by the availability of capital. The Company expects that if it does not receive adequate levels of cash warrant exercises over the next 12 months to fund operations it may be required to sell new debt or equity securities.

In order for us to achieve positive cash flow from operations, our product sales will need to increase. The Company in 2014 is now effectively shipping all new models and products as compared to its offerings last year. However, if these products are not successful within a reasonable time period, we will have to raise additional capital to maintain operations and/or materially reduce our operating and new product development costs. New products incorporating

our waveguide optics and HD resolution Video Eyewear products may be delayed as a result.

If the Company is required to raise additional funds by selling additional shares of its capital stock, or securities convertible into shares of its capital stock, the ownership interest of existing shareholders may be diluted. The amount of dilution could be increased by the issuance of new warrants or securities with other dilutive characteristics, such as full ratchet anti-dilution clauses or price resets. The Company can give no assurance that it will be able to obtain additional financing on favorable terms or at all. If it is unable to become profitable and self-sustaining on a cash flow basis and needs to obtain future external funding, the Company could be forced to delay, reduce or eliminate its research and development programs, future commercialization efforts or otherwise curtail its business, which could adversely affect its business prospects. These factors raise substantial doubt about our ability to continue as a going concern.

Note 3 – 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. Diluted earnings per share reflects the potential dilution from the assumed exercise of stock options and warrants and the conversion of any convertible debt. During periods of net loss, all common stock equivalents are excluded from the diluted EPS calculation because they are antidilutive. Since the Company reported a net loss for the three and nine months ended September 30, 2014, a total of 2,469,637 and 1,778,832 additional equivalent shares have been excluded from these diluted calculations as they would be anti-dilutive for the three and nine months ended September 30, 2014, respectively.

Note 4 — 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:

| | September 30, 2014 | December 31, 2013 |
|--------------------------------|-----------------------|----------------------|
| Purchased Parts and Components | \$716,649 | \$640,649 |
| Work in Process | 118,771 | 152,915 |
| Finished Goods | 246,019 | 160,063 |
| Inventories, Net | \$1,081,439 | \$953,627 |

Note 5 – Notes Payable

Notes payable represent promissory notes payable by the Company and consists of the following:

| | September 30, 2014 | December 31, 2013 |
|--|--------------------------|----------------------|
| Note payable to officers and stockholders of the Company. Blended payments of accrued interest and principal are being made to repay these notes by December 31, 2014. The notes are payable on demand, bear interest at 18.5% and secured by all the assets of the Company. | \$89,677 | \$229,787 |
| Note payable secured by all the assets of Company and the guarantee of its President and CEO. The effective interest rate is 31%. The note was repaid in 12 blended monthly payments of \$5,645. | — | 37,383 |
| Note payable to an officer of the Company. The note bears interest at 7.49% and was repaid in monthly principal payments of \$2,691 plus accrued interest. The note was secured by all the assets of the Company. | — | 11,297 |
| Total | \$89,677 | \$278,467 |

A total of \$27,339 in accrued interest was paid during the 9 month period ending September 30, 2014 to officers and stockholders related to various notes described above.

Note 6 — Customer Deposits

Customer deposits represents money the Company received in advance of providing a product or engineering services to a customer. All such deposits are short term in nature as the Company delivers the product, unfulfilled portions or engineering services to the customer before the end of its next annual fiscal period. These deposits are credited to the

customer against product deliveries or at the completion of the customer's order. These deposit amounts include deferred revenue against unfulfilled deliverables of multiple-element products, including unspecified post-delivery support and software updates. Included in Customer Deposits is Unearned Revenue of \$58,114 as of September 30, 2014 as compared to \$39,700 as of December 31, 2013.

Note 7 — Accrued Expenses

Accrued expenses consisted of the following:

| | September 30, 2014 | December 31, 2013 |
|---------------------------------|-----------------------|----------------------|
| Accrued Wages and Related Costs | \$95,427 | \$91,385 |
| Accrued Compensation | 432,786 | 360,670 |
| Accrued Professional Services | 55,000 | 69,500 |
| Accrued Warranty Obligations | 38,722 | 31,619 |
| Other Accrued Expenses | 12,373 | 1,090 |
| Total | \$634,308 | \$554,264 |

Included in the above accrued compensation are amounts owed to officers of the Company for services rendered that remain outstanding. These amounts are not subject to a fixed repayment schedule and they bear interest at a rate of 8% per annum, compounding monthly. The amounts were \$432,786 as of September 30, 2014 and \$360,670 as of December 31, 2013. The related interest amounts included in Accrued Interest were \$55,214 and \$28,173 respectively at September 30, 2014 and December 31, 2013.

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 nine months ended September 30, 2014 were as follows:

| | |
|--|----------|
| | 2014 |
| Accrued Warranty Obligations at December 31, 2013 | \$31,619 |
| Reductions for Settling Warranties | (68,540) |
| Warranties Issued During Period | 75,643 |
| Accrued Warranty Obligations at September 30, 2014 | \$38,722 |

Note 8 – Derivative Liability and Fair Value Measurements

The Company recognized a derivative liability for the warrants to purchase shares of its common stock issued in connection with the equity offering and related debt conversions on August 5, 2013 and convertible senior secured debentures issued in 2013. These warrants have a cashless exercise provision and an exercise price that is subject to adjustment in the event of subsequent equity sales at a lower purchase price (subject to certain exceptions) along with full-ratchet anti-dilution provisions. In accordance with ASC 815-10-25, we measured the derivative liability using a Monte Carlo Options Lattice pricing model at their issuance date and subsequently remeasured the liability on December 31, 2013 to \$12,035,816.

Accordingly, at the end of each quarterly reporting date the derivative fair market value is remeasured and adjusted to current market value. As at September 30, 2014 a total of 5,066,292 warrants were outstanding that contained a full-ratchet anti-dilution provision. The total derivative liability was revalued to \$8,092,045 based on the closing price of our common stock as of September 30, 2014. The mark-to-market adjustments on this derivatives' valuation for the three months ending September 30, 2014 was a loss of \$1,301,588 versus a loss \$259,426 for the same period in 2013 and a gain of \$2,492,028 on the derivative's valuation for the nine months ending September 30, 2014 versus a \$35,122 loss for the same period in 2013.

The Company recognized a derivative liability for the \$3,000,000 of senior convertible notes with a conversion price that is subject to adjustment in the event of subsequent equity sales at a lower purchase price (subject to certain exceptions). In accordance with ASC 815-10-25, we measured the derivative liability of this embedded conversion option using a Monte Carlo Options Lattice pricing model at the June 3, 2014 issuance date as \$1,938,988. The value of the derivative liability at issuance was recorded as a discount against the notes in the Long-Term Debt section of the balance sheet. Accordingly, at the end of each quarterly reporting date the derivative fair market value is remeasured and adjusted to current market value. The revaluation mark-to-market adjustments on this liability was remeasured on September 30, 2014 to \$1,828,762, resulting in a loss of \$397,352 for the three months ending September 30, 2014 versus nil in 2013 and a loss of \$367,150 on the derivative's valuation for the nine months ending September 30, 2014 versus a nil for the same period in 2013.

The Company has adopted ASC Topic 820 for financial instruments measured at fair value on a recurring basis. ASC Topic 820 defines fair value, establishes a framework for measuring fair value in accordance with accounting principles generally accepted in the United States and expands disclosures about fair value measurements.

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. ASC Topic 820 establishes a three-tier fair value hierarchy which prioritizes the inputs used in measuring fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (level 1 measurements) and the lowest priority to unobservable inputs (level 3 measurements). These tiers include:

- Level 1, defined as observable inputs such as quoted prices for identical instruments in active markets;
- Level 2, defined as inputs other than quoted prices in active markets that are either directly or indirectly observable
- such as quoted prices for similar instruments in active markets or quoted prices for identical or similar instruments in markets that are not active; and
- Level 3, defined as unobservable inputs in which little or no market data exists, therefore requiring an entity to
- develop its own assumptions, such as valuations derived from valuation techniques in which one or more significant inputs or significant value drivers are unobservable.

The carrying amount of cash, accounts receivable, accounts payable, and accrued expenses approximates their fair value due to their short maturity. The carrying amount of notes payable approximates fair value because stated or implied interest rates approximate current interest rates that are available for debt with similar terms.

We measure certain financial instruments at fair value on a recurring basis. Assets and liabilities measured at fair value on a recurring basis are as follows at September 30, 2014:

| | Total | (Level 1) | (Level 2) | Level (3) |
|--|-------------|--------------|--------------|-------------|
| Assets | \$— | \$— | \$— | \$— |
| Total assets measured at fair value | — | — | — | — |
| Liabilities | | | | |
| Derivative Liability | 9,920,807 | — | — | 9,920,087 |
| Total liabilities measured at fair value (Long-Term) | \$9,920,807 | \$ — | \$ — | \$9,920,087 |

| | |
|--|--------------|
| | 2014 |
| Fair value – beginning of period | \$12,035,816 |
| Warrants issue during period | — |
| Reclassification (reset expiration) of warrant liabilities to Additional Paid-in Capital | (117,010) |
| Reclassification of warrant exercises to Additional Paid-in Capital | (979,793) |
| Change in fair value for the period of warrant derivative liability | (2,575,262) |
| Fair value – March 31, 2014 | 8,363,751 |
| Reclassification of warrant exercises to Additional Paid-in Capital | (92,832) |
| Change in fair value for the period of warrant derivative liability | (1,218,354) |
| Convertible debt issued with an embedded conversion price adjustment provision | 1,938,988 |
| Change in fair value of debt conversion price adjustment for the period | (30,202) |
| Fair value – June 30, 2014 | \$8,961,351 |
| Reclassification of warrant exercises to Additional Paid-in Capital | (262,109) |

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| | |
|---|-------------|
| Change in fair value for the period of warrant derivative liability | 1,301,589 |
| Reclassification of debt conversions to Additional Paid-in Capital | (477,376) |
| Change in fair value of debt conversion price adjustment for the period | 397,352 |
| Fair value – September 30, 2014 | \$9,920,807 |

For period ending September 30, 2014, the Monte Carlo Options Lattice pricing model was used to estimate the fair value of the embedded conversion option conversion price adjustment right on the convertible notes issued during this period. The following summary table shows the assumptions used to compute the fair value of the embedded conversion option when granted at issuance and as of September 30, 2014:

| | September 30, 2014 | At Issuance – June 3, 2014 | | |
|-----------------------------------|-----------------------|-------------------------------------|---|--|
| Assumptions for Pricing Model: | | | | |
| Expected term in years | 2.67 | 3.00 | | |
| Volatility range for years 1 to 5 | 81 | % 57 | % | |
| Expected annual dividends | None | None | | |

Value of convertible debt price adjustment:

| | | |
|--|-------------|-------------|
| Fair value of debt embedded conversion price adjustment option | \$1,828,762 | \$1,938,988 |
|--|-------------|-------------|

For period ending September 30, 2014, the Monte Carlo Options Lattice pricing model was used to estimate the fair value of warrants outstanding as of September 30, 2014:

| | September 30, 2014 |
|--------------------------------|-----------------------|
| Assumptions for Pricing Model: | |
| Expected term in years | 3.47 to 4.04 |
| Volatility range for years | 72 to 81% |
| Risk-free interest rate | 0.93 to 1.83% |
| Expected annual dividends | None |
| Value of warrants outstanding: | |
| Fair value of warrants | \$8,092,045 |

Note 9 — Long-Term Debt

Long-term debt consisted of the following:

| | September 30, 2014 |
|--|-----------------------|
| Note payable for research and development equipment. The principal is subject to a fixed semi-annual repayment schedule commencing October 31, 2012 over 48 months. The note carries a 0% interest. | 208,542 |
| Unamortized discount related to imputing accrued interest based on a 12% discount rate and is reflected as a reduction in the principal. | (52,725) |
| Note payable for which the principal and interest is subject to a fixed blended repayment schedule of 36 months, commencing July 15, 2013. The loan bears interest at 12% per annum and is secured by a subordinated position in | 59,353 |

all the assets of the Company.

Convertible, Senior Secured Notes payable. The principal is due June 3, 2017 and no principal payments are required. The notes carry a 5% interest, payable upon the note's maturity. Both the interest plus accrued interest is convertible to shares of the Company's common shares at \$2.25, subject to adjustment. The notes are secured by a first security interest in all the assets of the Company. Most of the notes are held by existing stockholders of the Company. 2,400,000

Unamortized debt discount related to derivative liability associated with above notes' conversion price that is subject to adjustment in the event of subsequent equity sales at a lower purchase price (subject to certain exceptions). Upon issuance on June 3, 2014 the discount was \$1,938,988. As of September 30, 2014 a net of \$275,214 of the discount was recognized as interest expense and \$214,536 was reversed due to conversions of the notes into shares of common stock. (1,449,200)

Less: Amount Due Within One Year – net of Discounts \$1,165,930
(98,106)

Amount Due After One Year \$1,067,824

The calendar year aggregate maturities for all long-term borrowings exclusive of Discounts as of September 30, 2014 are as follows:

| Total Aggregate Maturity For Period | Amounts |
|---|--------------|
| 2015 | \$ 123,408 |
| 2016 | 144,488 |
| 2017 | 2,400,000 |
| Total Required Principal Payments Exclusive of Debt Discounts | 2,667,896 |
| Total Unamortized Debt Discounts | (1,501,963) |
| Net Long-Term Borrowings | 1,165,933 |
| Net Amounts Due Within One Year | (98,106) |
| Net Long Term Debt | \$ 1,067,827 |

On June 3, 2014, we entered into and closed a securities purchase agreement (the “June 2014 Purchase Agreement”) with various accredited investors (the “June 2014 Investors”) pursuant to which we issued and sold to the June 2014 Investors a total of \$3,000,000 principal amount of 5% Senior Secured Convertible Notes (the “June 2014 Notes”). The Company granted the June 2014 Investors a first priority security interest in all of the present and future assets of the Company and its subsidiaries, including the equity interests of its subsidiaries. There are no scheduled payments on the June 2014 Notes, which are due on June 3, 2017, prior to maturity. Interest on the June 2014 Notes accrues at the rate of 5% per year, compounded annually, and is payable at maturity in cash, or (provided certain conditions are met) in shares of common stock valued at the then effective conversion price. The June 2014 Notes are convertible into common stock at an initial conversion price of \$2.25 per share, subject to adjustment in the event of stock splits, stock dividends, and similar transactions, and in the event of subsequent sales of common stock or securities convertible or exercisable for common stock, at a price per share lower than the then effective conversion price, subject to certain exceptions. The Company is not permitted to prepay any portion of the principal amount of the June 2014 Notes without the prior written consent of the June 2014 Investors unless certain conditions are met.

Pursuant to a registration rights agreement, dated June 3, 2014, between the Company and the June 2014 Investors, the Company agreed to file a registration statement, relating to the resale of common stock issuable upon conversion of the June 2014 Notes and payable as interest on the June 2014 Notes. The Company filed such registration statement on July 2, 2014, and the registration statement was declared effective by the Securities and Exchange Commission on July 10, 2014.

For the three month period ending September 30, 2014, a total of \$600,000 of the June 2014 Notes were converted into 266,667 shares of common stock.

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.

Note 11 — Stock Warrants

A summary of the various changes in warrants during the nine month period ended September 30, 2014 is as follows.

| | Number of Shares |
|---|---------------------|
| Warrants Outstanding at December 31, 2013 | 7,147,775 |
| Exercised During the Period | (878,696) |
| Issued During the Period | — |
| Expired During the Period | (57,668) |
| Warrants Outstanding, September 30, 2014 | 6,211,411 |

The outstanding warrants as of December 31, 2014 expire from May 21, 2015 to August 5, 2018. The weighted average remaining term of the warrants is 3.5 years. The weighted average exercise price is \$2.75 per share.

Note 12 — Stock Option Plans

A summary of stock option activity for the nine months ended September 30, 2014 is as follows:

| | Number of Shares | Weighted Average Exercise Price | Exercise Price Range |
|-----------------------------------|---------------------|--|-------------------------|
| Outstanding at December 31, 2013 | 214,518 | \$ 9.72 | \$1.71 – \$ 17.50 |
| Granted | 548,000 | \$ 2.63 | \$ 2.60 – \$ 2.70 |
| Exercised | — | \$ — | \$— |
| Expired or Forfeited | (26,244) | \$ 11.42 | \$2.60 – \$ 15.00 |
| Outstanding at September 30, 2014 | 736,274 | \$ 4.41 | \$1.71 – \$ 17.50 |

As of September 30, 2014, there were 221,727 options that were fully vested and exercisable at a weighted average exercise price of \$8.46 per share. The weighted average remaining contractual term on the vested options is 6.0 years.

As of September 30, 2014 there were 514,547 unvested options exercisable at a weighted average exercise price of \$2.66 per share. The weighted average remaining contractual term on the unvested options is 9.8 years.

No cash was received from option exercises for the three or nine months ended September 30, 2014 and 2013.

The table below summarizes the impact of outstanding stock options on the results of operations for the three and nine months ended September 30, 2014 and 2013:

**Three Months
Ended**

Nine months ended

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| | September 30, 2014 | September 30, 2013 | September 30, 2014 | September 30, 2013 |
|---|-----------------------------------|-------------------------------|-------------------------------|-------------------------------|
| Stock-based compensation expense: - - Stock Options | \$97,977 | \$ 101,232 | \$136,671 | \$ 139,926 |
| Income tax benefit | — | — | — | — |
| Net Increase in Net Loss | \$97,977 | \$ 101,232 | \$136,671 | \$ 139,926 |
| Increase in Loss Per Share: | | | | |
| Basic and Diluted | \$0.0093 | \$ 0.0141 | \$0.0133 | \$ 0.0293 |

The Black-Scholes-Merton option pricing model was used to estimate the fair value of share-based awards under FASB ASC Topic 718. The Black-Scholes-Merton option pricing model incorporates various and highly subjective assumptions, including expected term and expected volatility. For valuation purposes, stock option awards were categorized into two groups, stock option grants to employees and stock option grants to members of the Board of Directors.

The expected term of options granted was estimated to be the average of the vesting term, historical exercise and forfeiture rates, and the contractual life of the option. The expected volatility at the grant date is estimated using historical stock prices based upon the expected term of the options granted. FASB ASC Topic 718 requires pre-vesting option forfeitures at the time of grant to be estimated and periodically revised in subsequent periods if actual forfeitures differ from those estimates. Stock-based compensation expense is recorded only for those awards expected to vest using an estimated forfeiture rate based on historical pre-vesting forfeiture data. The risk-free interest rate assumption is determined using the rates for U.S. Treasury zero-coupon bonds with maturities similar to those of the expected term of the award being valued. Cash dividends have never been paid and are not anticipated to be paid in the foreseeable future. Therefore, the assumed expected dividend yield is zero.

The following summary table shows the assumptions used to compute the fair value of stock options granted during nine period ending September 30, 2014 and their estimated value:

Assumptions for Black-Scholes:

| | |
|---------------------------|-----------------|
| Expected term in years | 5.61 to 10.0 |
| Volatility | 118.6 to 119.7% |
| Risk-free interest rate | 1.70 to 2.42% |
| Expected annual dividends | None |

Value of options granted:

| | |
|-----------------------------------|-------------|
| Number of options granted | 548,000 |
| Weighted average fair value/share | \$2.32 |
| Fair value of options granted | \$1,268,792 |

At September 30, 2014, the Company had approximately \$1,221,338 of unrecognized stock compensation expense, which will be recognized over a weighted average period of approximately 2.2 years.

Note 13 — Litigation

We are not currently involved in any pending legal proceeding or litigation.

Note 14 — Contractual Obligations

The Company leases office and manufacturing space under operating leases that expire on September 30, 2015. The Company's total contractual payment obligations for operating leases as of September 30, 2014 total \$60,893 of which \$15,223 is due in calendar year 2014 and \$45,670 is due in calendar 2015.

Note 15 — Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board issued Accounting Standards Update No. 2014-09 ("ASU 2014-09"), Revenue from Contracts with Customers, an updated standard on revenue recognition. ASU 2014-09 provides enhancements to the quality and consistency of how revenue is reported while also improving comparability in the financial statements of companies reporting using International Financial Reporting Standards and GAAP. The

core principle of the new standard is for companies to recognize revenue to depict the transfer of goods or services to customers in amounts that reflect the consideration to which the company expects to be entitled in exchange for those goods or services. The new standard also will result in enhanced disclosures about revenue, provide guidance for transactions that were not previously addressed comprehensively, and improve guidance for multiple-element arrangements. ASU 2014-09 will be effective in the first quarter of fiscal 2017 and may be applied on a full retrospective or modified retrospective approach. The Company is still currently evaluating the impact of implementation of this standard on its financial statements.

In August 2014, the FASB issued ASU 2014-15, "Presentation of Financial Statements – Going Concern", which provides guidance on determining when and how to disclose going-concern uncertainties in the financial statements. The new standard requires management to perform interim and annual assessments of an entity's ability to continue as a going concern within one year of the date the financial statements are issued. An entity will be required to provide certain disclosures if conditions of events raise substantial doubt about the entity's ability to continue as a going concern. The ASU applies to all entities and is effective for annual periods ending after December 15, 2016, and interim periods thereafter, with early adoption permitted. We are currently evaluating the impact of the adoption of ASU 2014-15 on our consolidated financial statements and have not yet determined when we will adopt the standard.

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 and in our annual report on Form 10-K for the year ended December 31, 2013. As used in this report, unless otherwise indicated, the terms "Company," "Vuzix," "management," "we," "our," and "us" refer to 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 unaudited condensed consolidated 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. We continually evaluate our estimates used in the preparation of our financial statements, including those related to revenue recognition, bad debts, inventories, product warranty reserves, carrying value of long-lived assets, fair value measurement of financial instruments and embedded derivatives, valuation of stock compensation awards, and income taxes. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about carrying values of assets and liabilities that are not apparent from other sources. 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.

Management believes certain factors and trends 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;
- software development costs
- revenue recognition;
- product warranty;
- fair value measurement of financial instruments and embedded derivatives;
- stock-based compensation; and
- income taxes.

Our accounting policies are more fully described in the notes to our condensed consolidated financial statements included in this quarterly report and in our annual report on Form 10-K for the year ended December 31, 2013. There have been no significant changes in our accounting policies for the three and nine month period ended September 30, 2014.

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.

Business Matters

We are engaged in the design, manufacture, marketing and sale of wearable display devices that are worn like eyeglasses and feature built-in video screens that enable the user to view video and digital content, such as movies, computer data, the Internet or video games. Our wearable display products, known commercially as Video Eyewear (also referred to as head mounted displays (or HMDs), smart glasses, wearable displays, video glasses, personal viewers, near-eye virtual displays, and near-eye displays or NEDs) contain micro video displays that offer users a portable high-quality viewing experience. Our Video Eyewear products provide virtual large high-resolution screens, fit in a user's pocket or purse and can be viewed practically anywhere, anytime. They can also be used for virtual and augmented reality applications, in which the wearer is either immersed in a computer generated world or has his or her real world view augmented with computer generated information or graphics. In the 4th quarter of 2013, we started commercially shipping and selling smart glasses, the M100 Smart Glasses, a new category of Video Eyewear that has much of the capabilities of a smartphone including wireless internet access but that is worn like glasses. We produce both monocular and binocular Video Eyewear devices. Video Eyewear are designed to work with mobile electronic devices, such as cell phones, laptop computers, tablets, portable media players and gaming systems.

Our Video Eyewear products feature high performance miniature display modules, low power electronics and related optical systems. We produce both monocular and binocular Video Eyewear devices that we believe are excellent solutions for many mobile computer or video viewing requirements. With respect to our Video Eyewear products, we focus on the consumer markets for gaming and mobile video while our Virtual and Augmented Reality products are also sold in the consumer, industrial, commercial, academic and medical markets. The consumer electronics and mobile phone accessory markets in which we compete has been subject to rapid technological change including the rapid adoption of tablets and most recently larger screen sizes and display resolutions along with declining prices on mobile phones, and as a result we must continue to improve our products' performance and lower our costs. We believe our intellectual property portfolio gives us a leadership position in microdisplay electronics, waveguides, ergonomics, packaging, motion tracking and optical systems.

Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board issued Accounting Standards Update No. 2014-09 ("ASU 2014-09"), Revenue from Contracts with Customers, an updated standard on revenue recognition. ASU 2014-09 provides enhancements to the quality and consistency of how revenue is reported while also improving comparability in the financial statements of companies reporting using International Financial Reporting Standards and GAAP. The core principle of the new standard is for companies to recognize revenue to depict the transfer of goods or services to customers in amounts that reflect the consideration to which the company expects to be entitled in exchange for those goods or services. The new standard also will result in enhanced disclosures about revenue, provide guidance for transactions that were not previously addressed comprehensively, and improve guidance for multiple-element arrangements. ASU 2014-09 will be effective in the first quarter of fiscal 2017 and may be applied on a full retrospective or modified retrospective approach. The Company is still currently evaluating the impact of implementation of this standard on its financial statements.

In August 2014, the FASB issued ASU 2014-15, "Presentation of Financial Statements – Going Concern", which provides guidance on determining when and how to disclose going-concern uncertainties in the financial statements. The new standard requires management to perform interim and annual assessments of an entity's ability to continue as a going concern within one year of the date the financial statements are issued. An entity will be required to provide certain disclosures if conditions of events raise substantial doubt about the entity's ability to continue as a going concern. The ASU applies to all entities and is effective for annual periods ending after December 15, 2016, and interim periods thereafter, with early adoption permitted. We are currently evaluating the impact of the adoption of ASU 2014-15 on our consolidated financial statements and have not yet determined when we will adopt the standard.

Results of Operations

Comparison of Three Months Ended September 30, 2014 and September 30, 2013

Sales. Our sales were \$664,586 for the quarter ended September 30, 2014 compared to \$338,816 for the same period in 2013. This represents a 96% increase for the three month period ended September 30, 2014 as compared to 2013. Product sales were \$624,586 or 94% of total sales for the third quarter of 2014 as compared to \$301,076 or 89% of our total sales for same period in 2013, an increase of \$323,510 or 107%. The increase was primarily attributable to our new product introductions, especially the M100. Sales from our engineering programs for the third quarter of 2014 were \$40,000 or 6% of total sales compared to \$37,740 or 11% of total sales in the same quarter 2013.

Cost of Sales and Gross Profit. Gross profit increased to \$204,352 for the third quarter of 2014 from \$148,789 for the same period in 2013, an increase of \$55,563 or 37%. As a percentage of net sales, gross profit decreased to 31%

for the third quarter of 2014 compared to 44% for the same period in 2013. This decrease was primarily the result of a change in our overall sales mix, with M100 Smart Glasses being a larger portion of overall sales in 2014 versus the 2013 period when the higher margin AR Video Eyewear models were a larger percentage of overall sales.

Research and Development. Our research and development expenses were \$484,510 for the third quarter of 2014 compared to \$470,302 in the same period of 2013, an increase of \$14,208 or 3%. The net increase in the 2014 period versus 2013 was primarily related to the relocation costs of certain waveguide manufacturing equipment from Finland, increased compliance testing costs on the M100 Smart Glasses for China, less a decrease in expensed salary costs as a portion related to development activities were capitalized as Software Development in 2014 period.

Selling and Marketing. Selling and marketing expenses were \$336,099 for the third quarter of 2014 compared to \$193,650 for the same period in 2013, an increase of \$142,449 or 74%. The increase was primarily attributable to higher salary and travel costs related to new personnel, and website software consulting services totaling \$55,177 for the Company's soon to be launched app store for its M100 products. In the same period of 2013, only \$1,490 was spent on website design and consulting services.

General and Administrative. General and administrative expenses were \$592,914 for the third quarter of 2014 as compared to \$585,260 for the same period in 2013, an increase of \$7,654 or just over 1%. The overall increase in general and administrative costs reflects higher investor relations costs as compared to the same period in 2013.

Depreciation and Amortization. Our depreciation and amortization expense for the third quarter of 2014 was \$59,680 as compared to \$95,595 in the same period in 2013, a decrease of \$35,915 or 38%. The reduction is the result of more assets becoming fully depreciated.

Other Income (Expense). Total other expense was \$2,032,470 in the third quarter of 2014 compared to an expense of \$660,682 in the same period in 2013, an overall expense increase of \$1,371,788. The other expense was primarily the result of a loss of \$1,698,940 on the derivatives liability valuation mark-to-market revaluation for the 2014 period versus a gain of \$259,426 for the same period in 2013. The amortization of term debt discount was \$253,977 as compared to \$592,970 for the same period in 2013 when there was a write-off of the unamortized discount from the early repayment of related loans upon the closing of our August 5, 2013 public offering. Interest expense for the 2014 period decreased to \$66,333 as compared to \$307,521 for the same period 2013 as a result of the reduction in interest paying debt owed by the Company for the 2014 period as compared to the third quarter of 2013. The provision for other taxes for the third quarter of 2014 was \$9,747 compared to \$24,288 for 2013. These other taxes are primarily for franchise taxes payable to the State of Delaware, our state of incorporation.

Provision for Income Taxes. There were no provisions for income taxes for the respective quarterly periods ended September 30, 2014 and 2013.

Net Loss and Loss per Share. Our net loss was \$3,301,321 or \$0.31 per share in the quarter ended September 30, 2014, compared to a net loss of \$1,856,700 or \$0.26 per share for the same period in 2013.

Comparison of Nine Months Ended September 30, 2014 and September 30, 2013

Sales. The Company's sales were \$2,186,262 for the nine months ended September 30, 2014 compared to \$1,778,195 for the same period in 2013. This represents a 23% increase for the nine month period ended September 30, 2014 as compared to the same period in 2013. Product sales increased to \$1,883,891 or 86% of total sales for the nine months ended September 30, 2014 compared to \$1,421,598 or 80% of the Company's total sales in the same period in 2013. The increase was attributable to growing sales of the Company's M100 Smart Glass products. Sales from the Company's engineering programs, all related to waveguide based HMDs, for the nine months ended September 30, 2014, decreased to \$302,371 or 14% of total sales compared to \$356,597 or 20% of total sales in same period in 2013. The major reason for the decrease was due to lower sales for engineering programs with the US government and the further wind-down of activities related to the TDG sale in 2012.

Cost of Sales and Gross Profit. Gross profit decreased to \$813,540 for the nine months ended September 30, 2014 from \$844,160 for the same period in 2013, a decrease of \$30,620 or 4%. As a percentage of net sales, gross profit decreased to 37% for the nine month period ended September 30, 2014 compared to 48% for the same period in 2014.

This decrease was primarily the result of a change in our overall sales mix, with M100 Smart Glasses being a larger portion of overall sales in 2014 versus the 2013 period when the higher margin AR Video Eyewear models were a larger percentage of overall sales.

Research and Development. Our research and development expenses were \$1,177,484 for the nine months ended September 30, 2014 compared to \$1,209,023 for the same period in 2013. The \$31,359 or 3% decrease in the 2014 period versus 2013 was a direct result of capitalizing a portion of our development activities as Software Development in 2014 and spending related to the relocation of certain waveguide manufacturing equipment from Finland.

Selling and Marketing. Selling and marketing expenses were \$957,422 for the nine months ended September 30, 2014 compared to \$756,134 for the same period in 2013, an increase of \$201,288 or 26%. The increases in the 2014 period was primarily attributable to higher personnel salary costs and travel as well as increased spending on the Company's website for its Q4 introduction of an App store for its M100 products.

General and Administrative. General and administrative expenses were \$1,605,112 for the nine months ended September 30, 2014 as compared to \$1,604,011 for the same period in 2013, a net increase of \$1,101 or less than 1%. The principal reasons for the net changes for the 9 month period ending September 30, 2014 were increased IT costs of \$29,503, decreased legal and accounting costs of \$26,556, decreased insurance costs of \$24,630, and increased travel costs of \$41,540 as the result of more international travel as compared to the same period in 2013.

Depreciation and Amortization. Our depreciation and amortization expense for the nine months ended September 30, 2014 was \$260,823 as compared to \$284,556 in the same period in 2013, a decrease of \$23,733 or 8%. The reduction is the result of more assets becoming fully depreciated.

Other Income (Expense). Total other income was \$1,636,996 for the nine month period ended September 30, 2014 compared to a loss of \$1,440,170 in the same period in 2013. The other income was primarily the result of a gain of \$2,124,878 on the derivative liability valuation mark-to-market revaluation for the 2014 period versus a loss of \$35,122 for the same period in 2013. The amortization of term debt discount was \$294,191 as compared to \$639,989 for the same period in 2013 when there was a write-off of the unamortized discount from the early repayment of related loans upon the closing of our August 5, 2013 public offering. Interest expense for the 2014 period decreased to \$133,699 as compared to \$718,759 for the same period 2013 as a result of the reduction in interest paying debt owed by the Company for the 2014 period as compared to 2013. The provision for other taxes for the first nine months of 2014 was \$56,282 compared to \$41,225 for 2013. These other taxes are primarily for franchise taxes payable to the State of Delaware, our state of incorporation.

Provision for Income Taxes. There were no provisions for income taxes for the respective nine month periods ending September 30, 2014 and 2013.

Net Loss and Loss per Share. Our net loss was \$1,550,305 or \$0.15 for the nine months ended September 30, 2014, versus a net loss of \$4,449,734 or \$0.93 loss per share for the same period in 2013.

Liquidity and Capital Resources

As of September 30, 2014, we had cash and cash equivalents of \$564,302, an increase of \$254,162 from \$310,140 as of December 31, 2013.

At September 30, 2014 we had current assets of \$1,996,306 compared to current liabilities of \$2,874,738 which resulted in a negative working capital position of \$878,432. At December 31, 2013, we had current liabilities of \$3,660,855 compared to current assets of \$1,679,623 which resulted in a negative working capital position of \$1,981,232. Our current liabilities are comprised principally of accounts payable, accrued expenses and notes payable.

Operating Activities. We used \$3,350,336 of cash for operating activities for the nine months ending September 30, 2014 and \$2,854,498 in the same period in 2013. Changes in operating assets and liabilities were \$(617,863) for the nine months ending September 30, 2014 and \$237,951 in the same period in 2013. The major operating items for the nine months ending September 30, 2014 resulted from a \$(678,576) decrease in accounts payable, a \$97,441 decrease in accounts receivable, a \$(127,812) increase in inventories and a \$80,044 increase in accrued expenses. The major operating items for the nine months ended September 30, 2013 resulted from a \$(501,802) decrease in accounts payable, a \$116,667 increase in accrued compensation, a \$459,029 increase in accrued interest and a \$92,427 increase in accrued expenses.

Investing Activities. Cash used in investing activities was \$902,232 for the nine months ending September 30, 2014 as compared to \$137,648 in the same period in 2013. During the nine months ending September 30, 2014, \$189,558 was used primarily for the purchase of manufacturing equipment and mold tooling, as compared to spending of \$98,723 for the same period in 2013. During the first nine months of 2014, a total of \$643,790 in software development costs related to our M100 product was capitalized, versus \$-0- for the same period in 2013 when no amounts were capitalized. The costs of registering our intellectual property rights, included in the investing activities totals described above, were \$68,884 in the nine month period ending September 30, 2014 and \$38,925 in the same period in 2013.

Financing Activities. Cash provided by financing activities was \$4,506,730 for the nine months ended September 30, 2014, whereas in the same period in 2013, our net financing activities provided \$5,494,727. During the nine month period ended September 30, 2014, the primary source of cash were the proceeds of \$1,928,241 from warrant exercises, the \$3,000,000 issuance of senior convertible notes, less payments on notes, long-term debt and capital leases of \$262,411. During the nine month period ended September 30, 2013, the primary source of cash were the gross proceeds from the public offering of \$8,050,000, less direct offering associated costs of \$(1,633,641), the proceeds of \$1,000,000 from the sale of a convertible debenture less issuance costs of \$(191,088) and \$382,884 from the sale of notes payable, less the repayment of \$1,952,327 in long and short-term notes payable.

Capital Resources. As of September 30, 2014, we had a cash balance of \$564,302. The outstanding balance under our line of credit as of September 30, 2014 was \$-0-, the same amount as of December 31, 2013. We anticipate that to meet our working capital needs, we will need to negotiate a new operating credit facility with a bank or seek alternative sources for an operating loan.

During the nine months ended September 30, 2014 and the years ended December 31, 2013 and 2012, we have has been unable to generate cash flow from operations sufficient to support our business and have been dependent on equity financings, term debt financings, and asset sales. We will remain dependent on outside sources of funding until our results of operations provide positive cash flows. There can be no assurance that we will be able to generate cash from those sources in the future.

Our independent auditors issued a going concern paragraph in their report for the years ended December 31, 2013 and 2012. The accompanying condensed consolidated financial statements have been prepared assuming that we will continue as a going concern. This basis of accounting contemplates the recovery of our assets and the satisfaction of liabilities in the normal course of business. These condensed consolidated financial statements do not include any adjustments to the specific amounts and classifications of assets and liabilities, which might be necessary should we be unable to continue as a going concern. As a result of our current level of funding and ongoing losses from operations, substantial doubt exists about our ability to continue as a going concern.

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 the development of our new products and to continue our waveguide and HD display engine development programs, hire and train additional staff, and undertake new product marketing activities. Such expenditures, along with further future net operating losses, product tooling expenses, software development costs, and related working capital investments, will be the principal uses of our cash.

We have previously attracted funding in the form of term debt, short term notes, a bank line of credit, a public offering of shares of common stock and warrants and most recently a convertible debt offering. However, there can be no assurance that we will be able to raise capital in the future or that if we raise additional capital it will be sufficient to execute our business plan. To the extent that we are unable to raise sufficient additional capital, we will be required to substantially modify our business plan and our plans for operations, which could have a material adverse effect on us and our financial condition.

We also rely on credit lines from key suppliers and customer deposits in managing liquidity. Several of our key vendors are currently extending us extended credit terms. As a result, if our trade creditors were to impose unfavorable terms or customers decline to make advance deposits for their orders, our ability to obtain products and services on acceptable terms, produce products and operate our business would be negatively impacted.

On June 3, 2014, we entered into and closed a securities purchase agreement (the “June 2014 Purchase Agreement”) with various accredited investors (the “June 2014 Investors”) pursuant to which we issued and sold to the June 2014 Investors a total of \$3,000,000 principal amount of 5% Senior Secured Convertible Notes (the “June 2014 Notes”). There are no scheduled payments on the June 2014 Notes, which are due on June 3, 2017, prior to maturity. Interest on the June 2014 Notes accrues at the rate of 5% per year, compounded annually, and is payable at maturity in cash, or (provided certain conditions are met) in shares of common stock valued at the then effective conversion price. The June 2014 Notes are convertible into common stock at an initial conversion price of \$2.25 per share, subject to adjustment in the event of stock splits, stock dividends, and similar transactions, and in the event of subsequent sales of common stock or securities convertible or exercisable for common stock, at a price per share lower than the then effective conversion price, subject to certain exceptions. The Company is not permitted to prepay any portion of the principal amount of the June 2014 Notes without the prior written consent of the June 2014 Investors unless certain conditions are met.

During the first nine months of 2014, holders of the warrants issued in our public offering which closed on August 5, 2013 exercised for cash warrants for the purchase of 856,996 shares of common stock and the Company received proceeds of \$1,928,241 from such warrant exercises. During the fourth quarter period running from October 1, 2014 to November 14, 2014, we received further warrant exercises to purchase 322,800 shares of common stock for which the Company received net proceeds of \$726,300.

We anticipate the June 2014 Note financing and previous and new cash warrant exercises should provide us sufficient capital to implement our current operating plan and planned new product development activities for the remainder of 2014. However if the Company does not receive adequate levels of cash warrant exercises over the next 12 months to help fund operations it may be required to sell new debt or equity securities.

Additionally, we intend to take actions necessary for us 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 condensed consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty. Management's plans concerning these matters and managing our liquidity includes 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 augmented reality and smart glasses products;
- the introduction of see-through waveguide and new higher resolution Video Eyewear;
- reducing our operating costs wherever possible;
- minimizing our capital expenditures by eliminating, delaying or curtailing discretionary and non-essential spending;
- deferring some research and development and delaying some planned new products based on our new technology;
- exploring our options with respect to new equity financings or debt borrowings; and
- exploring the licensing of our IP.

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 our liquidity plan will limit certain of our operational and strategic initiatives designed to grow our business over the long term or whether such initiatives will be limited by the availability of capital. We cannot make assurances that we will be able to generate sufficient cash flow from operations, service our remaining indebtedness or otherwise fund our new product development plans. The Company expects that if it does not receive adequate levels of cash warrant exercises over the next 12 months to help fund operations it may be required to sell new debt or equity securities.

In order for us to achieve positive cash flow from operations, our product sales will need to increase. We are now effectively selling all new products as compared to our products offerings last year. However, if these products are not successful we will have to raise additional capital to maintain operations and/or materially reduce our operating costs.

If we are required to 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 may be diluted. The amount of dilution could be increased by the issuance of warrants or securities with other dilutive characteristics, such as full ratchet anti-dilution clauses or price resets. We can give no assurance that we will be able to obtain additional financing on favorable terms or at all. If we are unable to become profitable and self-sustaining on a cash flow basis and are required to obtain future funding, the Company could be forced to delay, reduce or eliminate its research and development programs, future commercialization efforts or otherwise curtail its business, which could adversely affect its business prospects. These factors raise substantial doubt about our ability to continue as a going concern.

Forward Looking Statements

This quarterly report includes forward-looking statements. 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 cash needs and financing plans;

- 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 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, 2013 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 Annual Report on Form 10-K for the year ended December 31, 2013 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 our manufacturing capacity and arrangements, the protection of our 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, going concern and liquidity issues, our material working capital deficiency, and potential material weaknesses in internal control over financial reporting. Further, during weak or uncertain economic periods, customers may delay the placement of their orders. These factors often result in a substantial portion of our 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 our anticipated results. 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, except as may be required under applicable securities laws, we specifically disclaim any obligation to do so, even if our estimates change.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Not required for a smaller reporting company.

Item 4. Controls and Procedures

Disclosure Controls and Procedures

We maintain a system of disclosure controls and procedures designed to provide reasonable assurance that information required to be disclosed in reports that we file or submit under the Securities Exchange Act of 1934, as amended (the "Exchange Act") is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's (SEC) rules and forms. Disclosure controls are also designed to reasonably assure that such information is accumulated and communicated to management, including the Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO"), as appropriate to allow timely decisions regarding required disclosure. Disclosure controls include components of internal control over financial reporting, which consists of control processes designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements in accordance with GAAP.

As reported in our 2013 Annual Report on Form 10-K (the "2013 Form 10-K"), as of December 31, 2013, our management identified material weaknesses in our internal control over financial reporting that have a direct impact on our financial reporting. Due to these material weaknesses in internal control over financial reporting, our management concluded in our 2013 Form 10-K that our disclosure controls and procedures were ineffective as of December 31, 2013.

Our management, with the participation of our CEO and CFO, has evaluated the effectiveness of our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) as of September 30, 2014. As part of its evaluation, our management has evaluated whether the control deficiencies related to the reported material weakness in internal control over financial reporting continue to exist. As of September 30, 2014, we have not completed the development, assessment, implementation and testing of the changes in controls and procedures that we believe are necessary to conclude that the material weakness has been remediated and, therefore, our management has concluded that we cannot assert that the control deficiencies relating to the reported material weakness have been effectively remediated. As a result, our CEO and CFO have concluded that our disclosure controls and procedures were ineffective as of September 30, 2014.

In light of the foregoing conclusion, we undertook additional procedures in order that management could conclude that reasonable assurance exists regarding the reliability of financial reporting and the preparation of the consolidated

financial statements contained in this filing. Accordingly, management believes that our condensed consolidated financial statements included in this Quarterly Report on Form 10-Q for the period ended September 30, 2014 fairly present, in all material respects, our financial position, results of operations and cash flows for the periods presented.

A material weakness is a deficiency, or 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 consolidated financial statements will not be prevented or detected on a timely basis. In its assessment of the effectiveness of internal control over financial reports as of December 31, 2013, we determined that there were control deficiencies that constituted the following material weaknesses that continue to exist as of September 30, 2014:

Deficiencies in 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 to (a) 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 for 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. We cannot give any assurance as to whether or when we will be able to implement those changes.

Deficiencies in 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 in the financial statements as we rely on certain compensating controls, including periodic substantive review of the financial statements by the Chief Executive Officer and Chief Financial Officer.

Deficiencies in 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.

Weaknesses in Inventory Controls

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.

Deficiencies in 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.

Changes in internal control over financial reporting

During the three months ended September 30, 2014, there were no changes in our internal controls over financial reporting that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Part II. OTHER INFORMATION

Item 1. Legal Proceedings

We are not currently involved in any pending legal proceeding or litigation and we are not aware of any such proceedings contemplated by or against us or our property. 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 you should carefully consider the factors discussed in Part I, Item 1A. "Risk Factors" in the 2013 Form 10-K. There have been no material changes from those risk factors. The risks discussed in the 2013 Form 10-K could materially affect our business, financial condition and future results.

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

Sale of Unregistered Securities –

During the three months ended September 30, 2014 we issued 82,755 shares of common stock for investor relations services.

During the three months ended September 30, 2014, we issued 216,667 shares of common stock upon conversion of convertible notes in the principal amount of \$600,000.

In connection with the foregoing, we relied upon the exemption from registration provided by Section 4(a)(2) under the Securities Act of 1933, as amended, for transactions not involving a public offering.

Purchase of Equity Securities - none

Item 3. Defaults Upon Senior Securities

None

Item 4. Mine Safety Disclosures

Not Applicable

Item 5. Other Information

None

Item 6. Exhibits

| <u>Exhibit No.</u> | <u>Description</u> |
|---------------------------|--|
| 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 Document

101.CAL XBRL Taxonomy Extension Calculation Link base Document

101.DEF XBRL Taxonomy Extension Definition Link base

101.LAB XBRL Taxonomy Extension Label Link base Document

101.PRE XBRL Taxonomy Extension Presentation Link base Document

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SIGNATURES

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

VUZIX CORPORATION

Date: November 14, 2014 By: /s/ Paul J. Travers
Paul J. Travers
President, Chief Executive Officer
(Principal Executive Officer)

Date: November 14, 2014 By: /s/ Grant Russell
Grant Russell
Executive Vice President and Chief Financial Officer
(Principal Financial and Accounting Officer)