Cambridge Display Technology, Inc.
Form 10-Q
August 14, 2006
**Table of Contents**

# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

# FORM 10-Q

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

**For the quarterly period ended June 30, 2006**

**or**

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

**For the transition period from______ to______**

**Commission File Number: 000-51079**

# CAMBRIDGE DISPLAY TECHNOLOGY, INC.

**(Exact name of registrant as specified in its charter)**

| | |
|---|---|
| **Delaware** | **13-4085264** |
| **(State or other jurisdiction of incorporation or organization)** | **(IRS Employer Identification No.)** |

**c/o Cambridge Display Technology Limited**

**2020 Cambourne Business Park**

**Cambridge CB3 6DW, United Kingdom**

**(Address of principal executive offices)**

**011-44-1954-713-600**

**(Registrant s telephone number, including area code)**

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

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

Large accelerated filer ¨ Accelerated filer ¨ Non-accelerated filer x

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

The number of outstanding shares of the registrant s Common Stock, par value $0.01 per share, was 21,483,205 as of August 11, 2006.

Table of Contents

**CAMBRIDGE DISPLAY TECHNOLOGY, INC.**

**INDEX**

**Table of Contents**

CAUTIONARY STATEMENT

CONCERNING FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q contains forward-looking statements as defined in the Private Securities Litigation Reform Act of 1995. This Quarterly Report on Form 10-Q also contains information relating to us that is based on the beliefs of our management, as well as assumptions made by, and the information currently available to, our management. Among other things, these statements include, but are not limited to, the statements in this Quarterly Report on Form 10-Q regarding:

- the outcomes of our ongoing and future research and development activities, and those of our licensees, related to our polymer organic light emitting diode, or P-OLED, technology referred to below;
- the potential commercial applications of our P-OLED technology, and of OLED products in general;
- our ability to form and continue joint ventures and other strategic relationships with manufacturers of P-OLED materials and displays;
- successful commercialization of products including our P-OLED technology by our licensees;
- the willingness of these manufacturers and licensees to continue to develop, manufacture and sell commercial products integrating our technology;
- future demand for products using our P-OLED technology;
- the comparative advantages and disadvantages of our technology versus competing technologies currently on the market;
- the nature and potential advantages of any competing technologies that may be developed in the future;
- our ability to compete against third parties with resources greater than ours;
- our ability to maintain and improve our competitive position following the expiration of our fundamental patents;
- the adequacy of protection afforded to us by the patents that we own or license and the cost to us of enforcing that protection;
- our ability to obtain, expand and maintain patent protection in the future and to protect our unpatentable intellectual property;
- developments in and expenses associated with resolving matters currently in litigation;

- the payments that we expect to receive in the future under our existing contracts and the terms that we are able to enter into with new licensees of our technology;

- exposure of our international operations and those of our licensees to significant risks;

- our future capital requirements and our ability to obtain additional financing when needed; and

- our future P-OLED technology licensing and other revenues and results of operations.

In addition, when used in this Quarterly Report on Form 10-Q the words estimate , project , believe , expect , intend , anticipate , seek , w plan and similar expressions involving potential future developments are intended to identify forward-looking statements. All of these forward-looking statements reflect our current views with respect to future events and are subject to risks and uncertainties that could cause actual results to differ materially from those contemplated by the statements, including those risks discussed in this Quarterly Report on Form 10-Q.

You are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date of this Quarterly Report on Form 10-Q. We undertake no obligation to update beyond that required by law any forward-looking statements whether as a result of new information, future events or otherwise.

**Table of Contents**

In this Quarterly Report on Form 10-Q, the terms the Company , our company , CDT , we , us and our refer to Cambridge Display Technolo
Inc. and its subsidiaries, unless the context otherwise requires.

This Quarterly Report on Form 10-Q contains references to a number of trademarks that are registered trademarks of ours or our affiliates or trademarks for which we or our affiliates have pending applications or common law rights. These include P-OLED, CDT, Cambridge Display Technology and Sumation.

**Table of Contents**

**PART I. FINANCIAL INFORMATION**

**Item 1. Financial Statements**

**CAMBRIDGE DISPLAY TECHNOLOGY, INC.**

**Consolidated Balance Sheets**

(in thousands, except share information)

| | June 30, 2006 (unaudited) | December 31, 2005 |
|---|---|---|
| **ASSETS** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 21,106 | $ 31,263 |
| Marketable securities | 1,874 | |
| Inventory | 124 | 32 |
| Accounts receivable, net | 100 | 2,266 |
| Taxes receivable | 2,879 | 2,045 |
| Prepaid expenses and other current assets | 2,224 | 2,473 |
| Total current assets | 28,307 | 38,079 |
| Property, equipment and leasehold improvements, net | 11,463 | 13,593 |
| Investments in affiliates. | 3,845 | 1,899 |
| Marketable securities | 334 | 633 |
| Goodwill | 65,612 | 65,612 |
| Other intangible assets, net | 2,107 | 2,897 |
| Total assets. | $ 111,668 | $ 122,713 |
| **LIABILITIES AND SHAREHOLDERS EQUITY** | | |
| Current liabilities: | | |
| Accounts payable and accrued expenses | $ 6,149 | $ 7,910 |
| Deferred revenue | 1,044 | 1,290 |
| Due to affiliate | 70 | 52 |
| Taxes payable | | 6 |
| Other current liabilities | 2,109 | |
| Total current liabilities | 9,372 | 9,258 |
| Other liabilities | 580 | 567 |
| Commitments and contingencies (Note 8) | | |
| Common shareholders equity: | | |
| Preferred stock, voting $0.01 par value, 46,667 authorized, None issued or outstanding | | |
| Common stock, $0.01 par value, 100,000,000 shares authorized, 21,674,703 issued and 21,483,205 outstanding | 215 | 215 |
| Additional paid-in capital | 283,090 | 287,514 |
| Deferred compensation | | (6,082) |
| Accumulated other comprehensive loss | (1,277) | (1,052) |

| | | |
|---|---|---|
| Accumulated deficit | (180,312) | (167,707) |
| Total common shareholders equity | 101,716 | 112,888 |
| Total liabilities and shareholders equity | $ 111,668 | $ 122,713 |

See accompanying notes.

1

**Table of Contents**

**CAMBRIDGE DISPLAY TECHNOLOGY, INC.**

**Consolidated Statements of Operations**

(in thousands, except per share amounts)

(unaudited)

| | Three months ended June 30, 2006 | 2005 |
|---|---|---|
| Operating revenues: | | |
| License fees and royalties | $ 2,002 | $ 994 |
| Technology services and development | 683 | 1,678 |
| Equipment and supplies | 12 | |
| Total operating revenues | 2,697 | 2,672 |
| Cost of sales: | | |
| License fees and royalties | 11 | 12 |
| Technology services and development | 270 | 649 |
| Equipment and supplies | 11 | |
| Total cost of sales | 292 | 661 |
| Gross profit | 2,405 | 2,011 |
| Operating expenses: | | |
| Research and development expenses | 3,210 | 4,184 |
| Selling, general and administrative expenses | 3,605 | 4,358 |
| Amortization of intangibles acquired | 395 | 395 |
| Total operating expenses | 7,210 | 8,937 |
| Loss from operations | (4,805) | (6,926) |
| Other (expense) / income: | | |
| Equity in loss of affiliates | (1,599) | 191 |
| Foreign currency transaction gain / (loss) | 489 | (172) |
| Other income/(expense) | 357 | (373) |
| Interest income | 304 | 191 |
| Total other expense | (449) | (163) |
| Loss before benefit for income taxes | (5,254) | (7,089) |
| Benefit for income taxes | (282) | (380) |
| Net loss | $ (4,972) | $ (6,709) |
| Net loss per common share attributable to common shareholders, basic and diluted | $ (0.23) | $ (0.34) |
| Weighted average number of common shares outstanding, basic and diluted | 21,483 | 19,485 |

See accompanying notes.

Table of Contents

**CAMBRIDGE DISPLAY TECHNOLOGY, INC.**

**Consolidated Statements of Operations**

(in thousands, except per share amounts)

(unaudited)

| | Six months ended June 30, 2006 | 2005 |
|---|---|---|
| Operating revenues: | | |
| License fees and royalties | $ 2,081 | $ 1,123 |
| Technology services and development | 1,381 | 3,110 |
| Equipment and supplies | 270 | |
| Total operating revenues | 3,732 | 4,233 |
| Cost of sales: | | |
| License fees and royalties | 12 | 13 |
| Technology services and development | 486 | 1,124 |
| Equipment and supplies | 169 | |
| Total cost of sales | 667 | 1,137 |
| Gross profit | 3,065 | 3,096 |
| Operating expenses: | | |
| Research and development expenses | 6,305 | 8,164 |
| Selling, general and administrative expenses | 7,574 | 8,383 |
| Amortization of intangibles acquired | 790 | 790 |
| Total operating expenses | 14,669 | 17,337 |
| Loss from operations | (11,604) | (14,241) |
| Other (expense) / income: | | |
| Equity in loss of affiliates | (3,014) | (1,410) |
| Foreign currency transaction gain / (loss) | 276 | (94) |
| Other income/(expense) | 610 | (789) |
| Interest income | 561 | 361 |
| Total other expense | (1,567) | (1,932) |
| Loss before benefit for income taxes | (13,171) | (16,173) |
| Benefit for income taxes | (566) | (795) |
| Net loss | $ (12,605) | $ (15,378) |
| Net loss per common share attributable to common shareholders, basic and diluted | $ (0.59) | $ (0.79) |
| Weighted average number of common shares outstanding, basic and diluted | 21,483 | 19,485 |

See accompanying notes.

3

Table of Contents

**CAMBRIDGE DISPLAY TECHNOLOGY, INC.**

**Consolidated Statements of Cash Flows**

(in thousands)

(unaudited)

| | Six months ended June 30, 2006 | 2005 |
|---|---|---|
| **Operating activities** | | |
| Net loss | $ (12,605) | $ (15,378) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | |
| Depreciation and amortization of property, equipment and leasehold improvements | 2,689 | 2,830 |
| Loss on sale of property, equipment and leasehold improvements | (2) | (14) |
| Amortization of other intangible assets | 790 | 790 |
| Stock compensation expense | 1,658 | 1,537 |
| Equity in loss of affiliates | 3,014 | 1,410 |
| Changes in operating assets and liabilities: | | |
| Accounts and tax receivable | 1,332 | 2,857 |
| Due from affiliates | | 308 |
| Inventories and demo machines | (92) | |
| Prepaid expenses and other current assets | 249 | (1,585) |
| Accounts and tax payable and accrued expenses | (1,767) | (1,598) |
| Due to affiliates | 18 | |
| Deferred revenue | (246) | 861 |
| Other current and non-current liabilities | 2,122 | 82 |
| Net cash used in operating activities | (2,840) | (7,900) |
| **Investing activities** | | |
| Acquisition of property, equipment and leasehold improvements | (557) | (1,031) |
| Disposal of property, equipment and leasehold improvements | | 21 |
| Loans advanced to affiliate (Litrex) | | (1,715) |
| Investment in affiliates | (4,886) | (1,127) |
| Investment in marketable securities | (1,874) | |
| Net cash used in investing activities | (7,317) | (3,852) |
| **Financing activities** | | |
| Issuance of common stock | | (67) |
| Net cash used in financing activities | | (67) |
| Net decrease in cash | (10,157) | (11,819) |
| Cash and cash equivalents beginning of period | 31,263 | 26,892 |
| Cash and cash equivalents end of period | $ 21,106 | $ 15,073 |
| **Supplemental disclosures of cash flow information** | | |
| Interest paid | $ 2 | |
| Taxes paid | $ 108 | $ 111 |

See accompanying notes.

4

Table of Contents

**Cambridge Display Technology, Inc.**

**Notes to Consolidated Financial Statements**

### 1. Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the rules and regulations of the Securities and Exchange Commission. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the six and three months ended June 30, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006. For further information, refer to the consolidated financial statements and footnotes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2005, or our 2005 Form 10-K .

### 2. Significant Accounting Policies

In March 2006, the Company purchased a number of certificates of deposits, some with maturities of 90 days or less and others with maturities of more than 90 days but less than one year. The Company includes certificates of deposits with maturities of 90 days or less within Cash and cash equivalents and includes certificates of deposits with maturities of more than 90 days but less than one year as Marketable securities within current assets. The Company intends to hold these certificates until maturity and, therefore, considers these as held to maturity investments and not available for sale investments. The Company accrues interest receivable from these certificates as of the end of each period, but does not revalue them based on current market prices.

See Notes 5 and 7 for a description of changes to the Company s accounting policy with regard to stock-based compensation.

### 3. Other Comprehensive Loss

An unrealized loss of $0.2 million was reported in the six months ended June 30, 2006 due to the revaluation of securities held by the Company. The reported unrealized loss is due to the decline in the market price of these securities. The foreign currency translation adjustments include the effect of revaluing the marketable securities which are held in British pounds and also the effect of revaluing the Company s Japanese yen investment in Sumation Company Limited, or Sumation, a 50%-owned joint venture between the Company and Sumitomo Chemical Company Limited, or Sumitomo Chemical.

| | Six months ended June 30, 2006 (in thousands) | Six months ended June 30, 2005 (in thousands) |
|---|---|---|
| Net Loss | $ (12,605) | $ (15,378) |
| Other comprehensive loss: | | |
| Unrealized losses on marketable securities | (325) | (140) |
| Foreign currency translation adjustments | 100 | (76) |
| Other comprehensive loss: | (225) | (216) |
| Comprehensive loss | $ (12,830) | $ (15,594) |

### 4. Investments in Affiliates

In January 2006 and April 2006, the Company invested $1.6 million and $3.3 million, respectively, in Sumation. In the six months ended June 30, 2006, Sumation paid to the Company $6.0 million, in aggregate, as reimbursement of research and development expenses. This reimbursement covers the nine months from January 2006 to September 30, 2006 and, therefore,

5

Table of Contents

$4.0 million has been credited to research and development expense and the remaining $2.0 million is included within other current liabilities. In March 2006, Summation purchased from the Company intellectual property rights which the Company had acquired from a third party for $1.4 million.

**5. Recent Accounting Pronouncements**

In December 2004, the Financial Accounting Standards Board (the FASB ) issued Statement of Financial Accounting Standards ( SFAS ) No. 123 (revised 2004), Share-Based Payment ( SFAS 123(R) ), which replaces SFAS No. 123, Accounting for Stock-Based Compensation ( SFAS 123 ), and supersedes Accounting Principles Board ( APB ) Opinion No. 25, Accounting for Stock Issued to Employees ( APB 25 ). SFAS 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values, beginning with the first interim period after December 15, 2005. The Company adopted SFAS 123(R) effective January 1, 2006 and the impact and method of adoption is described in Note 7 below.

In February 2006, the FASB issued SFAS No. 155, Accounting for Certain Hybrid Financial Instruments - an amendment of FASB Statements No. 133 and 140 ( SFAS 155 ). SFAS 155 amends SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities ( SFAS 133 ) and SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities ( SFAS 140 ). SFAS 155 permits fair value re-measurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation, clarifies which interest-only strips and principal-only strips are not subject to the requirements of SFAS 133, establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation, clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives, and amends SFAS 140 to eliminate the prohibition on a qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. Since the Company does not have any such instruments, it does not expect the adoption of SFAS 155 to have a material impact on its financial condition or results of operations.

In March 2006, the FASB issued SFAS No. 156, Accounting for Servicing of Financial Assets an amendment of FASB Statement No. 140 ( SFAS 156 ). SFAS 156 requires an entity to recognize a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract in certain situations. Since the Company does not have any such liabilities, it does not expect the adoption of SFAS 156 to have a material impact on its financial condition or results of operations.

In June 2006, the FASB ratified a tentative conclusion of the Emerging Issues Task Force ( EITF ) on Issue 06-03 How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation) . The EITF conclusion requires companies to disclose whether reported revenues include any government-imposed sales or value added taxes. The Company will adopt this conclusion in its financial statements for the fiscal year ending December 31, 2006 by including in its significant accounting policy disclosures a statement that revenues are reported on a net basis, excluding sales and value added taxes but does not expect this to have a material impact on its financial condition or results of operations.

In July 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes - an Interpretation of FASB Statement No. 109 ( FIN 48 ). FIN 48 prescribes a comprehensive model for how a company should recognize, measure, present and disclose in its financial statements uncertain tax positions that it has taken or expects to take on a tax return. FIN 48 is effective beginning with the Company s first fiscal quarter of 2007. The Company has not yet evaluated the impact of FIN 48 s implementation on its financial condition or results of operations.

**6. Income Taxes**

Income taxes are a benefit for the six months ended June 30, 2006 and 2005 reflecting tax credits to be received for research and development costs from the United Kingdom government, net of Delaware franchise tax payments.

The Taxes receivable balance of $2.9 million at June 30, 2006 includes $2.0 million of income tax refunds due for the year ended December 31, 2005 and $0.7 million for the six months ended June 30, 2006. The remaining balance represents anticipated United Kingdom value added tax recoveries.

Table of Contents

**7. Stock-Based Compensation**

At June 30, 2006, the Company had three stock-based employee compensation plans, which are described more fully below. Prior to January 1, 2006, the Company accounted for those plans under the recognition and measurement provisions of APB 25 and related interpretations, as permitted by SFAS 123. No stock-based employee compensation cost was recognized in relation to the Company s two stock option plans in the Statement of Operations for the three and six months ended June 30, 2005, as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant. Stock compensation expense was recognized in relation to restricted stock units which had been issued pursuant to the Company s special bonus plan. Effective January 1, 2006, the Company adopted the fair value recognition provisions of SFAS 123(R) using the modified-prospective-transition method. Under that transition method, compensation cost recognized in the three and six months ended June 30, 2006 includes (a) compensation cost for all share-based payments granted prior to, but not yet vested, as of January 1, 2006, based on the grant-date fair value estimated in accordance with the original provisions of SFAS 123, and (b) compensation cost for all share-based payments granted subsequent to January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of Statement 123(R). Results for prior periods have not been restated.

SFAS 123(R) requires that compensation expense be adjusted for projected forfeitures of stock options. In calculating pro-forma stock-based employee compensation expense prior to January 1, 2006, the Company did not make any adjustment for such forfeitures.

The effect of the adoption of SFAS 123(R) on the Company s Loss from operations, Loss before benefit for income taxes and Net loss has been to decrease each of these by less than $0.1 million for the three months ended June 30, 2006 and to increase each of these by $0.2 million for the six months ended June 30, 2006, in relation to compensation expense for stock options as shown in the table below. The adoption of SFAS 123(R) has had no net impact on the Company s statement of cash flows and no material impact on earnings per share.

Table of Contents

| | Compensation Expense for three months ended June 30, 2006 | Pro Forma Compensation Expense for three months ended June 30, 2005 |
|---|---|---|
| | *(in thousands)* | |
| CDT Acquisition Corp. Stock Incentive Plan (1) | $ 4 | $ 77 |
| 2004 Stock Incentive Plan (1) | (32) | 58 |
| **Total Compensation Expense for Stock Options (1)** | **$ (28)** | **$ 135** |
| Special Bonus Plan (2) | $ 753 | $ 770 |
| **Total Compensation Expense for Restricted Stock Units (2)** | **$ 753** | **$ 770** |
| **Total Stock-Based Compensation Expense** | **$ 725** | **$ 905** |

| | Compensation Expense for six months ended June 30, 2006 | Pro Forma Compensation Expense for six months ended June 30, 2005 |
|---|---|---|
| | *(in thousands)* | |
| CDT Acquisition Corp. Stock Incentive Plan (1) | $ 25 | $ 159 |
| 2004 Stock Incentive Plan (1) | 132 | 109 |
| **Total Compensation Expense for Stock Options (1)** | **$ 157** | **$ 268** |
| Special Bonus Plan (2) | $ 1,501 | $ 1,537 |
| **Total Compensation Expense for Restricted Stock Units (2)** | **$ 1,501** | **$ 1,537** |
| **Total Stock-Based Compensation Expense** | **$ 1,658** | **$ 1,805** |

(1) compensation expense for stock options for the three and six months ended June 30, 2005 was only reported in pro-forma footnote disclosures and not in the Statement of Operations.

(2) compensation expense for restricted stock units issued in relation to the special bonus plan for the three and six months ended June 30, 2005 was both reported in pro-forma footnote disclosures and recognized in the Statement of Operations. The only impact on the adoption of SFAS 123(R) on the compensation expense recognized with respect to these units was to account for estimated future forfeitures. This impact is not material.

**Table of Contents**

For the three and six months ended June 30, 2005, the Company followed APB 25 and related interpretations in accounting for stock options awarded to employees. Accordingly the Company recognized no compensation expense with respect to options granted to employees. Had compensation cost been determined based upon the fair value at grant date for awards consistent with the methodology prescribed by SFAS 123, the Company s net loss for the three months and six months ended June 30, 2005 would have been the pro forma amounts indicated below:

| | Three Months Ended June 30, 2005 2005 | Six Months Ended June 30, 2005 2005 |
|---|---|---|
| | (in thousands) | |
| Net loss as reported | $ (6,709) | $ (15,378) |
| Add back: APB 25 expense | 770 | 1,537 |
| Less: total stock-based employee compensation expense under the fair value method | (905) | (1,805) |
| Net loss attributable to common shareholders - pro forma | $ (6,844) | $ (15,646) |
| Net loss per share: | | |
| Basic and diluted as reported | $ (0.34) | $ (0.79) |
| Basic and diluted pro forma | $ (0.35) | $ (0.80) |

*Employee Stock Options*

In April 2000, the Company adopted the CDT Acquisition Corp. Stock Incentive Plan (the 2000 Plan ). Under the 2000 Plan, options may be granted to employees, consultants and directors. Options available for grant under the 2000 Plan totaled 1,170,361. Under the 2000 Plan, employees generally were granted two types of options in one grant: Service Options (one-third of total grant) and Exit Options (two-thirds of total grant). Service Options granted in 2002 and later were granted at fair market value at date of grant, and generally vest 25% on the six-month anniversary of grant, and 25% on the anniversary date of each grant for each of the next three years and have lives of no more than 10 years. Fair value was determined by reference to equity sold during the relevant period. Prior to 2002, Service Options were generally granted at fair market value at date of grant, vest 25% on the date of grant and 25% per annum thereafter and have lives of no more than 10 years. Exit Options become exercisable, if at all, on the date of the first occurrence of a change in control (a Vesting Event , as defined in the 2000 Plan) in which the majority shareholders receive an internal rate of return of at least 30%. If upon the first Vesting Event, the required internal rate of return is not achieved, they shall not become exercisable as a result of a Subsequent Vesting Event, as defined in the 2000 Plan.

In August 2004, the Company adopted the 2004 Stock Incentive Plan (the 2004 Plan ). The 2004 Plan provides for the award of (i) stock options (including incentive stock options), (ii) restricted stock and restricted units, (iii) stock appreciation rights, (iv) incentive stock and incentive units and (v) deferred shares and supplemental units. Awards may be made to directors, officers, employees and consultants. Any options issued will be priced at fair market value and the number of shares subject to such options and awards will be a maximum of 725,000 shares of the Company s common stock plus such number of options granted under the 2000 Plan as are forfeited under the 2000 Plan or which otherwise lapse after December 2004. To date, only stock options with exercise prices of the fair market value on the date of grant have been issued under the 2004 Plan. All such options vest in three equal annual installments from the date of grant, with accelerated vesting upon change of control, and have no conditions attached to exercise other than continued employment with the Company. These options expire 10 years after grant. Effective January 1, 2006, the Company has been recognizing compensation expense for stock options ratably over the vesting period of the option, adjusted for projected and actual forfeitures.

The fair value of options is estimated at the date of grant using the Black-Scholes option pricing model using assumptions for the risk-free interest rate, volatility factor and expected life as detailed in the table below. The volatility factor for options issued prior to the Company s initial public offering in December 2004 was based on the volatility of the Company s stock price as measured using the prices at which stock was bought while the Company remained private. The volatility factor used for options issued on or after the Company s initial public offering but before the December 31, 2005 was based on fluctuations in the stock price of comparable public companies. Effective January 1, 2006, the Company calculated the volatility of its own stock using the daily closing price for the period since its initial public offering and determined that this provided a reasonable estimate of future volatility. The Company believes that an expected life of four years is a reasonable assumption for a company whose stock is relatively volatile but does not currently have any history of options being exercised.

Table of Contents

| Options Issued in: | 2006 Q1 | 2005 | 2004 (post-IPO) | 2004 (pre-IPO) | 2003 |
|---|---|---|---|---|---|
| Black-Scholes Assumptions: | | | | | |
| Risk Free Interest Rate | 4.363% | 3.31% | 3.31% | 4.25% | 4.25% |
| Volatility Factor | 68.0% | 74.8% | 74.8% | 15.3% | 15.7% |
| Expected Life | 4 Years | 4 Years | 4 Years | 4 Years | 4 Years |
| Dividend Yield | Zero | Zero | Zero | Zero | Zero |

No stock options were issued by the Company in the three months ended June 30, 2006.

The Company makes an estimate of projected stock option forfeitures based on historical staff departures, adjusted for any one-time events which it does not believe will be representative of future periods.

A summary of stock option activity for the six months ended June 30, 2006 is shown in the table below.

| Stock Options | Shares | Exercise Price Range | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term (Years) | Aggregate Intrinsic Value (in thousands) |
|---|---|---|---|---|---|
| **Outstanding December 31, 2005** | **786,690** | **$ 5.70 - $27.60** | **$ 20.50** | | |
| Granted | 149,400 | $ 8.21 - $ 8.21 | $ 8.21 | | |
| Cancelled | (47,863) | $ 8.00 - $27.60 | $ 19.13 | | |
| **Outstanding March 31, 2006** | **888,227** | **$ 5.70 - $27.60** | **$ 14.30** | **7.51** | **$ 205** |
| Cancelled | (243,716) | $ 7.40 - $27.60 | $ 8.98 | | |
| **Outstanding June 30, 2006** | **644,511** | **$ 5.70 - $27.60** | **$ 16.32** | **6.69** | **$ 7** |
| **Exercisable at June 30, 2006** | **248,532** | **$ 8.04 - $27.60** | **$ 19.31** | **5.34** | **$ 0** |

The fair value of each of the 149,400 options granted in the six months ended June 30, 2006 was $4.48. No options have been exercised since the Company s initial public offering in December 2004. The Company will issue new shares in the event that any options are exercised. At June 30, 2006, 942,406 shares were available for future grants.

The Company recognized less than $0.1 million of stock compensation expense in relation to stock options in the three months ended June 30, 2006 and $0.2 million of such compensation expense in the six months ended June 30, 2006. The Company will recognize $0.3 million of compensation expense in the remaining six months of 2006, $0.5 million in 2007 and $0.3 million in 2008 with respect to stock options which were granted prior to June 30, 2006 but were not fully vested on that date, assuming that all such options do vest. Lower expense will be recorded to the extent that such options are cancelled prior to becoming fully vested and higher expenses will be recorded to the extent that the Company issues further stock options.

*Special Bonus Plan*

In December 2004, the Company allocated awards under its special bonus plan to officers and employees. These awards were made from a bonus pool with a value of $14.4 million, based on the initial public offering price for our common stock of $12.00 per share. All awards under this plan made with respect to this offering were made in restricted stock units representing a right to receive, in the aggregate, 1,200,000 shares of our common stock. Such awards generally vest in three equal installments on each of the first three anniversaries of the public offering. However, if Kelso & Company, or Kelso, the Company s largest shareholder, sells, in the aggregate, more than 25% of its shares of our common stock, such awards will vest in full upon such sale. Except as discussed below in relation to the award made to the Company s chief executive officer, the Company is expensing the value of these awards over a three-year period commencing December 2004, subject to acceleration in the event of a Kelso sale.

A large majority of the awards made under this plan will be subject to U.K. employer s national insurance tax, which is currently 12.8% of the value of the awards and which would be payable by the Company based on the market value of the stock on the date it becomes available for sale. The charge for the U.K. employer s national insurance tax will depend on the market price of our common stock when it is delivered and will have to be paid at the time the stock is issued to the award holders.

The award to the Company s chief executive officer, representing 35% of the bonus pool, or restricted stock units with a value of $5.0 million at the initial public offering price of $12.00 per share, will vest whether or not he remains employed by the Company unless (a) he is terminated for cause (as defined in his employment agreement), (b) his employment agreement is not extended for cause or (c) he terminates his employment in circumstances that justify termination for cause. The value of the award to the Company s chief executive officer, plus the U.K. estimated employer s national insurance tax of 12.8% payable by the Company, was expensed in December 2004.

Until December 31, 2005, the Company accounted for these issued units under APB 25 whereby the fair value of these units at the issuance date is expensed over the vesting period. In adopting SFAS 123(R) effective January 1, 2006, the Company has continued to use the same fair value assumption for these units. The Company has considered likely future forfeitures of awards made under this plan and, in doing so, has divided the recipients into two categories: executive management which holds 92% of the award and other employees which hold 8% of the awards. The Company believes that it is highly unlikely that any of the executive management will forfeit any of their awards under this plan prior to vesting and has, therefore, applied a staff turnover assumption of zero to this category. It has applied the same staff turnover percentage as is being used for stock options to the other employees category. The result of applying these forfeiture assumptions is immaterial and no cumulative effect of accounting change has been reported as a result of the adoption of SFAS 123(R) with respect to this plan.

In the three months and six months ended June 30, 2006, the Company charged $0.8 million and $1.6 million, respectively, to operating expenses in relation to awards to bonus holders other than the Company s chief executive officer. There was a reduction of the liability which had been accrued at December 31, 2005 for U. K. national insurance tax on special bonus plan awards due to a decline in the Company s share price between December 31, 2005 and June 30, 2006 and a charge in relation to U.K. national insurance tax on awards which were expensed in the six months ended June 30, 2006. The net of these two amounts was $0.1 million and so no net charge of this amount was made in relation to U. K. national insurance tax on special bonus plan awards in the three and six months ended June 30, 2006.

The U.K. national insurance tax accrual on special bonus plan awards will continue to vary depending on the share price at the end of each quarter, the vesting schedule, the current U. K. employer s national insurance tax rate and whether or not award holders become subject to, or continue to be subject to, U.K. national insurance tax.

**8. Commitments and Contingencies**

In January 2005, Sunnyside Development Company filed a complaint against Opsys Limited and a company named by Sunnyside Development as CDT Limited, which is presumably intended to refer to one of the Company s subsidiaries, Cambridge Display Technology Limited, in California Supreme Court alleging breach of contract and fraud arising out of an alleged property lease agreement between Opsys Limited and Sunnyside Development. Sunnyside Development seeks compensatory damages that it claims exceed $10 million (principally by way of unpaid rent and other costs associated with the lease) and punitive damages in the amount of $25 million.

In February 2005, the action was removed to the United States District Court for the Northern District of California. In April 2005, the United States District Court dismissed all the claims against CDT Limited and the claim for fraud against Opsys Limited, but gave Sunnyside permission to amend all its claims. On May 11, 2005, Sunnyside filed an amended complaint reasserting breach of contract and fraud claims against both Opsys Limited and CDT Ltd. The Company made a further application to dismiss the claims and on August 8, 2005 the amended claims against CDT Limited and Opsys Limited were dismissed with prejudice and with no leave to amend, except for the claim for breach of contract against Opsys Limited. On January 17th, 2006 Sunnyside Development filed a Second Amended Complaint for breach of contract against Opsys Limited only.

Cambridge Display Technology Limited was not party to the lease and prior to the Company s acquisition of an interest in certain of the activities of Opsys in October 2002, Opsys Limited and Sunnyside Development executed an Assignment of Lease and Consent of Lessor, which included a release of Opsys Limited by Sunnyside Development. The Company therefore believes that the claim has no merit. The Company further believes that the claim for punitive damages is no longer valid since the claim for fraud has been dismissed.

Table of Contents

The Company therefore expects to defend the remaining claim. Fact discovery is ongoing and scheduled to close on September 8, 2006. The matter is scheduled for trial in February 2007.

Under the terms of a contract research agreement between Merck OLED, formerly known as Covion Organic Semiconductors, and the Company, the Company was obligated to provide the equivalent of ten full service equivalent scientists and engineers to work on research and development projects related to P-OLED materials until December 2006. The Company receives royalties from Merck OLED based on the revenues for all Merck OLED s sales of P-OLED materials, whether or not those materials were developed by the project team. These royalties were payable pursuant to the contract research agreement and a separate intellectual property license. Until June 30, 2006, the royalties received from Merck OLED were less than the costs of funding the project team and such excess costs were expensed. In July 2006, Merck OLED and the Company agreed to terminate the contract research agreement but the intellectual property license remains in force.

On the basis of facts presently known, the Company is not involved in any other legal proceedings which could have a material adverse effect on the Company s financial condition, liquidity or results of operations.

*Commitments*

In March 2006, the Company cancelled its line of credit from Lloyds TSB which had been secured by a letter of credit arranged by IPI Financial Services. As a result of this cancellation, the Company has been released from its obligations to pay certain fees to both Lloyds TSB and IPI Financial Services, to report the filing of any new patents, trademarks and copyrights and add those to the existing intellectual property portfolio which has been assigned as security to IPI Financial Services and to maintain the validity of all of its patents and only to license such patents to third parties under terms which are within the parameters of its customary licensing practices or to which IPI Financial Services has provided its consent.

**8. Subsequent Events**

In July 2006, pursuant to contractual arrangements which had been entered into in March 2005, the Company delivered a license to certain intellectual property to Add-Vision, Inc. in consideration for which it was issued with shares of preferred stock. Prior to this transaction, the Company had a 31% voting interest and a 42% ownership interest in Add-Vision, Inc. After the transaction, the Company had a 42% voting interest and a 55% ownership interest in Add-Vision, Inc.

Table of Contents

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

*The following discussion of our financial condition and results of operations should be read together with the consolidated financial statements and related notes that are included elsewhere in this Quarterly Report on Form 10-Q. This discussion may contain forward-looking statements based upon current expectations that involve risks and uncertainties. Our actual results may differ materially from those expected in these forward-looking statements as a result of various factors, including those set forth under Risk Factors in Item 1A of Part II below or elsewhere in this Quarterly Report on Form 10-Q.*

**Overview**

We are a pioneer in the development of P-OLEDs and their use in next-generation flat panel displays and other applications. The fundamental discoveries relating to our P-OLED materials were made by a team of researchers at the Cavendish laboratories at the University of Cambridge in 1989 that included Dr. Jeremy Burroughes, our Chief Technical Officer. Since our inception in 1992, we have focused on continuing research and development related to the production, manufacturing and commercialization of P-OLED technology in the flat panel display and other industries. Our revenues are primarily generated from the licensing of rights to use our IP portfolio, from ongoing product royalties, from fees generated from transfer of technology, from joint technology development agreements and from the sale of ink jet printing equipment, display test equipment and polymer inks.

We sold our first P-OLED license in 1996 to Royal Philips Electronics and currently have nine device licensees, three materials licensees and two component licensees and are working with a number of additional display manufacturers through joint technology development programs and informal relationships. We recognized our first royalty revenues in 2002 when commercial consumer electronics products began incorporating our P-OLED technology. Currently, our P-OLED technology is being used in mobile phones, MP3 players, medical equipment and other applications.

While we have made significant progress over the past few years in advancing our P-OLED technology, we have incurred significant losses and will continue to do so unless our P-OLED technology becomes more widely adopted and commercialized by flat panel display manufacturers. As of June 30, 2006, we had an accumulated deficit of $180.3 million, in large part due to the research and development expenditures we have incurred. Our total research and development expenditures since 1999 exceed $94 million.

Our business objective is to license our technology to leading display manufacturers and to generate royalties based on the sales of their products. As a pre-cursor to our licensing and royalty business we sell technology services, development services, ink jet printing equipment and polymer inks to companies working on P-OLED technology. We market our P-OLED IP and technology by building relationships with established and new entrant flat panel display manufacturers. This may involve developing relationships at a senior level over a period of years. Some manufacturers purchase a license from us at an early stage in their P-OLED development program. Other manufacturers begin their efforts to develop products using our P-OLED technology by working with us through a series of informal meetings, then by entering, either publicly or confidentially, into a formal technology development or technology transfer program which may culminate in the purchase of a license from us.

In order to accommodate our many current and potential Asian licensees and partners, we maintain representative offices in Japan and Taiwan. Two of our senior executives are based in Japan, one of whom is seconded to Sumation, our 50%-owned joint venture with Sumitomo Chemical. Other senior executives, including our Chief Executive Officer, travel frequently from our corporate offices to Asia and other destinations in order to develop our relationships with both existing and potential new licensees.

We believe that the key factors that will contribute to the successful execution of our strategy are:

- the further development of P-OLED materials and device structures in order to increase the commercial lifetimes of P-OLED products;

- the further development of ink jet printing equipment and process, and other deposition processes, so that mass production of full color P-OLED displays can be demonstrated;

- the further development of other technologies required for P-OLED displays, in particular active matrix thin film transistor display drivers; and

- the adoption of P-OLED technology by increasing numbers of existing and potential future display manufacturers.

Management monitors performance in achieving these goals by reference to internal and external technology developments. Progress in the other areas is demonstrated by the increasing service lifetimes of our P-OLED materials, the size of demonstration displays being exhibited by ourselves and display manufacturers, the increasing number of companies which are working with us on technology services and development projects and increasing revenues from these projects.

Table of Contents

Although we believe that P-OLED display technology has the potential to enable displays to be manufactured at lower cost than competing LCD technology, this cost advantage will not be realized until P-OLED technology is proved in volume manufacturing. LCD manufacturing companies continue to strive to reduce unit manufacturing costs and such cost reductions will make it more difficult for P-OLED technology to penetrate the market, although we believe that the simpler structure of P-OLED display devices compared to LCD will mean that, ultimately, P-OLED displays will be cheaper to produce.

We believe that the flat panel display, or FPD, market will remain price sensitive. Limited penetration of P-OLED displays will be possible if there is a price premium, but we believe that any such premium will have to erode and that production costs at volume will have to be lower for P-OLED than for competing technologies in order that P-OLED products can take significant market share.

The commercial exploitation of P-OLED technology is not limited to display applications. In March 2006, Seiko Epson Corporation announced that they had succeeded in creating a print head that uses OLED as a high brightness light source. We believe that this opens the way for utilization of P-OLED as a new technology for printers and will potentially lead to the manufacture of color printers that are smaller, have higher resolution and faster printing speeds. Other companies are conducting research and development into lighting applications for P-OLED technology.

In reading our financial statements, you should be aware of the following factors and trends that our management believes are important in understanding our financial performance:

- because our license fees often consist of large one-time payments and our royalties for the foreseeable future are expected to be smaller, recurring payments, we expect fluctuations in these revenues depending on the periods in which we enter into new licenses;

- we continue to invest significant resources in research and development in order to develop and effectively demonstrate our technology so that it can be commercialized in a growing number of applications, which is indicated by our total research and development expenditures in the first six months of 2006 of $ 6.3 million;

- we expect that our future royalties will be impacted by the extent to which we continue to enter into new technology development agreements and existing technology development partners enter into commercial licenses for use of our P-OLED technology; and

- we expect that our future royalties will be impacted by the extent to which our existing licensees expand the use of our P-OLED technology in commercial applications in consumer and industrial electronic products.

Table of Contents

**Results of Operations**

***Comparison of Three and Six Months Ended June 30, 2006 and June 30, 2005***

**Operating Revenues**

| ***(in thousands, except percentages)*** | **Three months ended June 30, 2006** | **Three months ended June 30, 2005** | **% Increase / (Decrease)** | **Six months ended June 30, 2006** | **Six months ended June 30, 2005** | **% Increase / (Decrease)** |
|---|---|---|---|---|---|---|
| License fees and royalties | $ 2,002 | $ 994 | 101% | $ 2,081 | $ 1,123 | 85% |
| Technology services and development | 683 | 1,678 | (59)% | 1,381 | 3,110 | (56)% |
| Equipment and supplies | 12 | | N/A | 270 | | N/A |
| **Total operating revenues** | **$ 2,697** | **$ 2,672** | **1%** | **$ 3,732** | **$ 4,233** | (12)% |

License fees and royalties revenues increased by $1.0 million, or 101%, from $1.0 million in the second quarter of 2005 to $2.0 million in the second quarter of 2006. This increase was attributable to a license fee of $1.0 million recognized in the second quarter of 2006 in relation to the licensing of intellectual property rights and the balance in each quarter comprised royalties received from four licensees in the second quarter of 2006 and five licensees in the second quarter of 2005.

License fees and royalty revenues increased by $1.0 million, or 85%, from $1.1 million in the first six months of 2005 to $2.1 million in the first six months of 2006 for the same reasons as described in the previous paragraph Royalty revenues were received from six licensees in both periods.

Technology services and development revenues declined by $1.0 million, or 59%, from $1.7 million in the second quarter of 2005 to $0.7 million in the second quarter of 2006 because revenue was received from Sumitomo Chemical in the second quarter of 2005 but no corresponding revenue was received from Sumitomo Chemical in the second quarter of 2006, due to the establishment of Sumation, our 50%-owned joint venture with Sumitomo Chemical, in November 2005 and the termination of the contract research arrangements with Sumitomo Chemical which had previously applied. Technology services and development revenues were received from seven customers during each of the second quarters of 2006 and 2005.

Technology services and development revenues declined by $1.7 million, or 56%, from $3.1 million in the first six months of 2005 to $1.4 million in the first six months of 2006 because of lower revenues from Sumitomo Chemical, as described in the previous paragraph. Technology services and development revenues were received from seven customers during each of the second quarters of 2006 and 2005.

Equipment and supplies revenue was less than $0.1 million in the second quarter of 2006 and $0.3 million in the first six months of 2006 compared with zero in the second quarter and first six months of 2005.

Samsung Electronics and Osram Opto each accounted for in excess of 10% of our revenues in both the second quarter and the first six months of 2006.

15

Table of Contents

**Cost of Sales**

| *(in thousands, except percentages)* | **Three months ended June 30, 2006** | **% of Revenues *** | **Three months ended June 30, 2005** | **% of Revenues *** | **Six months ended June 30, 2006** | **% of Revenues *** | **Six months ended June 30, 2005** | **% of Revenues *** |
|---|---|---|---|---|---|---|---|---|
| License fees and royalties | $ 11 | 1% | $ 12 | 1% | $ 12 | 1% | $ 13 | 1% |
| Technology services and development | 270 | 40% | 649 | 39% | 486 | 35% | 1,124 | 36% |
| Equipment and supplies | 11 | 92% | | | 169 | 63% | | |
| **Total cost of sales** | **$ 295** | **11%** | **$ 661** | **25%** | **$ 670** | **18%** | **$ 1,137** | **27%** |
| **Gross profit** | **$ 2,405** | **89%** | **$ 2,011** | **75%** | **$ 3,065** | **82%** | **$ 3,096** | **73%** |

* the percentages shown in these columns represent each Cost of sales figure divided by the corresponding Revenue figure from the Operating Revenues table above

Cost of sales related to License fees and royalties was 1% of related sales in the both the second quarters and the first six months of both 2006 and 2005. This comprises payments made to third parties from whom we have acquired intellectual property. We expect that cost of sales for License fees and royalties will average between 1% and 2% of related sales in the future.

Cost of sales related to Technology services and development increased from 39% in the second quarter of 2005 to 40% in the second quarter of 2006 and decreased from 36% in the first six months of 2005 to 35% in the first six months of 2006. Although the cost of sales percentage will fluctuate from quarter to quarter due to the differing requirements of revenue generating projects, we believe that the percentage reported in the second quarter of 2006 will be broadly representative of future periods.

Cost of sales related to Equipment and supplies revenues was 92% of related sales for the second quarter of 2006 and 63% of related sales for the first six months of 2006. There were no revenues or costs for Equipment and supplies in the first six months of 2005. We believe that cost of sales as a percentage of revenue for Equipment and supplies reported in the first six months of 2006 will be representative of future quarters.

Gross profit increased by $0.4 million, or 20%, from $2.0 million in the second quarter of 2005 to $2.4 million in the second quarter of 2006 and was $3.1 million in the first six months of both 2005 and 2006. The aggregate margin percentage was higher in each of the second quarter and the first six months of 2006 because of the revenue mix: a higher proportion of our revenues in each of the second quarter and the first six months of 2006 came from higher margin revenue categories compared with the second quarter and the first six months of 2005.

We only charge direct labor cost and variable cost of materials associated with each revenue-generating project to cost of sales and do not charge any allocation of fixed cost overheads. Therefore, relatively high margins are required, for both Technology services and development and Equipment and supplies, in order for the related contracts to make a contribution to our fixed costs, including our research and development costs.

**Table of Contents**

**Operating Expenses**

| *(in thousands, except percentages)* | **Three months ended June 30, 2006** | **Three months ended June 30, 2005** | **% Increase / (Decrease)** | **Six months ended June 30, 2006** | **Six months ended June 30, 2005** | **% Increase / (Decrease)** |
|---|---|---|---|---|---|---|
| Research and development expenses | 3,210 | 4,184 | (23)% | 6,305 | 8,164 | (23)% |
| Selling, general and administrative expenses | 3,605 | 4,358 | (17)% | 7,574 | 8,383 | (10)% |
| Amortization of intangibles acquired | 395 | 395 | | 790 | 790 | |
| **Total Operating Expenses** | **$ 7,210** | **$ 8,937** | **(19)%** | **$ 14,669** | **$ 17,337** | **(15)%** |

Our research and development expenses decreased by $1.0 million, or 23%, from $4.2 million in the second quarter of 2005 to $3.2 million in the second quarter of 2006 because of:

- a decrease of $1.9 million due to costs being reimbursed by Sumation, our 50%-owned joint venture with Sumitomo Chemical (this level of reimbursement is likely to continue in future periods);
- an increase of $0.5 million due to government grants received in the second quarter of 2005 versus zero in the second quarter of 2006;
- an increase of $0.1 million in stock compensation expense;
- a decrease of $0.1 million due to lower expenditures on research projects; and
- an increase of $0.4 million due to less of the cost of the research and development function being charged to revenue generating projects and correspondingly more being charged to Research and development expense, which $0.4 million increase was due to $0.9 million of such cost in the second quarter of 2005 compared with $0.5 million of such cost in the second quarter of 2006 incurred on activities which were similar in nature to research and development but which directly supported revenue-generating projects and were not therefore classified as Research and development expenses.

Our research and development expenses decreased by $1.9 million, or 23%, from $8.2 million in the first six months of 2005 to $6.3 million in the first six months of 2006 because of:

- a decrease of $3.7 million due to costs being reimbursed by Sumation, our 50%-owned joint venture with Sumitomo Chemical (this level of reimbursement is likely to continue in future periods);
- an increase of $0.6 million due to government grants received in the first six months of 2005 versus zero in the first six months of 2006;
- an increase of $0.2 million in stock compensation expense; and
- an increase of $1.0 million due to less of the cost of the research and development function being charged to revenue generating projects and correspondingly more being charged to Research and development expense, which $1.0 million increase was due to

$1.7 million of such cost in the first six months of 2005 compared with $0.7 million of such cost in the first six months of 2006 incurred on activities which were similar in nature to research and development but which directly supported revenue-generating projects and were not therefore classified as Research and development expenses.

Research and development expenses will continue to vary from quarter to quarter due to the specific requirements of the projects being carried out in any quarter.

Our selling, general and administrative expenses decreased by $0.8 million, or 17%, from $4.4 million in the second quarter of 2005 to $3.6 million in the second quarter of 2006 because of:

a decrease of $0.3 million due to lower stock compensation expense due primarily to a reversal of the expense accrued in prior periods with respect to unvested stock options which were forfeited when the option holders ceased being employed by us;

a decrease of $0.2 million due to administrative expenses being re-imbursed by Sumation, our 50%-owned joint venture with Sumitomo Chemical, a level of reimbursement which is expected to continue in future periods; and

a decrease of $0.3 million in relation to reductions in a number of expense items, the most significant of which was a $0.1 million decrease in relation to our line of credit which was terminated by us in the first quarter of 2006.

Table of Contents

Our selling, general and administrative expenses decreased by $0.8 million, or 10%, from $8.4 million in the first six months of 2005 to $7.6 million in the first six months of 2006 because of:

- a decrease of $0.2 million due to lower stock compensation expense due primarily to a reversal of the expense accrued in prior periods with respect to unvested stock options which were forfeited when the option holders ceased being employed by us;

- a decrease of $0.3 million due to administrative expenses being re-imbursed by Sumation, our 50%-owned joint venture with Sumitomo Chemical, a level of reimbursement which is expected to continue in future periods; and

- a decrease of $0.3 million in relation to reductions in a number of expense items, the most significant of which was a $0.1 million decrease in relation to our line of credit which was terminated by us in the first quarter of 2006.

Our amortization of intangibles acquired remained constant at $0.4 million in each of the second quarters of 2005 and 2006 and $0.8 million in each of the first six months of 2005 and 2006.

**Other Income / (Expense)**

| *(in thousands, except percentages)* | **Three months ended June 30, 2006** | **Three months ended June 30, 2005** | **Six months ended June 30, 2006** | **Six months ended June 30, 2005** |
|---|---|---|---|---|
| *(in thousands, except percentages)* | | | | |
| Equity in loss of affiliates | (1,599) | $ 191 | $ (3,014) | $ (1,410) |
| Foreign currency transaction gain / (loss) | 489 | (172) | 276 | (94) |
| Other income / (expense) | 357 | (373) | 610 | (789) |
| Interest income | 304 | 191 | 561 | 361 |
| **Total (Expense) / Income** | **$ (449)** | **$ (163)** | **$ (1,567)** | **$ (1,932)** |

*Equity in loss of affiliates:* Equity in loss of affiliates in the first six months of 2005 included 50% of the losses of Litrex Corporation, or Litrex. We ceased reporting any equity in loss in relation to Litrex in November 2005 following the sale of our remaining equity stake. Also in November 2005, we acquired a 50% interest in Sumation and the Equity in loss reported for the first six months of 2006 relates to our 50% interest in Sumation. We expect to continue reporting losses for Sumation in future periods. Sumation s revenues to customer other than ourselves were $0.5 million for the second quarter of 2006 and $1.0 million for the six months ended June 30, 2006.

*Foreign currency transaction gain / (loss):* Currency losses in the first six months of 2005 primarily resulted from the revaluing of assets and liabilities denominated in currencies other than U.S. dollars. We would expect a gain from such revaluations in 2006 if the U.S. dollar weakens versus the British pound during the year and a loss if it strengthens since our British pound assets exceed our British pound liabilities. The gain reported in the first six months of 2006 was primarily due to gains realized on the revaluation of bank balances held in British pounds.

*Other income / (expense):* The loss of $0.8 million reported in the first six months of 2005 related to unrealized losses in the value of forward exchange contracts, which we had taken out in order to economically hedge future British pound expenses. The gain of $0.6 million in the first six months of 2006 relates to the reversal of unrealized losses on these contracts which had been reported in prior periods. We expect to realize a loss of $0.1 million in the third quarter of 2006 due to the reversal of unrealized gains on these contracts as at June 30, 2006. We are not currently intending to take out additional forward exchange contracts and all existing contracts will have matured by September 30, 2006.

*Interest income:* Interest income increased by $0.2 million from $0.4 million in the first six months of 2005 to $0.6 million in the first six months of 2006 due to higher average cash balances.

Our benefit for income taxes fell from $0.8 million in the first six months of 2005 to $0.6 million in the first six months of 2006. A benefit is shown because we surrender tax losses which related to certain research and development expenditures to the U. K. tax authorities in return for a cash payment. The amount of benefit we can accrue is reduced to the extent that such expenses support revenue-generating contracts and this amount is lower in the first quarter of 2006 because we are not able to claim any benefit in relation to research and development costs which are re-imbursed by Sumation, our 50%-owned joint venture company with Sumitomo Chemical.

Table of Contents

Our net loss decreased by $1.7 million from $6.7 million in the second quarter of 2005 to $5.0 million in the second quarter of 2006 because higher Gross profit, lower Total operating expenses, higher Interest income and higher gains related to foreign exchange movements more than offset the increase Equity in loss of affiliates and decrease in tax benefit, as described above. Our net loss decreased by $2.8 million from $15.4 million for the first six months of 2005 to $12.6 million in the first six months of 2006 for the same reasons.

**Liquidity and Capital Resources**

| *(in thousands)* | Six months ended June 30, 2006 | 2005 |
|---|---|---|
| **Summary Cash Flow** | | |
| Net loss | $ (12,605) | $ (15,378) |
| Non-cash items | 8,149 | 6,553 |
| Changes in operating assets and liabilities | 1,616 | 925 |
| **Net cash used in operating activities** | **$ (2,840)** | **$ (7,900)** |
| Acquisition of fixed and intangible assets | $ (557) | $ (1,010) |
| Acquisition of equity interests | (4,886) | (1,127) |
| Loans to affiliates | | (1,715) |
| Investments in marketable securities | (1,874) | |
| **Net cash used in investing activities** | **$ (7,317)** | **$ (3,852)** |
| **Cash used in financing activities** | | **$ (67)** |
| **Net decrease in cash** | **$ (10,157)** | **$ (11,819)** |
| **Cash at December 31, 2005 and 2004** | **$ 31,263** | **$ 26,892** |
| **Cash at June 30, 2006 and 2005** | **$ 21,106** | **$ 15,073** |
| Current Marketable Securities at June 3, 2006 and 2005 | $ 1,874 | |
| **Cash and Current Marketable Securities at June 30, 2006 and 2005** | **$ 22,980** | **$ 15,073** |

Net cash used in operating activities decreased by $5.1 million from $7.9 million in the first six months of 2005 to $2.8 million in the first six months of 2006 due to:

- a decrease of $2.7 million due to lower operating expenses;
- a decrease of $1.8 million due to foreign currency gains and losses and other income and expense related to the revaluation of foreign exchange contracts;
- a decrease of $0.2 million due to an increase in interest income;
- an increase of $0.2 million due to taxation; and

a decrease of $0.6 million due to changes in operating assets and liabilities.

In the first six months of 2005 we invested $1.1 million in Add-Vision Inc, a California company. We have not made additional investments since then but may do so in future periods. In the first six months of 2006 we invested $4.9 million in Sumation and are committed to investing a further $3.2 million during 2006 and 2007. We expect to provide funding in excess of the amounts we have already committed in future periods. The amount of funding required by Sumation will be dependent on the extent to which Sumation is able to fund its activities from sales of P-OLED materials. Sumation funds some of our research and development activities and we expect to receive more in reimbursements from Sumation than we will invest in the funding of Sumation.

We have $1.9 million invested in certificates of deposit with maturities of more than 90 days but less than one year. We anticipate holding these investments to maturity.

Table of Contents

We expect, based on our internal forecast and assumptions relating to our operations (including, among others, assumptions regarding our working capital requirements, the progress of our research and development efforts and revenues) that we have sufficient cash to meet our obligations for at least the next 12 months. Until March 2006 we had a line of credit for a maximum amount of $15.0 million, of which $0.5 million could not be borrowed. We have had no drawings under this line of credit since December 2004 and, in March 2006, we determined that it was no longer cost effective to retain this facility and we terminated the line of credit at that time.

During 2005 we entered into a number of forward exchange contracts to sell U.S. dollars and buy British pounds in order to fund our U. K. operating expenses during 2006. Under the terms of these contracts, if the spot exchange rate as each contract matures is higher than an agreed protection rate we will sell the U.S. dollars at that rate. If the spot exchange rate as each contract matures is lower than the protection rate we will sell half of the contracted U.S. dollars at that rate and half at the spot exchange rate. The purpose of these transactions is to limit the risk of adverse exchange rate fluctuations while retaining some benefit in the event of favorable fluctuations. At June 30, 2006, we had outstanding contracts covering each of the months from July to September 2006 each for an amount of $1.75 million and at exchange rates of between 1.80 and 1.83 U. S. dollars to one British Pound. We are no longer entering into such contracts but may do so in the future. These contracts were not designated as hedging instruments and, therefore, gains and losses are recognized immediately in earnings during the period.

In February 2006 we outsourced responsibility for managing our cash investments and foreign exchange conversion requirements to Schroder Investment Management Limited, or Schroders, a professional treasury management firm. We now sell U. S. dollars and buy British pounds at spot exchange rates based on our cash requirement projections and advice as to the timing of such transaction provided by Schroders.

**Critical Accounting Policies**

*General*

The discussion and analysis of our financial condition and results of operations are based on our consolidated financial statements. The preparation of these statements requires us to make certain estimates and judgments that affect the statement of operations, balance sheet, cash flow or disclosures relating to contingent assets or liabilities. Our actual results might, under different assumptions and conditions, differ from our estimates. Significant estimates include the valuation of our goodwill, lives of our long-lived assets and estimates related to the delivery of know-how and services under technology services contracts. The following is an update of the discussion of our critical accounting policies set forth in our 2005 Form 10-K. For a complete discussion of our most critical accounting policies, as well as the estimates and judgments involved, refer to Critical Accounting Policies and Significant Developments and Estimates under Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations, of our 2005 Form 10-K.

*Stock Based Compensation*

As explained in Note 7 to our consolidated financial statements, we followed APB 25 and related interpretations in accounting for stock options through December 31, 2005. Accordingly, we recognized no compensation expense with respect to options granted to employees in the second quarter and first six months of 2005.

Effective January 1, 2006, we adopted SFAS 123(R), which replaces SFAS123 and supersedes APB 25, and started recorded compensation expense with respect to unvested stock options using the modified prospective method. We have continued using the Black-Scholes model to calculate the fair value of stock option awards. Prior to December 2004, we issued some options which could only vest if a specified rate of return was made by our largest shareholders but, since December 2004, no such conditions have applied to any of our stock option awards. We are using similar assumptions to those we used previously when applying this model with the exception that, instead of basing our volatility assumption solely on the historic volatility of stocks comparable to ours, we use the historic volatility of our own stock as a guide to assist us in making a reasonable determination of expected future volatility.

We have made no modifications to the terms of any stock option awards prior to the adoption of SFAS 123(R). We will continue to calculate vesting using the straight line method over the requisite service period.

In adopting SFAS 123(R) we have taken account of projected future stock option forfeitures when calculating stock option compensation expense which was not included in determining the pro forma expense discussed above.

SFAS 123(R) also applies to our special bonus plan pursuant to which restricted stock units were issued to employees in December 2004. We have charged the fair value of these units to compensation expense over their vesting period, other than with

20

Table of Contents

respect to those units issued to our Chief Executive Officer which were charged to compensation expenses in the period in which they were issued. The application of SFAS 123(R) has not had a material impact on the expense recorded in relation to these restricted stock units.

We recognized $0.2 million of compensation expense in relation to stock options in the first six months of 2006, all of which was recognized in the first quarter due to a significant number of options being forfeited in the second quarter. We will recognize $0.3 million of compensation expense in the remaining six months of 2006, $0.5 million in 2007 and $0.3 million in 2008 with respect to stock options which were granted prior to June 30, 2006 but were not fully vested on that date, assuming that all such options do vest. Lower expense will be recorded to the extent that such options are cancelled prior to becoming fully vested and higher expense will be recorded to the extent that we issue further stock options.

Table of Contents

**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

A majority of our revenues are denominated in U.S. dollars. These revenues include royalties based on revenues or production costs of our licensees that may be denominated in U.S. dollars or other currencies. Where such revenues or productions costs of our licensees are denominated in other currencies, they are converted to U.S. dollars for the purpose of calculating any licensing royalties due to us. Our licensing royalty revenues may decrease as a result of any appreciation of the U.S. dollar against these other currencies.

The majority of our current expenditures are incurred in British pounds in order to fund our operations in the United Kingdom. If the U. S. dollar depreciates versus the British pound, additional U.S. dollars will be required to fund our operations in the United Kingdom. For example, a change in the rate at which we exchange U.S. dollars to British pounds from 1.8 to 1.9 would, at the current rate of expenditure, cost us approximately an additional $1 million per year.

**Item 4. Controls and Procedures**

(a) ***Evaluation of disclosure controls and procedures.*** The Company s management, with the participation of the Company s Chief Executive Officer and Vice-President Finance, has evaluated the effectiveness of the Company s disclosure controls and procedures as of June 30, 2006. Based on that evaluation, the Company s Chief Executive Officer and Vice-President Finance concluded that the Company s disclosure controls and procedures were effective as of June 30, 2006.

(b) ***Changes in internal control over financial reporting***. Daniel Abrams, Chief Financial Officer, resigned on June 30, 2006 and his responsibilities were assumed on July 3, 2006 by Michael Black, Vice-President, Finance as Principal Financial Officer. As a result of this change and in order to maintain effective internal control over financial reporting, responsibilities for operating certain financial controls were reallocated within the finance department in order to preserve adequate segregation of duties. There were no other changes in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) identified in connection with the evaluation described in Item 4(a) above that occurred during the quarter ended June 30, 2006 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents

## PART II. OTHER INFORMATION

### Item 1. Legal Proceedings

In January 2005, Sunnyside Development Company filed a complaint against Opsys Limited and a company named by Sunnyside Development as CDT Limited, which is presumably intended to refer to one of our subsidiaries, Cambridge Display Technology Limited, in the California Supreme Court alleging breach of contract and fraud arising out of an alleged property lease agreement between Opsys Limited and Sunnyside Development. Sunnyside Development asserted compensatory damages that it claims exceed $10 million (principally by way of unpaid rent and other costs associated with the lease) and punitive damages in the amount of $25 million.

In February 2005, the action was removed to the United States District Court for the Northern District of California. In April 2005, the United States District Court dismissed all the claims against CDT Limited and the claim for fraud against Opsys Limited, but gave Sunnyside Development permission to amend all its claims. On May 11, 2005, Sunnyside Development filed an amended complaint reasserting breach of contract and fraud claims against both Opsys Limited and CDT Ltd. We made a further application to dismiss the claims and on August 8, 2005 the amended claims against CDT Limited and Opsys Limited were dismissed with prejudice and with no leave to amend, except for the claim for breach of contract against Opsys Limited. On January 17, 2006 Sunnyside Development filed a second amended complaint for breach of contract against Opsys Limited only, which is still being pursued by Sunnyside Development.

Cambridge Display Technology Limited was not party to the lease and prior to our acquisition of an interest in certain of the activities of Opsys in October 2002, Opsys Limited and Sunnyside Development executed an Assignment of Lease and Consent of Lessor, which included a release of Opsys Limited from its obligations under the lease by Sunnyside Development. We therefore believe that the claim has no merit. We further believe that the claim for punitive damages is no longer valid since the claim for fraud has been dismissed.

We expect to defend the action. Fact discovery is ongoing and scheduled to close on September 8, 2006. The action is scheduled for trial in February 2007.

We review any outstanding claims against us with internal and, if deemed appropriate, external legal counsel to assess the probability and estimates of loss. We reassess the risk of loss as new information becomes available and we adjust liabilities, if any, as appropriate. The actual cost of resolving any claims may be substantially different from the amounts of liability recorded. We have not recorded any liability with respect to the action by Sunnyside Development described above.

Table of Contents

### Item 1A. Risk Factors

*An investment in our common stock involves a high degree of risk. You should carefully consider the risks and uncertainties described below together with all of the other information included in this Quarterly Report on Form 10-Q and our 2005 Form 10-K before making an investment decision. If any of the following risks or uncertainties actually occurs, our business, financial condition or results of operations could suffer. In that case, the trading price of our common stock could decline, and you may lose all or part of your investment. This Quarterly Report on Form 10-Q also contains forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from those expected in those forward-looking statements as a result of certain factors, including the risks and uncertainties faced by us described below and elsewhere in this Quarterly Report on Form 10-Q and our 2005 Form 10-K.*

**Risks Relating to Our Business and Industry**

***We have a history of losses, do not expect to be profitable in the foreseeable future and may never be profitable.***

Since inception, we have generated limited revenues while incurring significant losses. We expect to incur losses for the foreseeable future until such time, if ever, as we are able to achieve sufficient levels of revenue from the commercial exploitation of our P-OLED technology to support our operations. You should note that:

- P-OLED technologies may never be broadly commercially adopted;
- markets for FPD using P-OLED technologies may be limited; and
- we may never generate sufficient revenues from the commercial exploitation of our P-OLED technology to become profitable.

We license our P-OLED technology to P-OLED materials manufacturers and display manufacturers, which then incorporate our technology into the materials and products they sell. Even if we and our display manufacturer licensees develop commercially viable applications for our P-OLED technologies, we may never recover our research and development expenses. We have had significant net losses in previous periods and expect to report net losses in future periods, and as of June 30, 2006, we had an accumulated deficit of $180.3 million. We cannot predict what impact continued net losses might have on our ability to finance our operations in the future or on the market value of our common stock.

***Because we are at an early stage of development and have a limited operating history, our future results are unpredictable.***

Our future success is uncertain because we have a limited operating history and face many risks and uncertainties. If we are unsuccessful in addressing these risks and uncertainties, we may be unable to generate sufficient revenue growth to support ongoing operations. We were formed in 1992 to research and develop P-OLED technology. We began licensing P-OLED technology to original equipment manufacturers, or OEMs, in 1996, and in 2002 this technology was initially commercialized. Accordingly, there is only a limited amount of past experience upon which to evaluate our business and prospects, and a potential investor should consider the challenges, expenses, delays and other difficulties involved in the development of our business, including the continued development of our P-OLED technology, refinement of processes and components for commercial products using our P-OLED technology, formation of additional commercial relationships and achievement of market acceptance for products using P-OLED technology.

***If our P-OLED technology is not feasible for broad-based product applications, we may never generate revenues sufficient to support ongoing operations.***

Before manufacturers of displays and other products which use our P-OLED technology will agree to use this technology for wide-scale commercial production, they will likely require us to demonstrate to their satisfaction that our P-OLED technology is feasible for their particular product applications. This, in turn, would require additional advances in our research and development efforts, as well as those of others, for applications in a number of areas, including:

device reliability;

the development of P-OLED materials with sufficient lifetimes, brightness and color coordinates for the applications in question; and

issues related to scalability and cost-effective fabrication technologies.

Table of Contents

Currently, P-OLED displays are being or have been used or tested for small- to medium-sized product applications such as mobile phones, PDAs, digital cameras and camcorders (including electronic viewfinders), portable DVD players, electric shavers, MP3 players, in-car entertainment and navigation displays and other applications. P-OLED displays have not yet been commercially introduced in larger applications such as laptop computers, desktop computer monitors or televisions other than in prototypes. To date, we have not attained the service lifetimes required by the manufacturers of these more demanding larger applications.

Our research and development efforts remain subject to all of the risks associated with the development of new products based on emerging and innovative technologies, including, for example, unexpected technical problems or the possible insufficiency of funds for completing development of these products. Technical problems may result in delays in the implementation of our technologies in specific applications and cause us to incur additional expenses that would increase our losses. If we cannot complete research and development of our P-OLED technology successfully, or if we experience delays in completing research and development of our P-OLED technology for use in potential commercial applications, particularly after incurring significant expenditures, our business may fail.

***Even if our P-OLED technology is technically feasible, it may not be adopted by display manufacturers.***

The potential size, timing and viability of market opportunities targeted by us through our display manufacturer licensees are uncertain at this time. Market acceptance of our P-OLED technology will depend, in part, upon this technology providing benefits comparable to or greater than those provided by cathode ray tube display, LCD or plasma technology (the current standard display technologies) at an advantageous cost to manufacturers, and the adoption of products incorporating this technology by consumers.

Display manufacturers make the determination during their product development programs whether to incorporate our P-OLED technology or pursue other alternatives, and they may be forced to make significant investments of time and cost well before they introduce their products incorporating our technology to the consumer market and before they can be sure that they will generate any significant sales to recover their investment. Moreover, certain existing licensees and potential licensees of our P-OLED technology currently manufacture FPDs using competing technologies, and they may, therefore, be reluctant to redesign their products or manufacturing processes or invest in new or converted facilities to incorporate our P-OLED technology.

During a display manufacturer licensee s entire product development process, we face the risk that our technology will fail to meet our licensee s technical, performance or cost requirements or will be replaced by a competing product or alternative technology. For example, we are aware that some of our licensees have entered into arrangements with our competitors regarding the development of competing technologies, including the potential production of OLED displays by ink jet printing using phosphorescent materials. Even if we offer technology that is satisfactory to a display manufacturer licensee, they may choose to delay or terminate their product development efforts for reasons unrelated to our technology. The occurrence of any of these events would adversely affect our royalty revenues and may make it difficult to attract additional licensees.

***There are alternatives to P-OLEDs for FPDs, which may limit our ability to commercialize our P-OLED technology.***

The FPD market is currently, and will likely continue to be for some time, dominated by displays based on LCD technology. Numerous companies have made and are continuing to make substantial investments in, and are conducting research to improve the characteristics of, LCDs. Several other FPD technologies have been, or are being, developed, including technologies for the production of field emission, inorganic electroluminescence and plasma. Advances in LCD technology or any of these other technologies may overcome their current limitations and permit them to remain or become more attractive technologies for FPDs, either of which could limit the potential market for FPDs using our P-OLED technology. This, in turn, would cause display manufacturers to avoid entering into commercial relationships with us or to renegotiate, terminate or not renew their existing relationships with us, which may cause our business strategy to fail.

***Other OLED technologies may be more successful than ours, which may limit the commercial adoption of our P-OLED technology.***

Other companies have developed OLED technologies that differ from and compete with our P-OLED technology. Certain of these competing OLED technologies entered the marketplace prior to ours and may become entrenched in the flat panel industry before our P-OLED technologies have a chance to become widely adopted. Moreover, competitors may succeed in developing new OLED technologies or new manufacturing techniques that are more cost-effective or have fewer limitations than our P- OLED technology or other existing OLED technologies. If our P-OLED technology is unable to capture a substantial portion of the OLED display market, our business strategy may fail.

Table of Contents

***Because we do not manufacture or sell any products to end users, we depend on the manufacturing capabilities of our display manufacturer licensees. Any difficulties or delays affecting their manufacturing processes or any decision to terminate or reduce their display manufacturing businesses could harm our business.***

We license our P-OLED technology to display manufacturers, who then incorporate our technology into the products that they sell. Because we do not manufacture any commercial products, our success depends on the ability and willingness of our licensees to develop, manufacture and sell commercial products integrating our technology. Any significant disruption or increase in cost of the manufacturing processes of our display manufacturer licensees or a decision by any of our display manufacturer licensees to terminate or reduce their efforts to manufacture or sell displays would adversely affect our royalty revenues and thus our business.

Mass production of P-OLED displays will require the availability of suitable manufacturing equipment, components and materials. Equipment is currently available for many of the required process steps, but the processes and equipment that will be required to deposit P-OLED materials for large-sized, full-color displays are still under development. High precision ink jet printing equipment that could be used to deposit P-OLED materials is being developed by some companies, but, to our knowledge, is only being made available for sale at this time by Litrex, our former subsidiary. The availability of suitable ink jet printing equipment will be contingent on the continued technical success of and sufficient funding for Litrex s or another manufacturer s development program. In addition, certain of the components, such as low temperature poly silicon backplanes, used in the production of our licensees display products are available only from a limited number of suppliers.

If display manufacturers are unable to obtain ink jet printing or other suitable P-OLED deposition equipment or are unable to source other key equipment for the manufacture of large panel sizes or, if they experience unexpected difficulties, expenses or delays with respect to additional required technologies, components or other materials, they may experience increased costs or manufacturing delays and may not be able to manufacture larger-sized, full-color P-OLED displays or may exit the display manufacturing business entirely. This would adversely affect our license fees or royalty payments from them, and we may not be able to increase our revenues and achieve profitability.

***We expect to derive an increasing portion of our revenues from royalties on sales of products commercialized by our licensees that incorporate our technology. Our display manufacturer licensees operate in a highly competitive environment, and they may not be able to achieve and sustain market position. If they fail to compete successfully, our royalties will decrease or be eliminated.***

Because we do not sell any products directly to end-users, our success depends upon the ability and continuing willingness of our display manufacturer licensees to market commercial products integrating our technology and the widespread acceptance of those products. Any slowdown in the demand for our licensees products would adversely affect our royalty revenues and thus our business. The markets for our display manufacturer licensees products are highly competitive, with pressure on prices and profit margins due largely to additional and growing capacity from FPD industry competitors. The principal elements affecting our licensees competitive performance in the market for end-user products include their abilities to:

- access required capital;
- conduct research and development;
- reduce time-to-market;
- reduce production costs;
- offer a competitive price;
- offer attractive product features and quality;

- offer customer service, including product design support; and

- provide sufficient quantity of products to fulfill end-user demand.

Success in the market for end-user products that may integrate our P-OLED technology also depends on factors beyond the control of our licensees and us, including the cyclical and seasonal nature of the end-user markets that our licensees serve, as well as industry and general economic conditions. If our licensees fail or otherwise reduce their efforts to commercialize products that incorporate our technology or exit the display manufacturing business entirely, our business strategy may fail.

Table of Contents

***Many of our competitors have greater resources, which may make it difficult for us to compete successfully against them.***

The FPD industry is characterized by intense competition. Many of our LCD and OLED competitors have better name recognition and greater financial and personnel resources and technical, marketing and research capabilities than us, and because of these differences, we may never be able to compete successfully in the FPD market.

LCD is currently the dominant technology in the FPD market. Many of the leading LCD panel manufacturers, such as AU Optronics, Chunghwa Picture Tubes, LG.Philips, Samsung Electronics and Sharp, are large, established companies with global marketing capabilities, widespread brand recognition and extensive financial resources.

Eastman Kodak Company is our principal competitor in the OLED industry, with a number of licensees already in commercial production of displays incorporating its passive matrix small molecule OLED, or SMOLED, technology and two companies in production of active matrix driven displays.

With the formation of our 50%-owned joint venture, Sumation, we have an interest in the supply of materials to the OLED industry. Merck OLED currently competes with Sumation in the supply of P-OLED materials and other companies, such as DuPont, are believed to be developing similar products. Kodak, Idemitsu Kosan and Universal Display Corporation supply materials to display makers using Kodak s SMOLED technology.

The leading LCD panel manufacturers, who use competing technologies but are also potential licensees of our P-OLED technology, are considerably larger and more established companies, and they have global marketing capabilities and substantially greater financial resources to devote to research and development than we have. If our technology does not compete effectively with these and other display technologies, our business strategy may fail.

***If our materials supplier licensees fail to make advances in their research, or if they exit that business or otherwise terminate or elect not to renew their relationships with us, we might not succeed in commercializing our P-OLED technology.***

Research and development of commercially viable applications for our P-OLED technology depends substantially on the success of work relating to P-OLED materials, including resolution of issues relating to materials lifetimes and efficiencies at the brightness levels required for large panel applications. We cannot be certain that we or our materials supplier licensees will make sufficient additional advances in the research and development of P-OLED materials to satisfy these requirements. Moreover, if our materials supplier licensees are unable to meet the requirements of our display manufacturer licensees, or if they exit the P-OLED materials supply business or otherwise terminate or elect not to renew their relationships with us and no viable successor can be found, our business strategy may fail.

***If we cannot form and maintain lasting business relationships with P-OLED display manufacturers, our business strategy will fail.***

Our business strategy depends upon our development and maintenance of commercial licensing relationships with high-volume manufacturers of P-OLED displays. We have issued licenses to a number of display manufacturers and have technology development relationships with a number of other companies in the industry for the purpose of evaluating our P-OLED technology for possible use in commercial production. Any of these relationships may fail to result in the display manufacturers entering into a licensing arrangement or, subsequently, commercial production, as applicable, of devices using our P-OLED technology on a scale sufficient for our business strategy to succeed. Moreover, if a licensee is no longer using our technology, it can generally terminate the license agreement upon notice and without further payment to us.

Under our existing technology development and evaluation agreements, we are working with display manufacturers to incorporate our technology into their products for the commercial production of P-OLED displays. However, these technology development and evaluation agreements typically last for limited periods of time, and these relationships may never lead to development of products and entry into license agreements.

Currently, and for the foreseeable future, a significant portion of our revenues are and will be derived from a concentrated number of licensees. Our future success will depend upon our ability to establish and maintain relationships with key licensees and to attract new licensees. If our royalty revenues continue to be derived from a few licensee relationships, our operating results will be harmed if those licensees experience operating difficulties or curtail or terminate their use of our licensed technology, and we are not able to obtain replacement royalty sources. Replacement royalty sources may be difficult to obtain because of the lengthy periods required to attract and sign-up new licensees and have them enter commercial production.

Our ability to enter into additional commercial licenses, or to maintain our existing technology development and evaluation relationships, may require us to make financial or other commitments. We might not be able, for financial or other reasons, to enter into or continue these relationships on commercially acceptable terms or at all. Failure to do so would cause our business strategy to fail.

***Conflicts may arise with our licensees or joint development partners, resulting in renegotiation or termination of, or litigation related to, our agreements with them. This would adversely affect our revenues.***

Conflicts could arise between us and our licensees or joint development partners as to royalty rates, milestone payments or other commercial terms. Similarly, the parties may disagree as to which party owns or has the right to commercialize intellectual property that is developed during the course of the relationship or as to other non-commercial terms. If such a conflict were to arise, a licensee or joint development partner might attempt to compel renegotiation of certain terms of their agreement or terminate their agreement entirely, and we might lose the royalty revenues and other benefits of the agreement. Either we or the licensee or joint development partner might initiate litigation to determine commercial obligations, establish intellectual property rights or resolve other disputes under the related agreements. Such litigation could be costly to us and require substantial attention of management. If we were unsuccessful in such litigation, we could lose the commercial benefits of the agreement, be liable for other financial damages and suffer losses of intellectual property or other rights that are the subject of dispute. Any of these adverse outcomes could cause our business strategy to fail. Some of our licenses contain most favored nation provisions. These provisions give licensees the right to reduced royalty rates or refunds of upfront fees in the event that we issue new licenses that have more favorable upfront fee or royalty rates than the existing licenses that contain these most favored nation provisions, but are otherwise similar in their terms.

***If we do not receive additional financing in the future, we might not be able to continue the research, development and commercialization of our P-OLED technology.***

Our capital requirements have been, and will continue to be, significant. Substantial additional funds will be required in the future to maintain current levels of expenditure for research, development and commercialization of our P-OLED and related technologies, to obtain and maintain patents and other intellectual property, or IP, rights in these technologies, as well as for working capital and other purposes, the timing and amount of which are difficult to forecast. If we do not achieve our revenue goals, our cash on hand may not be sufficient to meet all of our future needs. When we need additional funds, such funds may not be available on commercially reasonable terms or at all. If we cannot obtain more money when needed, we might be forced to cut back our current activities and our business might fail. In December 2005, we sold 2,187,500 shares of our common stock in a private placement for which the gross proceeds were $17.5 million. We believe that our current cash balance will be sufficient to meet our needs for at least another twelve months.

In November 2005, we sold Litrex to ULVAC, Inc. of Japan. Under the terms of our agreements with Litrex and ULVAC, they are obligated to continue to support Litrex s development of ink jet printers for the display manufacturing industry. If they do not fulfill this obligation, we may exercise our rights under a fallback license to obtain the necessary IP to develop, manufacture and supply ink jet printing equipment for use by manufacturers using our P-OLED technology independent of Litrex. In any such circumstance, we may incur substantial additional costs in order to ensure that ink jet printing equipment is made available for P-OLED display manufacturers. We have the right, but no obligation, to fund ink jet printing development programs at Litrex and may incur costs in doing so if we believe this is necessary for the furtherance of our P-OLED technology.

If we are unable to meet our currently projected liquidity requirements from our existing resources, we may need to borrow money or issue additional equity or debt securities. We may not be able to borrow money on commercially reasonable terms or at all. If we attempt to raise money in an offering of shares of our common stock, preferred stock, warrants or debt securities, or if we engage in acquisitions involving the issuance of such securities, our then-existing stockholders may be diluted. If we are unable to obtain required financing or reasonable terms, our business may fail.

Sumation, our 50%-owned joint venture with Sumitomo Chemical, will require additional funding in future periods. If we are unable to provide such funding our ownership interest may become diluted and the potential realizable value from this investment may be reduced.

**Table of Contents**

***We or our licensees may incur substantial costs or lose important rights as a result of litigation or other proceedings relating to our patent and other intellectual property rights.***

In recent years, there has been significant litigation involving patents and other IP rights in many technology-related industries, including our own.

There may be patents owned by third parties that may be infringed by the use of our technology or a part thereof, thus substantially interfering with the future conduct of our or our licensees businesses. Our licensees could be sued by such parties for patent infringement. Such lawsuits could subject them to liability for damages, prevent our licensees from incorporating such patented technology in their products or require our licensees to obtain additional licenses that could increase the cost of their products. As a result there could be an adverse affect on their sales and thus our royalties and this could also cause our licensees to seek to renegotiate our royalty rates. This problem is made more difficult to evaluate, because certain patent applications in the United States are retained in secrecy unless and until the patent issues.

In addition, in the future we may assert our IP rights by instituting legal proceedings against others. We cannot assure you that we will be successful in enforcing our patents in any lawsuits we may commence. Defendants in any litigation we may commence to enforce our patents may attempt to establish that our patents are invalid or are unenforceable. Thus, any patent litigation we commence could lead to a determination that one or more of our patents are invalid or unenforceable. If a third party succeeds in invalidating one or more of our patents, that party and others could compete more effectively against us. Our ability to derive licensing revenues from products or technologies covered by these patents could also be adversely affected.

Whether our licensees are defending the assertion of third-party IP rights against their businesses arising as a result of the use of our technology, or we are asserting our own IP rights against others, such litigation can be complex, costly, protracted and highly disruptive to our or our licensees business operations by diverting the attention and energies of management and key technical personnel. As a result, the pendency or adverse outcome of any IP litigation to which we or our licensees are subject could disrupt business operations, require the incurrence of substantial costs and subject us or our licensees to significant liabilities, each of which could severely harm our business.

Plaintiffs in IP cases often seek injunctive relief. Any IP litigation commenced against our licensees could force them to take actions that could be harmful to their business and thus to our royalties, including the following:

- stop selling their products that incorporate or otherwise use technology that contains our allegedly infringing IP;
- attempt to obtain a license to the relevant third-party IP, which may not be available on reasonable terms or at all; or
- attempt to redesign their products to remove our allegedly infringing IP to avoid infringement of the third-party IP.

If our licensees are forced to take any of the foregoing actions, they may be unable to manufacture and sell their products that incorporate our technology at a profit or at all. Furthermore, the measure of damages in IP litigation can be complex and is often subjective or uncertain. If our licensees were to be found liable for infringement of proprietary rights of a third party, the amount of damages they might have to pay could be substantial and is difficult to predict. Decreased sales of our licensees products incorporating our technology would adversely affect our royalty revenues under existing licenses. Any necessity to procure rights to the third-party technology might cause our existing licensees to renegotiate the royalty terms of their license with us to compensate for this increase in their cost of production or, in certain cases, to terminate their license with us entirely. Were this renegotiation to occur, certain of our license agreements that contain most favored nation provisions, requiring that we offer at least as favorable terms to the holder of such a license as we offer to any other licensee, would be affected and we would also receive reduced royalties from those licenses. These developments would also harm our ability to compete for new licensees and would adversely affect the terms of the royalty arrangements we could enter into with any new licensees.

As is commonplace in technology companies, we employ individuals who were previously employed at other technology companies. To the extent our employees are involved in research areas that are similar to those areas in which they were involved at their former employers, we may be subject to claims that such employees or we have, inadvertently or otherwise, used or disclosed the alleged trade secrets or other proprietary information of the former employers. Litigation may be necessary to defend against such claims. The costs associated with these actions or the loss of rights critical to our or our licensees business could negatively impact our revenues or cause our business to fail.

***If we cannot obtain and maintain appropriate patent and other intellectual property rights protection for our P-OLED technology, our business will suffer.***

The value to us of our P-OLED and related technologies is dependent on our ability to secure and maintain appropriate patent and other IP rights protection. Although we own or license many patents covering our technology that have already been issued, there can be no assurance that additional patents applied for will be obtained or that any of these patents, once issued, will afford commercially significant protection for our technology or will be found valid if challenged. Moreover, we have not obtained patent protection for some of our technology in all foreign countries in which P-OLED displays or materials might be manufactured or sold. In any event, the patent laws and enforcement regimes of other countries may differ from those of the United States as to the patentability of our P-OLED and related technologies and the degree of protection afforded.

The strength of our current IP position results primarily from the essential nature of our fundamental patents covering the P-OLED device and its manufacturing process and electroluminescent devices containing conjugated polymers. These patents expire in 2010, 2011 and 2015. While we hold a wide range of additional patents and patent applications whose expiration dates extend (and in the case of patent applications, will extend) well beyond 2015, many of which are also of key importance in the OLED industry, none is of an equally essential nature as our fundamental patents, and therefore our competitive position after their expiration may be less certain.

We may become engaged in litigation to protect or enforce our patent and other IP rights or in International Trade Commission proceedings to abate the importation of goods that would compete unfairly with those of our licensees. In addition, we may have to participate in interference or reexamination proceedings before the U.S. Patent and Trademark office, or in opposition, nullity or other proceedings before foreign patent offices, with respect to our patents or patent applications. All of these actions would place our patents and other IP rights at risk and may result in substantial costs to us as well as a diversion of management attention. Moreover, if successful, these actions could result in the loss of patent or other IP rights protection for the key P-OLED and related technologies on which our business strategy depends.

In addition, we rely in part on unpatented proprietary technology, and others may independently develop the same or similar technology or otherwise obtain access to our unpatented technology. To protect our trade secrets, know-how and other proprietary information, we require employees, consultants, financial advisors and strategic partners to enter into confidentiality agreements. These agreements may not ultimately provide meaningful protection for our trade secrets, know-how or other proprietary information in the event of any unauthorized use, misappropriation or disclosure of those trade secrets, know-how or other proprietary information. In particular, we may not be able to fully or adequately protect our proprietary information as we conduct discussions with potential strategic partners. If we are unable to protect the proprietary nature of our technology, it will harm our business.

***We are subject to developments in and expenses associated with resolving matters currently in litigation.***

We have been and may continue to be the subject of complaints or litigation in connection with disputes unrelated to patent or other IP rights described above. We are currently the subject of litigation with Sunnyside Development as described under Legal Proceedings in Item 1 of Part II above. There is considerable risk associated with any litigation, particularly litigation such as this action, which may be decided by a jury and the outcome of which will be affected by a number of factors beyond our control. As is also the case with other complaints or litigation to which we may become subject, we may incur significant legal costs in defending or settling the action with Sunnyside Development, and if a court finds against us, we could be liable for substantial financial damages or suffer other losses that are the subject of dispute. Such complaints and litigation are also often complex and protracted and disrupt our business operations by diverting the attention and energies of management and key technical personnel. As a result, the pendency or adverse outcome of such complaints and litigation could require the incurrence of substantial costs, subject us to significant liabilities and otherwise disrupt our business operations, each of which could severely harm our business.

We review any outstanding claims against us with internal and, if deemed appropriate, external legal counsel to assess the probability and estimates of loss. We reassess the risk of loss as new information becomes available and we adjust liabilities, if any, as appropriate. The actual cost of resolving any claims may be substantially different from the amounts of liability recorded. We have not recorded any liability with respect to the action by Sunnyside Development referred to above.

***We are exposed to currency fluctuations, which may have an adverse effect on us.***

A substantial majority of our licensing revenues are denominated in U.S. dollars. These licensing revenues include royalties based on revenues or production costs of our licensees that may be denominated in U.S. dollars or other currencies. Where such revenues or production costs of our licensees are denominated in other currencies, they are converted to U.S. dollars for the purpose of calculating any licensing royalties due to us. Our licensing royalty revenues may decrease as a result of any appreciation of the U.S. dollar against these other currencies. The majority of our current expenditures are incurred in British pounds in order to fund our operations in the United Kingdom. If the U.S. dollar depreciates versus the British pound, additional U.S. dollars will be required to fund our operations in the United Kingdom.

Table of Contents

We take out forward currency contracts to cover future projected currency conversions. We engage in hedging activities, but there is no guarantee that they will be successful in reducing the risks to us of our exposure to foreign currency fluctuations and these fluctuations may adversely affect our results of operations, financial condition or cash flows. We no longer take out forward contracts but have outsourced management of foreign exchange transactions to Schroders Investment Management Limited. There is no guarantee that they will be successful in reducing the risks to us of our exposure to foreign currency fluctuations and these fluctuations may adversely affect our results of operations, financial condition or cash flows.

***We are a holding company with no significant independent operations, and we therefore rely on our subsidiaries to make funds available to us.***

We are a holding company with no significant independent operations and no significant assets other than the capital stock of our subsidiaries. We, therefore, will be dependent upon the receipt of dividends or other distributions from our subsidiaries. The declaration of dividends by our subsidiaries will be subject to the discretion of their boards of directors and will depend on a number of factors, including their results of operations, financial condition, liquidity requirements and indebtedness and restrictions imposed by applicable law. Our inability to receive funds from our operating subsidiaries would adversely affect our ability to meet our obligations and to make dividend payments and other distributions, if any, to holders of our common stock.

***Due to our significant level of international operations, we are subject to international operational, financial, legal and political risks that may negatively impact our operations.***

A substantial part of our operations are in the United Kingdom, two of our senior executives are resident in Japan, and many of our licensees have a majority of their operations in countries outside the United States and Europe. Risks associated with our doing business internationally include:

- compliance with a wide variety of foreign laws and regulations, particularly labor, environmental and other laws and regulations that govern our operations in the United Kingdom;
- legal uncertainties regarding taxes, tariffs, quotas, export controls, export licenses and other trade barriers;
- potentially difficulties in managing an organization effectively where management is geographically dispersed;
- difficulties in creating and maintaining effective business relationships in foreign cultural environments;
- economic instability in the countries of our licensees, particularly in the Asia-Pacific region, causing delays or reductions in orders for their products and therefore our royalties;
- political instability in the countries in which our licensees operate, particularly in South Korea relating to its disputes with North Korea and in Taiwan relating to its disputes with China;
- difficulties in collecting accounts receivable and longer accounts receivable payment cycles; and
- potentially adverse tax consequences.

Any of these factors could harm our or our licensees existing international operations and business and impair our or our licensees ability to continue expanding into international markets.

A significant portion of our assets and most of our executive officers are located outside of and are not residents of the United States. As a result, it may be difficult or impossible for U.S. investors to effect service of process upon such non-resident directors or officers within the United States or to realize against them in the United States upon judgment of courts of the United States predicated upon civil liabilities under the federal securities laws of the United States or the securities or blue sky laws of any state or other jurisdiction within the United States. In addition, courts of another country may not enforce judgments of United States courts obtained in actions against us, our directors or officers predicated upon the civil liability provisions of the United States federal securities laws or the securities or blue sky laws of any state or other jurisdiction within the United States or enforce, in original actions, liabilities against us, our directors or our officers predicated upon the United States federal securities laws or any state securities or blue sky laws.

***Our agreements with our licensees and joint development partners are subject to regulation by the European Commission, and particularly to antitrust provisions of such regulations, which could result in fines to us or in those agreements being declared void in whole or in part, either of which would negatively impact our revenues.***

Our IP licensing agreements and joint development agreements fall under the antitrust provisions of the Treaty of Rome and related regulations. While our display license agreements are generally non-exclusive and without geographic restriction, and while our licensing and joint development relationships generally represent lower market shares than would result in the application of the regulations remedies, any violation of the regulations could result in the anti-competitive provisions or the entire relevant agreement being declared void and unenforceable. In addition, we could be subject to a fine of up to 10% of the income of our worldwide group.

***If we cannot keep our key employees or hire other talented persons as we grow, our business might not succeed.***

Our performance is substantially dependent on the continued services of senior management, particularly our Chief Executive Officer who has been principally responsible for establishing and maintaining many of our most important commercial relationships, and our Chief Technology Officer, who was one of the inventors of our fundamental P-OLED technology and helps direct our technology development program, and on our ability to offer competitive salaries and benefits to our employees. Also, Dr. Fyfe s current employment agreement with us expires in August 2007. We do not carry key person life insurance on any of our senior management or other key personnel. If we lose the services of key senior management personnel, we may not be able to find suitable replacements in a timely manner or at all, which would seriously harm our business. Additionally, competition for highly skilled technical, managerial and other personnel is intense. We might not be able to attract, hire, train, retain and motivate the highly skilled managers and employees that we might need to be successful. If we fail to attract and retain the necessary technical and managerial personnel, our business will suffer and might fail. We currently have fewer than 130 employees, and we may encounter increasing difficulty in attracting enough qualified personnel as our operations expand and the demand for their services increases. This difficulty could impede the attainment of our research and development objectives and cause our business strategy to fail.

In December 2004, we awarded restricted stock units to a number of our senior executives. These units will vest over a three-year period that will end in December 2007, which was intended to retain the services of these executives during this period. We are considering what new arrangements would be appropriate to retain and provide suitable incentives for our senior executives, but there is no assurance that we will be able to continue to retain their services after the existing restricted stock units have fully vested.

***Our Technology Development Center and our research and development laboratories are critical to our success.***

Our Technology Development Center in Godmanchester, England and our research and development laboratories are critical to our success. These facilities currently house our principal research, development, engineering and design operations. Our research and development activities involve the controlled use of a small amount of hazardous substances as well as other potentially harmful materials, waste and chemicals, which could cause interruption of our research and development efforts or injury to our employees, resulting in liabilities under federal, state, local or foreign laws or regulations governing the use, storage and disposal of these materials. While to date we have not had any issues relating to the use of hazardous materials, any event that causes a disruption of the operation of these facilities for even a relatively short period of time would adversely affect our ability to conduct research and development operations and to provide technical support for our licensees, which would negatively affect our revenues.

***If we acquire or invest in any companies or technologies or enter into joint ventures in the future, they could prove difficult to integrate, disrupt our business, dilute stockholder value or have an adverse effect on our results of operations.***

We intend to expand our business primarily through internal growth, but from time to time we may consider strategic acquisitions or other investments, as well as joint ventures, to develop P-OLED materials and displays. Any future acquisition, investment or joint venture would involve numerous risks, including:

- potential disruption of our ongoing business and distraction of management;
- difficulty integrating the operations and products of the acquired business;

unexpected expenses related to technology integration;

- exposure to unknown liabilities, including litigation against the companies we may acquire or in which we invest or the joint ventures we form;

- future losses or failure of the acquired business resulting in the impairment of the carrying value of any investment;

- additional costs due to differences in culture, geographic locations and duplication of key talent; and

- potential loss of key employees or customers of the acquired company.

In addition, the failure to complete any such acquisition, investment or joint venture after it has been announced and negotiations commenced may have an adverse effect on our business, including the diversion of our management s time and attention, the negative impact on our business prospects or a decline in the market price for shares of our common stock.

We have made investments in Add-Vision Inc., a California company, and MicroEmissive Displays, or MED, which is a publicly quoted company in the United Kingdom. We may not be successful in addressing the risks or any other problems encountered in connection with these or other investments. If the companies in which we invest are not successful in achieving their business objectives the value of their stock may fall and we might have to write down the value of our investment.

In November 2005, we and Sumitomo Chemical entered into a joint venture agreement, which provides for the organization and capitalization of Sumation to develop and supply advanced P-OLED materials and formulated inks for use in commercial P-OLED displays and lighting applications. Each party to the joint venture agreement has contributed initial working capital to Sumation in exchange for a 50% voting and ownership interest, with an initial two-year budget and any additional funds to be funded equally by each party. To the extent that Sumation does not achieve its expected sales revenues or margins, we may need to provide 50% of any additional working capital funding requirements, although we will be under no formal obligation to do so. The joint venture agreement includes provisions for the possible sale of part or all of our equity stake to Sumitomo at fair market value after a minimum of five years. After the initial two-year period of the joint venture, the parties have agreed to engage in good faith discussions regarding how the manpower and facilities requirements of the joint venture will be resourced in the third and subsequent years. The joint venture agreement may be terminated by either party by mutual written agreement, or by one of the parties in the case of a material breach of the other party. It may also be terminated in the event of the bankruptcy or insolvency of either party, or if a 40% interest is acquired in one party by a direct and substantial competitor of the other joint venture party. The agreement will also terminate if Sumitomo acquires 100% of the shares in Sumation.

Although we already had a strong research relationship with Sumitomo, we believe that the strengthening of our relationship through the formation of this joint venture is the most effective way of accelerating P-OLED material development in the future. There can be no assurance, however, that the joint venture will not be terminated or that part or all of our interest in Sumation will not be acquired or that we will be successful in addressing the risks described above or any other problems encountered in connection with our joint venture, whether as a result of potential disruption of our ongoing business and distraction or duplication of management and other key talent or additional and unexpected costs and expenses related to technology integration or that could result from cultural differences or as a result of the geographic location of the joint venture in Japan.

Table of Contents

### Risks Relating to our Common Stock and Financial Results

***Our operating results may have significant period-to-period fluctuations, which would make it difficult to predict our future performance.***

Due to the current stage of commercialization of our technology and the significant development and manufacturing objectives that we and our licensees must achieve to be successful, our quarterly operating results will be difficult to predict and may vary significantly from quarter to quarter.

We believe that period-to-period comparisons of our operating results are not a reliable indicator of our future performance at this time. Among other factors affecting our period-to-period results, our license fees often consist of large one-time payments in the period during which we enter into a new license, followed by smaller recurring payments in later periods, resulting in significant fluctuations in our revenues. We recognize revenues in accordance with accounting principles generally accepted in the United States and, depending on the exact nature of the deliverables in any agreement, or set of agreements entered into contemporaneously, the recognition of revenues may be substantially delayed following receipt of cash from our customers and may be difficult to predict. If, in some future period, our operating results or business outlook fall below the expectations of securities analysts or investors, our stock price would be likely to decline and investors in our common stock may not be able to resell their shares at or above the price at which they were purchased. Broad market, industry and global economic factors may also materially reduce the market price of our common stock, regardless of our operating performance.

***The market price of our common stock may be highly volatile.***

The market price of our common stock has been highly volatile, as has been the case with the securities of many other emerging growth companies. Factors such as the following may have a significant impact on the market price of our common stock in the future:

- our operating results and capital resources;
- announcements by us or our competitors of technological developments, new product applications or license arrangements; and
- other factors affecting the FPD and related industries in general.

In addition, the stock market in general has experienced extreme price and volume fluctuations that have often been unrelated or disproportionate to the operating performance of companies like us.

***One of our stockholders owns a significant amount of our common stock. If this ownership concentration continues, it could prevent you and other stockholders from influencing significant corporate decisions.***

Affiliates of Kelso & Company, or Kelso, beneficially own approximately 40% of the outstanding shares of our common stock. Kelso is also represented on our board. As a result, Kelso exercises significant influence over matters requiring stockholder approval. The concentrated holding of Kelso may result in the delay or deterrence of possible changes in control of our company, which may negatively impact the market price of our common stock. The interests of Kelso and other of our existing stockholders may conflict with the interests of our other stockholders.

***Because we do not intend to pay dividends, stockholders will benefit from an investment in our common stock only if it appreciates in value.***

We have never declared or paid any cash dividends on our common stock. We currently intend to retain our future earnings, if any, to finance the operation and growth of our business and do not expect to pay any cash dividends in the foreseeable future. As a result, the success of an investment in our common stock will depend upon any future appreciation in its value. There is no guarantee that our common stock will appreciate in value or even maintain the price at which stockholders have purchased their shares.

Table of Contents

***Our share price may decline due to the large number of shares eligible for future sale.***

Sales of substantial amounts of our common stock, or the possibility of such sales, may adversely affect the price of our common stock and impede our ability to raise capital through the issuance of equity securities. As of August 4, 2006, there were 21,483,205 shares of our common stock outstanding. In addition, we may in the future issue additional shares of our common stock that might be or become freely transferable, including shares that may be issued under additional registration statements that we may file, such as our shelf registration statement described below, upon the exercise of warrants or options or pursuant to our special bonus or other plans.

| | | |
|---|---|---|
| Shares freely transferable without restriction or further registration under the Securities Act of 1933 pursuant to Rule 144(k) or otherwise | 11,331,006 | 52.7% |
| Shares held by Kelso and eligible for sale under Rule 144 * | 8,657,833 | 40.3% |
| Shares held by other affiliates and eligible for sale under Rule 144 * | 491,953 | 2.3% |
| Shares held by non-affiliates and eligible for sale under Rule 144 * | 1,002,413 | 4.7% |
| **Total shares outstanding at August 11, 2006** | 21,483,205 | 100.0% |
| Shares issuable pursuant to outstanding warrants | 659,468 | |
| Shares issuable pursuant to outstanding stock options | 644,511 | |
| Shares issuable pursuant to awards under our special bonus plan | 1,200,000 | |
| Share reserved for future grants under stock incentive plans | 942,406 | |

* subject to volume, manner of sale, holding period and other limitations of Rule 144

We have registered 6.5 million shares of our common stock with the SEC under a shelf registration statement on Form S-3, which covers 3.9 million shares that may be issued and sold by us and 2.6 million outstanding shares that may be sold by certain selling stockholders, including Kelso.

Kelso, which, together with its affiliates, owns an aggregate of approximately 40% of the outstanding shares of our common stock, has rights, subject to some conditions, to require us to file registration statements covering the unregistered shares that it currently holds or may acquire or to include these shares in registration statements that we may file for ourselves or other stockholders, including in connection with our shelf registration statement described above. Sales by Kelso of a substantial number of shares could significantly reduce the market price of our common stock.

The price of our common stock can be expected to decrease if we issue additional shares of our common stock that might be or become freely salable, including shares that may be issued under additional registration statements that we may file, such as our proposed shelf registration described above, upon the exercise of warrants or options or pursuant to our special bonus or other plans.

***We can issue shares of preferred stock that may adversely affect your rights as a shareholder of our common stock.***

Our certificate of incorporation authorizes us to issue up to 46,667 shares of preferred stock with designations, rights and preferences determined from time-to-time by our board of directors. Accordingly, our board of directors is empowered, without shareholder approval, to issue preferred stock with dividend, liquidation, conversion, voting or other rights superior to those of stockholders of our common stock. For example, an issuance of shares of preferred stock could:

- adversely affect the voting power of the stockholders of our common stock;
- make it more difficult for a third party to gain control of us;

- discourage bids for our common stock at a premium;
- limit or eliminate any payments that the stockholders of our common stock could expect to receive upon our liquidation; or
- otherwise adversely affect the market price of our common stock.

We may issue additional shares of authorized preferred stock at any time in the future.

Table of Contents

***We are incurring costs as a result of being a public company.***

We incur significant legal, accounting, administrative and other costs and expenses as a public company. We are required to comply with the Sarbanes-Oxley Act of 2002, as well as rules subsequently implemented by the SEC and the Nasdaq National Market. Compliance with these rules and regulations causes us to incur legal, audit and financial compliance costs, and diverts management attention from operations and strategic opportunities. We will incur additional costs in evaluating and reporting on our internal control over financial reporting and having our independent auditors annually attest to our evaluation as required by Section 404 of the Sarbanes-Oxley Act of 2002 and the rules and regulations thereunder, which we expect to commence with our Annual Report on Form 10-K for the fiscal year ending December 31, 2007. We are preparing to comply with Section 404 by strengthening, assessing and testing our system of internal controls to provide the basis for our initial report on our internal control over financial reporting. The process of strengthening our internal controls and complying with Section 404 is expensive and time consuming, and it requires significant management attention. We cannot be certain that these measures will ensure that we will maintain adequate controls over our financial processes and reporting in the future. Effective internal controls are necessary for us to provide reliable financial reports. We have in the past discovered, and may in the future discover, areas of our internal controls that require improvement. Failure to implement required new or improved controls, or difficulties encountered in their implementation, could harm our operating results or cause us to fail to meet our reporting obligations. If we or our independent auditors discover a material weakness, the disclosure of the fact, even if quickly remedied, could reduce the market s confidence in our financial statements and harm our stock price. In addition, non-compliance with Section 404 could subject us to a variety of administrative sanctions, including the suspension or delisting of our common stock from the Nasdaq National Market and the inability of registered broker-dealers to make a market in our common stock, which would further reduce our stock price.

We are required to retain independent directors to serve on our board of directors. If vacancies on our board of directors occur that need to be filled by independent directors, we may encounter difficulty in attracting qualified persons to serve on our board, and, in particular, our audit committee. If we fail to attract and retain the required number of independent directors we may be subject to SEC enforcement proceedings and delisting of our common stock from the Nasdaq National Market. We are also incurring high costs to maintain directors and officers insurance.

***Our certificate of incorporation and bylaws and Delaware law may discourage takeovers and business combinations that our stockholders might consider in their best interests.***

Provisions in our certificate of incorporation and by-laws may delay, defer, prevent or render more difficult a takeover attempt that our stockholders might consider in their best interests. These provisions may prevent our stockholders from receiving the benefit from any premium to the market price of our common stock offered by a bidder in a takeover context. Even in the absence of a takeover attempt, the existence of these provisions may adversely affect the prevailing market price of our common stock if they are viewed as discouraging takeover attempts in the future.

**Item 4. Submission of Matters to a Vote of Security Holders**

(a) The Annual Meeting of Stockholders was held on May 31, 2006.

(b) The matters voted upon at the meeting and results of the voting with respect to those matters were as follows:

(1) Election of Directors:

| | Votes For | Withheld |
|---|---|---|
| Dr. David Fyfe | 15,860,294 | 71,461 |
| Dr. Malcolm J. Thompson | 15,895,564 | 36,191 |
| Frank K. Bynum, Jr. | 15,894,514 | 37,241 |
| Joseph Carr | 15,859,544 | 72,211 |
| James V. Sandry | 15,894,814 | 36,941 |

(2) Ratification of the appointment of Ernst & Young LLP as the Company s independent registered public accounting firm

| Votes For | Against | Abstain |
|---|---|---|
| 15,910,210 | 21,043 | 502 |

**Item 5. Other Information**

Effective on August 14, 2006, James V. Sandry resigned as a member of the audit committee of our board of directors. Mr. Sandry, who had served as the chairman of the audit committee since our initial public offering in December 2004, was compelled to resign solely because of his recent acceptance of an opportunity to be the chief financial officer of another company in which Kelso & Company holds a controlling interest. The Nasdaq Stock Market s listing standards prohibit a member of a company s audit committee, such as Mr. Sandry, from acting as an executive officer of an affiliated company, such as this other Kelso-backed company. Mr. Sandry will remain a member of our board of directors and continues to comply with the independence requirements generally applicable to members of our board.

We have commenced the process of recruiting a qualified person to replace Mr. Sandry as chairman of the audit committee who both meets the independence requirements applicable to audit committees and is an audit committee financial expert. Effective upon his resignation, Mr. Sandry became an advisor to the audit committee until his replacement is appointed.

As a result of Mr. Sandry s resignation from the audit committee, we are no longer in compliance with the listing standards of Nasdaq Marketplace Rule 4350(d)(2)(A), which requires that we have an audit committee comprised of at least three members. With Mr. Sandry s resignation, we have two members of the audit committee and one vacancy. We notified Nasdaq on August 14, 2006 that we are aware of the noncompliance with these listing standards and that we intend to cure such noncompliance as soon as possible. Nasdaq Marketplace Rule 4350(d)(4)(B) provides that if we fail to comply with the requirements of Rule 4350(d)(2)(A) because of one vacancy on the audit committee, then we have until our next annual stockholder meeting to comply with the requirements of Rule 4350(d)(2)(A) to fill that vacancy. On August 14, 2006, we received notice from Nasdaq that we are not in compliance with these requirements and confirming that we must appoint a third member of the audit committee by our next annual stockholder meeting.

**Item 6. Exhibits**

| Exhibit | Description of Document |
|---|---|

| Number | | |
|---|---|---|
| 10.19.1 | | Amendment Number 1, dated July 4, 2006, to the Contract Research Agreement, dated December 14, 2001, between CDT International Limited and Merck OLED Materials GmbH (formerly known as Covion Organic Semiconductors GmbH) ( Merck OLED ) and the Patent and Know-How License, dated December 14, 2001, between Cambridge Display Technology Limited and Merck OLED. |
| 10.2 | (1) | Compromise agreement with Daniel Abrams, dated June 30, 2006 (incorporated by reference to Exhibit 10.1 to the Company s Current Report on Form 8-K filed July 3, 2006) |
| 10.3 | (1) | Employment agreement with Michael Black, dated July 3, 2006 (incorporated by reference to Exhibit 10.2 to the Company s Current Report on Form 8-K filed July 3, 2006) |
| 31.1 | | Rule 13a-14(a) Certification of Principal Executive Officer |
| 31.2 | | Rule 13a-14(a) Certification of Principal Financial Officer |
| 32.1 | (2) | Certification of Principal Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. Section 1350) |
| 32.2 | (2) | Certification of Principal Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. Section 1350) |

(1) Indicates a management contract or compensatory plan or arrangement.

(2) In accordance with Item 601(b)(32)(ii) of Regulation S-K and SEC Release Nos. 33-8238 and 34-47986, Final Rule: Management s Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, the material contained in Exhibits 32.1 and 32.2 is furnished and not deemed filed with the SEC and is not to be incorporated by reference into any filing of the registrant under the Securities Act of 1933 or the Exchange Act whether made before or after the date hereof and irrespective of any general incorporation language contained in such filing, except to the extent that the registrant specifically incorporates it by reference.

Confidential treatment has been requested with respect to certain portions of this agreement.

Table of Contents

## 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.

| | |
|---|---|
| | CAMBRIDGE DISPLAY TECHNOLOGY, INC. |
| Dated: August 14, 2006 | By: /s/ DAVID FYFE<br>DAVID FYFE<br>Chief Executive Officer<br>(Principal Executive Officer) |
| Dated: August 14, 2006 | By: /s/ MICHAEL BLACK<br>MICHAEL BLACK<br>Vice-President Finance<br>(Principal Financial Officer) |

38