

POWER EFFICIENCY CORP  
Form 10-Q  
November 14, 2011

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

☒ QUARTERLY REPORT UNDER SECTION 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended: September 30, 2011

OR

☐ TRANSITION REPORT UNDER SECTION 13 OR 15 (d)  
OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File No. 0-31805

POWER EFFICIENCY CORPORATION

(Exact Name of Issuer as Specified in its Charter)

Delaware  
(State or Other Jurisdiction of  
Incorporation or Organization)

22-3337365  
(I.R.S. Employer Identification No.)

5744 Pacific Center Blvd. Suite 311  
San Diego, CA 92121  
(Address of Principal Executive Offices)

(858) 750-3875  
(Issuer's Telephone Number,  
Including Area Code)

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

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

Large Accelerated filer ☐ Accelerated filer ☐ Non-Accelerated filer ☐ Smaller reporting company ☒

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

The number of shares of common stock outstanding as of November 11, 2011 was 54,346,832.

Transitional Small Business Disclosure Format (check one): Yes ☐ No ☒

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Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes ☒ No ☐

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POWER EFFICIENCY CORPORATION

FORM 10-Q INDEX

PART I - FINANCIAL INFORMATION

ITEM 1. Financial Statements (Unaudited)

|   |   |
|---|---|
| Condensed Balance Sheets as of September 30, 2011 and December 31, 2010 | 3 |
|---|---|

|  |   |
|--|---|
| Condensed Statements of Operations for the three and nine months ended September 30, 2011 and 2010 | 4 |
|--|---|

|  |   |
|--|---|
| Condensed Statements of Cash Flows for the nine months ended September 30, 2011 and 2010 | 5 |
|--|---|

|   |      |
|---|------|
| Notes to Condensed Financial Statements | 6-11 |
|---|------|

|   |       |
|---|-------|
| ITEM 2. Management's Discussion and Analysis Of Financial Condition and Results of Operations | 12-23 |
|---|-------|

|   |    |
|---|----|
| ITEM 3. Quantitative and Qualitative Disclosure About Market Risk | 24 |
|---|----|

|                                 |    |
|---------------------------------|----|
| ITEM 4. Controls and Procedures | 24 |
|---------------------------------|----|

Part II — OTHER INFORMATION

|                           |    |
|---------------------------|----|
| ITEM 1. Legal Proceedings | 25 |
|---------------------------|----|

|   |    |
|---|----|
| ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds | 25 |
|---|----|

|   |    |
|---|----|
| ITEM 3. Defaults Upon Senior Securities | 25 |
|---|----|

|                  |    |
|------------------|----|
| ITEM 4. Reserved | 25 |
|------------------|----|

|                           |    |
|---------------------------|----|
| ITEM 5. Other Information | 25 |
|---------------------------|----|

|                  |    |
|------------------|----|
| ITEM 6. Exhibits | 26 |
|------------------|----|

|            |    |
|------------|----|
| Signatures | 27 |
|------------|----|

|   |  |
|---|--|
| Certification of Chief Executive Officer as Adopted |  |
|---|--|

|   |  |
|---|--|
| Certification of Principal Financial Officer as Adopted |  |
|---|--|

## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

POWER EFFICIENCY CORPORATION  
CONDENSED BALANCE SHEETS  
Unaudited

|  | September 30,<br>2011  | December 31,<br>2010   |
|--|------------------------|------------------------|
| <b>ASSETS</b>  |                        |                        |
| <b>CURRENT ASSETS:</b>   |                        |                        |
| Cash   | \$78,979               | \$2,567,607            |
| Accounts receivable, net   | 81,665                 | 106,066                |
| Inventory  | 171,283                | 217,119                |
| Prepaid expenses and other current assets  | 21,580                 | 22,550                 |
| <b>Total Current Assets</b>  | <b>353,507</b>         | <b>2,913,342</b>       |
| <br><b>PROPERTY AND EQUIPMENT, Net</b>   | <br><b>105,795</b>     | <br><b>64,847</b>      |
| <b>OTHER ASSETS:</b>   |                        |                        |
| Patents, net   | 151,387                | 141,907                |
| Deposits   | 91,304                 | 36,971                 |
| Goodwill   | 1,929,963              | 1,929,963              |
| <b>Total Other Assets</b>  | <b>2,172,654</b>       | <b>2,108,841</b>       |
| <br><b>Total Assets</b>  | <br><b>\$2,631,956</b> | <br><b>\$5,087,030</b> |
| <br><b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>  |                        |                        |
| <b>CURRENT LIABILITIES:</b>  |                        |                        |
| Accounts payable and accrued expenses  | \$803,261              | \$687,168              |
| <b>Total Current Liabilities</b>   | <b>803,261</b>         | <b>687,168</b>         |
| <br><b>LONG TERM LIABILITIES</b>   |                        |                        |
| Deferred rent  | 29,170                 | 11,282                 |
| Deferred tax liability   | 486,972                | 449,513                |
| <b>Total Long Term Liabilities</b>   | <b>516,142</b>         | <b>460,795</b>         |
| <br><b>Total Liabilities</b>   | <br><b>1,319,403</b>   | <br><b>1,147,963</b>   |
| <br><b>COMMITMENTS AND CONTINGENCIES</b>   |                        |                        |
| <br><b>STOCKHOLDERS' EQUITY:</b>   |                        |                        |
| Series B, C-1 and D Convertible Preferred Stock, \$.001 par value, 10,000,000 shares authorized, 488,377 and 500,877 issued and outstanding in 2011 and 2010, respectively | 488                    | 501                    |
| Common stock, \$.001 par value, 350,000,000 shares authorized, 54,346,832 and 49,005,733 issued and outstanding in 2011 and 2010, respectively                             | 54,347                 | 49,006                 |
| <b>Additional paid-in capital</b>  | <b>47,687,324</b>      | <b>46,737,632</b>      |

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|  |               |               |
|--|---------------|---------------|
| Accumulated deficit                        | (46,429,606 ) | (42,848,072 ) |
| Total Stockholders' Equity                 | 1,312,553     | 3,939,067     |
| Total Liabilities and Stockholders' Equity | \$2,631,956   | \$5,087,030   |

Accompanying notes are an integral part of the financial statements.

- 3 -

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POWER EFFICIENCY CORPORATION  
CONDENSED STATEMENTS OF OPERATIONS  
Unaudited

|   | For the three months ended<br>September 30, |                | For the nine months ended<br>September 30, |                |
|---|---|----------------|--|----------------|
|   | 2011  | 2010           | 2011                                       | 2010           |
| REVENUES  | \$123,571                                   | \$180,787      | \$394,342                                  | \$416,393      |
| COST OF REVENUES  |   |                |  |                |
| Materials, labor and overhead                                       | 99,282                                      | 100,733        | 290,687                                    | 301,755        |
| Inventory obsolescence  | -   | -              | 44,633                                     | -              |
| Total Cost of Revenues  | 99,282                                      | 100,733        | 335,320                                    | 301,755        |
| GROSS PROFIT  | 24,289                                      | 80,054         | 59,022                                     | 114,638        |
| COSTS AND EXPENSES:   |   |                |  |                |
| Research and development  | 314,465                                     | 230,758        | 892,386                                    | 546,377        |
| Selling, general and administrative                                 | 608,421                                     | 629,378        | 1,878,189                                  | 1,892,839      |
| Depreciation and amortization                                       | 8,766                                       | 11,405         | 28,727                                     | 37,667         |
| Total Costs and Expenses  | 931,652                                     | 871,541        | 2,799,302                                  | 2,476,883      |
| LOSS FROM OPERATIONS  | (907,363 )                                  | (791,487 )     | (2,740,280 )                               | (2,362,245 )   |
| OTHER INCOME (EXPENSE):   |   |                |  |                |
| Interest income   | 152   | 7,794          | 5,749                                      | 9,451          |
| Interest expense  | -   | -              | -  | (934,649 )     |
| Change in fair value of warrant liability                           | -   | 4,745          | -  | 828,827        |
| Total Other Income (Expense)  | 152   | 12,539         | 5,749                                      | (96,371 )      |
| LOSS BEFORE PROVISION FOR INCOME TAXES                              | (907,211 )                                  | (778,948 )     | (2,734,531 )                               | (2,458,616 )   |
| PROVISION FOR INCOME TAXES  | 12,486                                      | 15,884         | 37,459                                     | 50,309         |
| NET LOSS  | (919,697 )                                  | (794,832 )     | (2,771,990 )                               | (2,508,925 )   |
| DIVIDENDS PAID OR PAYABLE ON<br>SERIES B, C-1 AND D PREFERRED STOCK | 272,100                                     | 358,279        | 809,544                                    | 3,259,030      |
| NET LOSS ATTRIBUTABLE TO<br>COMMON SHAREHOLDERS                     | \$(1,191,797 )                              | \$(1,153,111 ) | \$(3,581,534 )                             | \$(5,767,955 ) |
| BASIC AND FULLY DILUTED LOSS PER<br>COMMON SHARE                    | \$(0.02 )                                   | \$(0.03 )      | \$(0.07 )                                  | \$(0.13 )      |
| WEIGHTED AVERAGE COMMON<br>SHARES OUTSTANDING, BASIC AND            | 54,346,832                                  | 45,119,984     | 51,507,462                                 | 45,013,643     |

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Accompanying notes are an integral part of the financial statements.

- 4 -

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POWER EFFICIENCY CORPORATION  
CONDENSED STATEMENTS OF CASH FLOWS  
Unaudited

For the nine months ended  
September 30,  
2011                      2010

## CASH FLOWS FROM OPERATING ACTIVITIES:

|   |                |                |
|---|----------------|----------------|
| Net loss  | \$(2,771,990 ) | \$(2,508,925 ) |
| Adjustments to reconcile net loss to net cash used in operating activities: |                |                |
| Depreciation and amortization   | 28,727         | 37,667         |
| Cost of goods sold depreciation   | 5,922          | -              |
| Warrants and options issued to employees and consultants                    | 145,476        | 212,619        |
| Change in fair value of warrant liability                                   | -              | (828,827 )     |
| Noncash interest expense related to debt discount                           | -              | 818,542        |
| Loss on sale of equipment   | 1,653          | -              |
| Inventory obsolescence  | 44,633         | -              |
| Changes in assets and liabilities:  |                |                |
| Accounts receivable, net  | 24,401         | (17,279 )      |
| Inventory   | 1,203          | 85,625         |
| Prepaid expenses and other current assets                                   | 970            | (16,491 )      |
| Deposits  | (54,333 )      | (10,057 )      |
| Accounts payable and accrued expenses                                       | 116,093        | 287,006        |
| Deferred tax liability  | 37,459         | 37,460         |
| Deferred rent   | 17,888         | (6,153 )       |
| Net Cash Used in Operating Activities                                       | (2,401,898 )   | (1,908,811 )   |

## CASH FLOWS FROM INVESTING ACTIVITIES

|                                       |           |           |
|---------------------------------------|-----------|-----------|
| Costs related to patent applications  | (11,624 ) | (22,335 ) |
| Purchases of property and equipment   | (83,606 ) | (9,595 )  |
| Sale of property and equipment        | 8,500     | -         |
| Net Cash Used in Investing Activities | (86,730 ) | (31,930 ) |

## CASH FLOWS FROM FINANCING ACTIVITIES:

|  |   |            |
|--|---|------------|
| Proceeds from issuance of equity securities        | - | 3,976,200  |
| Proceeds from issuance of notes payable            | - | 1,687,083  |
| Repayment of notes payable                         | - | (450,000 ) |
| Fees paid to investment banks for equity financing | - | (126,992 ) |
| Net Cash Provided by Financing Activities          | - | 5,086,291  |

|                             |              |             |
|-----------------------------|--------------|-------------|
| Increase (Decrease) in cash | (2,488,628 ) | 3,145,550   |
| Cash at beginning of period | 2,567,607    | 247,564     |
| Cash at end of period       | \$78,979     | \$3,393,114 |

Accompanying notes are an integral part of the financial statements.





#### NOTE 1 - BASIS OF PRESENTATION

The accompanying financial statements have been prepared by the Company, without an audit. In the opinion of management, all adjustments have been made, which include normal recurring adjustments necessary to present fairly the condensed financial statements. Operating results for the three and nine months ended September 30, 2011 are not necessarily indicative of the operating results for the full year. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted. The Company believes that the disclosures provided are adequate to make the information presented not misleading. These unaudited condensed financial statements should be read in conjunction with the audited financial statements and related notes included in the Company's Annual Report for the year ended December 31, 2010 on Form 10-K.

The preparation of condensed financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

#### NOTE 2 - GOING CONCERN:

The accompanying financial statements have been prepared assuming the Company is a going concern, which assumption contemplates the realization of assets and satisfaction of liabilities in the normal course of business. The Company experienced a \$2,401,898 deficiency of cash from operations for the nine months ended September 30, 2011, and expects significant cash deficiencies from operations until the Company's sales and gross profit grow to exceed its expenses. The Company had a working capital deficit (current assets less current liabilities) of approximately \$450,000 at September 30, 2011 and has an immediate need for capital.

These factors raise substantial doubt about the Company's ability to continue as a going concern. The financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts or the amount of liabilities that might be necessary should the Company be unable to continue in existence. Continuation of the Company as a going concern is dependent upon achieving profitable operations or accessing sufficient operating capital. Management's plans to achieve profitability include developing new products such as hybrid motor starters and single-phase to three-phase converters, developing business in the Asian market, obtaining new customers and increasing sales to existing customers. Management is seeking to raise additional capital through equity issuance, debt financing or other types of financing (see Note 13). However, there are no assurances that sufficient capital will be raised. If we are unable to obtain it on reasonable terms, we would be forced to restructure, file for bankruptcy or significantly curtail operations.

#### NOTE 3 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

There were no significant changes to the Company's significant accounting policies as disclosed in Note 3 of the Company's financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2010.

New Accounting Pronouncements:

In May 2011, the FASB issued Accounting Standards Update (“ASU”) 2011-04, “Fair Value Measurement – Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs,” addressing how to measure fair value and what disclosures to provide about fair value measurements. This amendment is largely consistent with the existing GAAP guidance, but aligned the international guidance and eliminated unnecessary wording differences between GAAP and International Financial Reporting Standards (“IFRS”). The amendment is effective for interim and annual periods beginning after December 15, 2011, and should be applied prospectively. The implementation of this standard is not expected to affect the Company’s financial condition, results of operations, or cash flows.

In June 2011, the FASB issued ASU 2011-05, “Statement of Comprehensive Income,” which revises the manner in which entities present comprehensive income in their financial statements, requiring entities to report components of comprehensive income in either (1) a continuous statement of comprehensive income or (2) two separate but consecutive statements. The amendments are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2011 and should be applied retrospectively. The implementation of this standard is not expected to affect the Company’s financial condition, results of operations or cash flows.

In September 2011, the FASB issued ASU 2011-08, “Intangibles – Goodwill and Other (Topic 350): Testing Goodwill for Impairment,” which adds a new option entities can use to determine whether it is necessary to apply the traditional two step goodwill impairment test, based on qualitative factors. If the entity elects to use the option, it must assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If so, the existing quantitative calculations in steps one and two continue to apply. However, if after assessing the totality of the qualitative factors, an entity determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step impairment test is unnecessary. Under the amendments, an entity has the option to bypass the qualitative assessment for any reporting unit in any period and proceed directly to performing the first step of the two-step goodwill impairment test. An entity may resume performing the qualitative assessment in any subsequent period. The amendments are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2011 and should be applied prospectively. The implementation of this standard is not expected to affect the Company’s financial condition, results of operations or cash flows.

NOTE 4 – CONCENTRATIONS OF CREDIT RISK

Financial instruments which potentially subject the Company to concentrations of credit risk consist primarily of cash and temporary cash investments and accounts receivable.

Cash is maintained at financial institutions and, at times, balances may exceed federally insured limits. We have never experienced any losses related to these balances. All of our non-interest bearing cash balances were fully insured at September 30, 2011 and December 31, 2010 due to a temporary federal program in effect from December 31, 2010 through December 31, 2012. Under the program, there is no limit to the amount of insurance for eligible accounts. Beginning 2013, insurance coverage will revert to \$250,000 per depositor at each financial institution, and our non-interest bearing cash balances may again exceed federally insured limits. Interest-bearing amounts on deposit in excess of federally insured limits at December 31, 2010 approximated \$2.1 million and no balances exceeded the federally insured limits as of the quarter ended September 30, 2011.

Accounts receivable totaled \$106,066 and \$81,665 as of December 31, 2010 and September 30, 2011, respectively. Of these amounts, three customers accounted for 98% of accounts receivable at December 31, 2010, and four customers accounted for 96% of accounts receivable at September 31, 2011.

#### NOTE 5 – INVENTORIES

Inventories are valued at the lower of cost (first-in, first-out) or market. The Company reviews inventory for impairments to net realizable value whenever circumstances arise. Such circumstances may include, but are not limited to, the discontinuation of a product line or re-engineering certain components making certain parts obsolete. Management recorded an inventory obsolescence charge of \$44,633 in March, May and June of 2011. Management has determined a reserve for inventory obsolescence is not necessary at September 30, 2011 or December 31, 2010.

Inventories are comprised as follows:

|                | September 30,<br>2011 | December 31,<br>2010 |
|----------------|-----------------------|----------------------|
| Raw materials  | \$165,911             | \$170,251            |
| Finished goods | 5,372                 | 46,868               |
| Inventories    | \$171,283             | \$217,119            |

#### NOTE 6 – GOODWILL

On January 1, 2011, the Company adopted FASB ASU No. 2010-28, Intangibles (Topic 350): When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts. The Guidance calls for reporting units with zero or negative carrying amounts to perform Step 2 of the goodwill impairment test. As of September 30, 2011, the Company's fair value exceeded its carrying value, which was positive; therefore, the Company is not required to perform Step 2.

In accordance with ASC 350, Goodwill and Other Intangible Assets, previously recognized goodwill was tested by management for impairment during 2011 and 2010 utilizing a two-step test. At a minimum, an annual goodwill impairment test is required, or when certain events indicate a possible impairment.

The first part of the test is to compare the Company's fair market value to the book value of the Company. If the fair market value of the Company is greater than the book value, no impairment exists as of the date of the test. However, if book value exceeds fair market value, the Company must perform part two of the test, which involves recalculating the implied fair value of goodwill by repeating the acquisition analysis that was originally used to calculate goodwill, using purchase accounting as if the acquisition happened on the date of the test, to calculate the implied fair value of goodwill as of the date of the test.

The Company has no accumulated impairment losses on goodwill. The Company's impairment analysis is performed on December 31 each year, on the Company's single reporting unit. Using the Company's market capitalization (a Level 1 input), management determined that the estimated fair market value exceeded the company's book value as of September 30, 2011 and December 31, 2010. Based on this, no impairment exists as of September 30, 2011 and December 31, 2010.

#### NOTE 7 – EARNINGS PER SHARE

The Company accounts for its earnings per share in accordance with ASC 260, Earnings Per Share, which requires presentation of basic and diluted earnings per share. Basic earnings per share is computed by dividing income or loss attributable to common shareholders by the weighted average number of common shares outstanding for the reporting period. Diluted earnings per share reflect the potential dilution that could occur if securities or other contracts, such as stock options, to issue common stock were exercised or converted into common stock.

|  | Three Months<br>Ended<br>September 30,<br>2011 | Three Months<br>Ended<br>September 30,<br>2010 | Nine Months<br>Ended<br>September 30,<br>2011 | Nine Months<br>Ended<br>September 30,<br>2010 |
|--|--|--|---|---|
| Net loss attributable to common shareholders                 | \$(1,191,797 )                                 | \$(1,153,111 )                                 | \$(3,581,534 )                                | \$(5,767,955 )                                |
| Basic weighted average number of common shares outstanding   | 54,346,832                                     | 45,119,984                                     | 51,507,462                                    | 45,013,643                                    |
| Dilutive effect of stock options                             | -  | -  | -   | -   |
| Diluted weighted average number of common shares outstanding | 54,346,832                                     | 45,119,984                                     | 51,507,462                                    | 45,013,643                                    |
| Basic and diluted loss per share                             | \$(0.02 )                                      | \$(0.03 )                                      | \$(0.07 )                                     | \$(0.13 )                                     |

For the three and nine months ended September 30, 2011, warrants and options to purchase 65,679,324 shares of common stock at per share exercise prices ranging from \$0.08 to \$19.25 were not included in the computation of diluted loss per share because inclusion would have been anti-dilutive. For the three and nine months ended September 30, 2010, warrants and options to purchase 70,578,324 shares of common stock at per share exercise prices ranging from \$0.11 to \$19.25 were not included in the computation of diluted loss per share because inclusion would have been anti-dilutive.

## NOTE 8 – STOCK-BASED COMPENSATION

At September 30, 2011, the Company had two stock-based compensation plans. There were 5,500,000 options granted in the nine months ended September 30, 2011, of which 2,000,000 options have been cancelled. The fair value of these options was approximately \$566,000 at issuance. There were 10,500,000 options granted in the nine months ended September 30, 2010, of which 4,657,500 have been cancelled. The fair value of these options was approximately \$1,731,000 at issuance. No stock options were exercised in the periods ending September 30, 2011 and 2010. The Company accounts for stock option grants in accordance with ASC 718, Compensation – Stock Compensation. Compensation costs related to share-based payments recognized in the Condensed Statements of Income were \$145,476 and \$212,619 for the periods ended September 30, 2011 and 2010, respectively.

## NOTE 9 – MATERIAL AGREEMENTS

In March 2011, the Company entered into a lease for office space, engineering and manufacturing facilities. The new lease calls for an initial base rent of \$9,298 per month, plus operating costs, and annual increases equal to 3% of the base rent. For the first 11 months of the lease term, the company is only required to pay one-half of the initial base rent per month. The term of the lease is 48 months and commenced on April 1, 2011. Total rent expense was \$39,168 and \$41,937 for the three months and \$171,100 and \$150,436 for the nine months ended September 30, 2011 and 2010, respectively.

In July 2011, the Company entered into a sublease agreement for its Las Vegas office facilities. Under the sublease, the Company will receive rents of \$8,098 per month. The term of the sublease is for 16 months, expiring on November 30, 2012.

## NOTE 10 – WARRANT LIABILITY

The Company issued 5,696,591 warrants in connection with a private offering of its common stock on July 8, 2005 and August 31, 2005. The proceeds attributable to the warrants, based on the fair value of the warrants at the date of issuance, amounted to \$1,433,954 and were accounted for as a liability and valued in accordance with ASC 815 Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity's Own Stock based on an evaluation of the terms and conditions related to the warrant agreements, which provide that the exercise price of these warrants shall be reduced if, through a subsequent financing, the Company issues common stock below the lowest per share purchase price of the offering. In each subsequent period, the Company adjusted the warrant liability to equal the fair value of the warrants at each balance sheet date. Changes in the fair value of warrants classified as a liability are recognized in earnings. The warrant liability, including the effect of the anti-dilution provision, was valued as follows:

|                                | Three months<br>ended<br>September 30,<br>2010 | Nine month<br>ended<br>September 30,<br>2010 |
|--------------------------------|--|--|
| Balance at beginning of period | \$4,745  | \$828,827                                    |
| Change in fair value           | (4,745 )                                       | (828,827 )                                   |
| Balance at end of period       | \$-  | \$-  |

All the liability warrants had expired as of December 31, 2010.



## NOTE 11 – INCOME TAXES

The Company utilizes the asset and liability method of accounting for income taxes pursuant to ASC 740, Accounting for Income Taxes (“ASC 740”). ASC 740 requires the recognition of deferred tax assets and liabilities for both the expected future tax impact of differences between the financial statement and tax basis of assets and liabilities, and for the expected future tax benefit to be derived from tax loss and tax credit carryforwards. ASC 740 additionally requires the establishment of a valuation allowance to reflect the likelihood of realization of deferred tax assets. The Company has evaluated the net deferred tax asset, taking into consideration operating results, and determined that a full valuation allowance should be maintained.

The Company accounts for uncertain tax positions under the provisions of ASC 740-10. The Company has not identified any uncertain tax positions, nor does it believe it will have any material changes over the next 12 months. Any interest or penalties resulting from examinations will be recognized as a component of the income tax provision. However, since there are no unrecognized tax benefits as a result of the tax positions taken, there are no accrued interest and penalties.

## NOTE 12 – SUPPLEMENTAL DISCLOSURE OF CASH FLOWS INFORMATION

Cash paid during the nine months ended September 30, for:

|                        | 2011     | 2010     |
|------------------------|----------|----------|
| Income/franchise taxes | \$18,612 | \$12,849 |

Non-cash investing and financing activities during the nine months ended September 30, for:

|   | 2011      | 2010        |
|---|-----------|-------------|
| Common stock issued to vendors  | \$-       | \$60,000    |
| Senior secured notes converted into Series D preferred stock  | \$-       | \$1,237,083 |
| Accrued interest and accrued wages converted into Series D preferred stock                          | \$-       | \$181,718   |
| Preferred stock dividend recognized for beneficial conversion features of preferred stock issuances | \$-       | \$2,643,679 |
| Preferred stock dividends paid or payable in common stock   | \$809,544 | \$615,352   |

## NOTE 13 – SUBSEQUENT EVENTS

On October 4, 2011, the Company entered into a bridge financing transaction in which it issued an aggregate of \$1,000,000 in senior secured notes, before discount, and 2,777,780 warrants to purchase the Company’s common stock. The notes bear interest of 10% per annum, payable upon maturity. The notes mature on March 31, 2012, and have a first priority securing interest in all of the assets of the Company. The holders of the notes have the right to convert the amounts due plus all accrued but unpaid interest under the note into any subsequent financing while the note is outstanding, on the same terms as such new financing, at the sole discretion of the note holder. The warrants to purchase the Company’s common stock have a per share exercise price of \$0.09 and expire on October 3, 2016.



## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

### FORWARD LOOKING STATEMENTS

This report and the documents incorporated into this report contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 (the "PSLRA"), including, but not limited to, statements relating to the Company's business objectives and strategy. Such forward-looking statements are based on current expectations, management beliefs, certain assumptions made by the Company's management, and estimates and projections about the Company's industry. Words such as "anticipates," "expects," "intends," "plans," "believes," "seeks," "estimates," "forecast," "likely," "predicts," "projects," "judgment," variations of such words and similar expressions are intended to identify such forward-looking statements. These statements are not guarantees of future performance and are subject to certain risks, uncertainties and assumptions that are difficult to predict with respect to timing, extent, likelihood and degree of occurrence. Therefore, actual results and outcomes may differ materially from those expressed, forecasted, or contemplated by any such forward-looking statements.

Factors that could cause actual events or results to differ materially include, but are not limited to, the following: continued market acceptance of the Company's products; the Company's ability to expand and/or modify its products on an ongoing basis; general demand for the Company's products, intense competition from other developers, manufacturers and/or marketers of energy reduction and/or power saving products; the Company's negative net tangible book value; the Company's negative cash flow from operations; delays or errors in the Company's ability to meet customer demand and deliver products on a timely basis; the Company's lack of working capital; the Company's need to upgrade its facilities; changes in laws and regulations affecting the Company and/or its products; the impact of technological advances and issues; the outcomes of pending and future litigation and contingencies; trends in energy use and consumer behavior; changes in the local and national economies; and other risks inherent in and associated with doing business in an engineering and technology intensive industry. See "Management's Discussion and Analysis or Plan of Operation." Given these uncertainties, investors are cautioned not to place undue reliance on any such forward-looking statements.

Unless required by law, the Company undertakes no obligation to update publicly any forward-looking statements, whether as a result of new information, future events or otherwise. However, readers should carefully review the risk factors set forth in other reports or documents that the Company files from time to time with the Securities and Exchange Commission (the "SEC"), particularly Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q and any Current Reports on Form 8-K.

## OVERVIEW

The Company generates revenues from a single business segment: the design, development, marketing and sale of proprietary energy efficiency technologies and products for electric motors. The Company's products, called Motor Efficiency Controllers ("MEC"), save up to 35 percent of the electricity used by a motor in appropriate applications. The Company's patented technology platform, called E-Save Technology®, saves energy when a constant speed alternating current induction motor is operating in a lightly loaded condition. Target applications for the Company's three-phase MECs include escalators, MG set elevators, grinders, crushers, saws, stamping presses, and many other types of industrial equipment. The Company has also developed a single-phase MEC targeted at smaller motors, such as those found in clothes washers, dryers, and other appliances and light commercial equipment. The Company has three existing patents and one patent pending on E-Save Technology® in the US, and has made numerous international patent filings. These patents primarily focus on algorithms and other control methods to optimize motor energy use while maintaining the stability and speed of the motor.

### Analog Three-phase MEC

The Company began generating revenues from sales of its patented analog three-phase MEC line of motor controllers in the late 1990's. The Company sold this product through the second quarter of 2009, and is currently providing repair services and parts for units in the field.

### Digital Three-phase MEC

In 2005, the Company began development of a digital version of its three-phase MEC so that the product would be capable of high volume sales through existing distribution channels for motor controls. The digital version is much smaller in size and easier to install than the analog product, is driven by a powerful digital signal processor. The digital MEC is a complete motor control device, meaning it can start, stop, soft start and protect a motor, and is therefore capable of replacing standard motor starters and soft starts that do not save energy. The product can be installed by OEMs at their factories or it can be retrofitted on to existing equipment.

In 2008, the Company launched limited sales of the digital three-phase MEC and initiated testing of the digital product by several OEMs, primarily in the elevator/escalator industry. In the summer of 2009, the Company announced its first OEM agreements and that it had received Underwriters' Laboratories ("UL") certification on a full line of the Company's digital three-phase products. UL certification enables the Company to sell its digital three-phase products to industrial markets. The Company is working with independent sales representatives and distributors, as well as directly with OEMs, to penetrate the industrial markets.

In the first quarter of 2011, the Company launched its 2nd generation digital three-phase MEC for products ranging from 22 to 80 amps. These are the Company's highest volume three-phase products. The 2nd generation digital three-phase MEC uses a more powerful processor and has generally enhanced capabilities. The 2nd generation products also incorporate numerous cost saving advantages over the 1st generation products. The Company expects these cost savings to have a significant impact on the average cost of these products in the fourth quarter of 2011.

## Digital Single-phase MEC

In 2006, the Company began development on its digital single-phase product. The digital single phase MEC is targeted at appliances, such as clothes washers and dryers. The single phase MEC can also be incorporated directly into a motor, making a combined motor and motor control with energy efficiency, soft start and other advanced features.

Because of the nature of our business, the Company makes significant investments in research and development for new products and enhancements to existing products. Historically, the Company has funded its research and development efforts through cash flow primarily generated from debt and equity financings. Management anticipates that future expenditures in research and development will continue at current levels.

The Company's results of operations for the three and nine months ended September 30, 2011 were marked by a decrease in revenues and an increase in loss from operations that are more fully discussed in the following section, "Results of Operations for the Three and Nine Months Ended September 30, 2011 and 2010". Sales cycles for our products range from less than a month to well over one year, depending on customer profile. Larger original equipment manufacturer ("OEM") deals and sales to larger end users generally take a longer period of time, whereas sales through channel partners may be closed within a few days or weeks. Because of the complexity of this sales process, a number of factors that are beyond the control of the Company can delay the closing of transactions.

## RESULTS OF OPERATIONS FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2011 AND 2010

The following table sets forth certain line items in our condensed statement of operations as a percentage of total revenues for the periods indicated:

|  | Three Months<br>Ended<br>September 30,<br>2011 |   | Three Months<br>Ended<br>September 30,<br>2010 |   | Nine Months<br>Ended<br>September 30,<br>2011 |   | Nine Months<br>Ended<br>September 30,<br>2010 |   |
|--|--|---|--|---|---|---|---|---|
| Revenues   | 100.0  | % | 100.0  | % | 100.0   | % | 100.0   | % |
| Cost of revenues   | 80.3   |   | 55.7   |   | 85.0  |   | 72.5  |   |
| Gross profit   | 19.7   |   | 44.3   |   | 15.0  |   | 27.5  |   |
| Costs and expenses:  |  |   |  |   |   |   |   |   |
| Research and development   | 254.5  |   | 127.6  |   | 226.3   |   | 131.2   |   |
| Selling, general and administrative                              | 492.4  |   | 348.1  |   | 476.3   |   | 454.6   |   |
| Depreciation and amortization                                    | 7.1  |   | 6.3  |   | 7.3   |   | 9.0   |   |
| Total expenses   | 754.0  |   | 482.0  |   | 709.9   |   | 594.8   |   |
| Loss from operations   | (734.3)  | ) | (437.7)  | ) | (694.9)                                       | ) | (567.3)                                       | ) |
| Other income (expense)   | 0.1  |   | 6.9  |   | 1.5   |   | (23.1)  | ) |
| Loss before provision for income taxes                           | (734.2)  | ) | (430.8)  | ) | (693.4)                                       | ) | (590.4)                                       | ) |
| Provision for income taxes                                       | 10.1   |   | 8.8  |   | 9.5   |   | 12.1  |   |
| Net loss   | (744.3)  | ) | (439.6)  | ) | (702.9)                                       | ) | (602.5)                                       | ) |
| Dividends paid or payable on Series B, C-1 and D Preferred Stock | 220.2  |   | 198.2  |   | 205.3   |   | 782.7   |   |
| Net loss attributable to common shareholders                     | (964.5)  | ) | (637.8)  | ) | (908.2)                                       | ) | (1,385.2)                                     | ) |

## REVENUES

Total revenues for the three months ended September 30, 2011 were approximately \$124,000, compared to \$181,000 for the three months ended September 30, 2010, a decrease of \$57,000 or 31%. This decrease is mainly attributable to a decrease in sales in the industrial market in the third quarter of 2011. Specifically, industrial sales fell to approximately \$10,000 for the three months ended September 30, 2011, from approximately \$83,000 for the three months ended September 30, 2010, which was partially offset by an increase in sales in the elevator and escalator market which grew to approximately \$115,000 for the three months ended September 30, 2011, from \$98,000 for the three months ended September 30, 2010. The decrease in industrial sales is primarily due to one large international sale that occurred during the three months ended September 30, 2010, of which no comparable sale occurred during the three months ended September 30, 2011. The increase in elevator and escalator sales in the three months ended September 30, 2011 is primarily due to the commercialization and increased market acceptance of the Company's digital products resulting from the OEM agreements the Company signed in 2009 and 2010. For the three months ended September 30, 2011, industrial and other sales were approximately 8% of total sales, and escalator and elevator sales were approximately 92% of total sales. All sales for the three months ended September 30, 2011 consisted entirely of digital units. For the three months ended September 30, 2010, industrial and other sales were approximately 46% of total sales, and escalator and elevator sales were approximately 54% of total sales. All sales for the three months ended September 30, 2010 consisted entirely of digital units.

Total revenues for the nine months ended September 30, 2011 were approximately \$394,000, compared to \$416,000 for the nine months ended September 30, 2010, a decrease of \$22,000 or 5%. This decrease is mainly attributable to a decrease in sales in the industrial market in the first three quarters of 2011. Specifically, sales in the industrial market fell to approximately \$102,000 for the nine months ended September 30, 2011, compared to \$150,000 for the nine months ended September 30, 2010, which was partially offset by an increase in elevator and escalator sales, which grew to approximately \$293,000 for the nine months ended September 30, 2011, from approximately \$266,000 for the nine months ended September 30, 2010. The decrease in industrial sales is primarily due to one large international sale that occurred during the nine months ended September 30, 2010, of which no comparable sale occurred during the nine months ended September 30, 2011, partially offset by sales to an Asian industrial distributor during the nine months ended September 30, 2011. The increase in elevator and escalator sales in the nine months ended September 30, 2011 is primarily due to the commercialization and increased market acceptance of the Company's digital products resulting from the OEM agreements the Company signed in 2009 and 2010. The digital product has been tested and approved for use on a retrofit and OEM basis by two elevator and escalator OEMs and on a retrofit basis by a third OEM. Currently, two of the three OEMs we have agreements with have approved and adopted our second generation digital product. For the nine months ended September 30, 2011, industrial and other sales were approximately 26% of total sales, and escalator and elevator sales were approximately 74% of total sales. For the nine months ended September 30, 2010, industrial sales, of which all but one order consisted of digital units, were approximately 34% of total sales, and escalator and elevator sales were approximately 66% of total sales.

#### COST OF REVENUES

Total cost of revenues, which includes material, direct labor, overhead and inventory obsolescence for the three months ended September 30, 2011, was approximately \$99,000 compared to approximately \$101,000 for the three months ended September 30, 2010, a decrease of \$2,000 or 2%. This decrease is mainly attributable to an overall decrease in sales in the third quarter of 2011, as described above. As a percentage of revenue, total cost of revenues increased to approximately 80% for the three months ended September 30, 2011 compared to approximately 56% for the three months ended September 30, 2010. The increase in the costs as a percentage of revenues was primarily due to an abnormally large amount of warranty costs during the three months ended September 30, 2011. These large warranty costs approximated \$28,000 and were caused by a faulty batch of our first generation digital controllers. We have since replaced all such units with our second generation digital controllers at no additional cost to our customers, and we are no longer selling our first generation digital controllers.

Total cost of revenues, which includes material, direct labor, overhead and inventory obsolescence for the nine months ended September 30, 2011, was approximately \$335,000 compared to approximately \$302,000 for the nine months ended September 30, 2010, an increase of \$33,000 or 11%. This increase is mainly attributable to an inventory obsolescence charge of approximately \$45,000 and the \$28,000 in warranty costs as described above. There was no comparable inventory obsolescence charge during the nine months ended September 30, 2010. As a percentage of revenue, total cost of sales increased to approximately 85% for the nine months ended September 30, 2011 compared to approximately 73% for the nine months ended September 30, 2010. The increase in the costs as a percentage of sales were due to the inventory obsolescence charge and the warranty costs as described above.

The inventory obsolescence charge is related to the Company's switch from its 1st generation digital MECs to its 2nd generation digital MECs, for products ranging from 22 to 80 amps. These are the Company's highest volume products. As of September 30, 2011 all of our customers were accepting shipments of the 2nd generation digital MECs. The Company expects the cost savings associated with the switch to its 2nd generation product to have a significant impact on the average per unit cost of the 22 to 80 amp units in the fourth quarter of 2011 and the first quarter of 2012.

## GROSS PROFIT

Gross profit for the three months ended September 30, 2011 was approximately \$24,000 compared to approximately \$80,000 for the three months ended September 30, 2010. This decrease is mainly attributable to decreased revenues as well as the abnormally high warranty costs described above. As a percentage of revenue, gross profit decreased to approximately 20% for the three months ended September 30, 2011 compared to approximately 44% for the three months ended September 30, 2010 for the reasons explained above.

Gross profit for the nine months ended September 30, 2011 was approximately \$59,000 compared to approximately \$115,000 for the nine months ended September 30, 2010. As a percentage of revenue, gross profit decreased to approximately 15%, which included inventory obsolescence charges of 11% and abnormally high warranty costs, for the nine months ended September 30, 2011 compared to approximately 28%, which included one large sale with extremely reduced pricing to a marquee end user who was considered a strategic customer, for the nine months ended September 30, 2010.

## OPERATING EXPENSES

### Research and Development Expenses

Research and development expenses were approximately \$314,000 for the three months ended September 30, 2011, as compared to approximately \$231,000 for the three months ended September 30, 2010, an increase of \$83,000 or 36%. This increase is mainly attributable to an increase in product development and certification costs related to the Company's digital controller for both its single-phase and three-phase products of \$48,000, consulting fees of \$8,000, office expenses of \$12,000, rent of \$15,000 and travel expenses of \$14,000, during the three months ended September 30, 2011, partially offset by a decrease in payroll and payroll related costs of \$23,000.

Research and development expenses were approximately \$892,000 for the nine months ended September 30, 2011, as compared to approximately \$546,000 for the nine months ended September 30, 2010, an increase of \$346,000 or 63%. This increase is mainly attributable to an increase in salaries and payroll related costs of \$45,000, product development and certification costs related to the Company's digital controller for both its single-phase and three-phase products of \$79,000, tools and supplies of \$24,000, consulting fees of \$24,000, office expenses of \$33,000, rent of \$50,000 and travel expenses of \$59,000, during the nine months ended September 30, 2011.

### Selling, General and Administrative Expenses

Selling, general and administrative expenses were approximately \$608,000 for the three months ended September 30, 2011, as compared to \$629,000 for the three months ended September 30, 2010, a decrease of \$21,000 or 3%. The decrease in selling, general and administrative expenses compared to the prior year was primarily due to decreases in salaries and payroll related costs of \$30,000, rent of \$23,000 and conferences of \$5,000. These decreases were partially offset by increased consulting fees of \$41,000.

Selling, general and administrative expenses were approximately \$1,878,000 for the nine months ended September 30, 2011, as compared to \$1,893,000 for the nine months ended September 30, 2010, a decrease of \$15,000 or 1%. The decrease in selling, general and administrative expenses compared to the prior year was primarily due to decreases in salaries and payroll related costs of \$41,000, and legal and professional fees of \$42,000. These decreases were partially offset by increases in travel expenses of \$65,000.

### Change in Fair Value of Warrant Liability

Warrants issued in connection with a private offering of the Company's common stock completed on July 8, 2005 and August 31, 2005 were accounted for as liabilities in accordance with ASC 820-10, Fair Value Measurements and Disclosures, based on an analysis of the terms and conditions of the warrant agreements.

The \$4,745 and \$828,827 decreases in the fair value of these warrants during three and nine months ended September 30, 2010, respectively, were reflected as non-operating gains in the Statement of Operations for the three and six months ended September 30, 2010. The warrants were valued at each reporting period using the Black-Scholes pricing model to determine the fair market value per share. All of these liability warrants had expired as of December 31, 2010.

### Financial Condition, Liquidity, and Capital Resources

The Company has suffered recurring losses from operations, and experienced a deficiency of cash of approximately \$2,402,000 and \$1,909,000 from operations for the nine months ended September 30, 2011 and 2010, respectively. For the nine months ended September 30, 2011 and 2010, we had net losses of \$2,772,000 and \$2,509,000, respectively, and expect significant cash deficiencies from operations until the Company's sales and gross profit grow to exceed its expenses. The Company had a working capital deficit (current assets less current liabilities) of approximately \$450,000 at September 30, 2011 and has an immediate need for capital.

These factors raise substantial doubt about the Company's ability to continue as a going concern. Our financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts or the amount of liabilities that might be necessary should we be unable to continue in existence.

The Company's continuation as a "going concern" is dependent upon achieving profitable operations and related positive cash flow and satisfying our immediate cash needs by external financing until we are profitable. Our plans to achieve profitability include developing new products such as hybrid motor starters and single-phase to three-phase converters, developing business in the Asian market, obtaining new customers and increasing sales to existing customers. We are seeking to raise additional capital through equity issuance, debt financing and other types of financing, but we cannot guarantee that sufficient capital will be raised.

Since inception, the Company has financed its operations primarily through the sale of its securities. In 2010, the Company received a total of approximately \$5,395,000 in gross proceeds from private placements of its Series D preferred stock, Secured Notes and Series C-1 preferred stock and warrants to purchase common stock. In 2009, the Company received a total of approximately \$1,210,000 in gross proceeds from a private placement of its Series C preferred stock and Series C-1 preferred stock and warrants to purchase common stock. Total stockholders' equity as of September 30, 2011 was \$1,312,553.

Cash used for operating activities for the nine months ended September 30, 2011 was \$2,401,898, which consisted of a net loss of \$2,771,990; less depreciation and amortization of \$28,727, cost of goods sold depreciation of \$5,922, warrants and options issued to employees and consultants of \$145,476, loss on sale of equipment of \$1,653, inventory obsolescence of \$44,633, and decreases in accounts receivable of \$24,401, inventory of \$1,203 and prepaid expenses of \$970, offset by an increase in deposits of \$54,333. In addition, these amounts were offset by increases in accounts payable of \$116,093, deferred tax liability of \$37,459 and deferred rent of \$17,888.

Cash used for operating activities for the nine months ended September 30, 2010 was \$1,908,811, which consisted of a net loss of \$2,508,925; less depreciation and amortization of \$37,667, warrants and options issued to employees and consultants of \$212,619, noncash interest expense of \$818,542, and a decrease in inventory of \$85,625, offset by a change in the fair value of our warrant liability of \$828,827, and increases in accounts receivable of \$17,279, prepaid expenses and other current assets of \$16,490 and deposits of \$10,057. In addition, these amounts were offset by a decrease in deferred rent of \$6,153, and increases in accounts payable of \$287,006 and deferred tax liability of \$37,460.

Net cash used in investing activities for the nine months ended September 30, 2011 was \$86,730, compared to \$31,930 for the nine months ended September 30, 2010. The amount for the first three quarters of 2011 consisted of purchases of property and equipment of \$83,606, and capitalized costs related to patent applications of \$11,624, partially offset by proceeds from the sale of property and equipment of \$8,500. The total amount for the first three quarters of 2010 consisted of capitalized costs related to patent applications of \$22,335, and the purchase of property and equipment of \$9,595.

Net cash provided by financing activities was \$5,086,291 for the nine months ended September 30, 2010. Of this amount, \$3,976,200 was from the proceeds from the issuance of equity securities, \$1,687,083 was from the proceeds from the issuance of debt securities, offset by payments on notes payable of \$450,000, and payments to investment banks for fees related to equity financings of \$126,992. There was no cash provided by or used for financing activities for the nine months ended September 30, 2011.



On October 4, 2011, the Company entered into a bridge financing transaction in which it issued an aggregate of \$1,000,00 in senior secured notes, before discount, and 2,777,780 warrants to purchase the Company's common stock (see Note 13 to the financial statements).

The Company expects to experience growth in its operating expenses, particularly in research and development and selling, general and administrative expenses, for the foreseeable future in order to execute its business strategy. As a result, the Company anticipates that operating expenses will constitute a material use of any cash resources.

#### Cash Requirements and Need for Additional Funds

The Company anticipates a substantial need for cash to fund its working capital requirements. In accordance with the Company's prepared expansion plan, the opinion of management is that approximately \$3 to \$4 million will be required to cover operating expenses, including, but not limited to, the development of the Company's next generation products, marketing, sales and operations during the next twelve months. Although we currently have some obtained bridge financing, we may nevertheless need to issue additional debt or equity securities to raise required funds. If the Company is unable to obtain funding on reasonable terms or finance its needs through current operations, the Company may be forced to restructure, file for bankruptcy or cease operations.

Notable changes to expenses are expected to include an increase in the Company's sales personnel and efforts, and developing more advanced versions of the Company's technology and products.

On October 4, 2011, the Company entered into a financing transaction in which it issued an aggregate of \$1,000,000 in senior secured notes, before discount, and 2,777,780 warrants to purchase the Company's common stock. The notes bear interest of 10% per annum, payable upon maturity. The notes mature on March 31, 2012, and have a first priority securing interest in all of the assets of the Company. The warrants to purchase the Company's common stock have a per share exercise price of \$0.09 and expire on October 3, 2016.

#### Critical Accounting Policies and Estimates

Management's discussion and analysis of Power Efficiency Corporation's financial condition and results of operations are based upon the condensed financial statements contained in this Quarterly Report on Form 10-Q, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and disclosure of contingent assets and liabilities. On an on-going basis, management evaluates estimates, including those related to the valuation of inventory and the allowance for uncollectible accounts receivable. We base our estimates on historical experience and on various other assumptions that management believes to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ materially from these estimates under different assumptions or conditions. We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our condensed financial statements.

## Inventories

Inventories are valued at the lower of cost (first-in, first-out) or market. The Company reviews inventory for impairments to net realizable value whenever circumstances arise. Such circumstances may include, but are not limited to, the discontinuation of a product line or re-engineering certain components making certain parts obsolete. The Company recorded an inventory obsolescence charge of \$0 and \$44,633 for the three and nine months ended September 30, 2011, respectively, associated with its switch from its 1st generation digital three-phase products to its 2nd generation three-phase digital products, ranging from 22 to 80 amps. Management has determined a reserve for inventory obsolescence is not necessary at September 30, 2011 or December 31, 2010.

## Accounts Receivable

The Company carries its accounts receivable at cost less an allowance for doubtful accounts and returns. On a periodic basis, the Company evaluates its accounts receivable and establishes an allowance for doubtful accounts, based on a history of past write-offs and collections and current credit conditions. Change in customer liquidity or financial condition could affect the collectability of that account, resulting in the adjustment upward or downward in the provision for bad debts, with a corresponding impact to our results of operations.

## Fair Value Measurements:

ASC 820-10 emphasizes that fair value is a market-based measurement, not an entity-specific measurement. Therefore, a fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability. As a basis for considering market participant assumptions in fair value measurements, ASC 820-10 establishes a fair value hierarchy that distinguishes between market participant assumptions based on market data obtained from sources independent of the reporting entity (observable inputs that are classified within Levels 1 and 2 of the hierarchy) and the reporting entity's own assumptions about market participant assumptions (unobservable inputs classified within Level 3 of the hierarchy). The Company has applied ASC 820-10 to measure the amount of the liability related to its derivative instruments at fair value and to determine fair value for purposes of testing goodwill for impairment.

Level 1 inputs utilize quoted prices (unadjusted) in active markets for identical assets or liabilities that the Company has the ability to access. Level 2 inputs are inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. Level 2 inputs may include quoted prices for similar assets and liabilities in active markets, as well as inputs that are observable for the asset or liability (other than quoted prices), such as interest rates and yield curves that are observable at commonly quoted intervals. Level 3 inputs are unobservable inputs for the asset or liability, which is typically based on an entity's own assumptions, as there is little, if any, related market activity. In instances where the determination of the fair value measurement is based on inputs from different levels of the fair value hierarchy, the level in the fair value hierarchy within which the entire fair value measurement falls is based on the lowest level input that is significant to the fair value measurement in its entirety. The Company's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment, and considers factors specific to the asset or liability.

Liabilities measured at fair value on a recurring basis include warrant liabilities resulting from an equity financing in 2005. Total gains resulting for this fair value measurement are recorded as a component of other income in the statement of operations. There were no purchases, sales, issuance or settlements, nor were there any transfers in and/or out of a Level 3 classification. In accordance with ASC 820-10, the warrant liabilities were being remeasured to fair value each quarter until they all expired. The warrants were valued using the Black-Scholes option pricing model, using observable and unobservable assumptions (Level 3) consistent with our application of ASC 718. All the liability warrants had expired as of December 31, 2010.

#### Revenue Recognition

Revenue from product sales is recognized when persuasive evidence of an arrangement exists, delivery has occurred, the price to the buyer is fixed or determinable, and collectability is reasonably assured. Returns and other sales adjustments (warranty accruals, discounts and shipping credits) are provided for in the same period the related sales are recorded. The Company does not have any post shipment obligations nor customer acceptance provisions, but it does provide its customers a limited right of return for defective products under its two year warranty. Shipping and handling fees and related freight costs and supplies associated with shipping products to customers are included as a component of cost of goods sold. The Company accounts for sales returns as a component of its estimated warranty accrual, discounts as a reduction in revenue, and shipping credits as a reduction in its cost of goods sold. The Company does not grant price concessions to its OEMs, resellers or distributors.

#### Accounting for Stock Based Compensation

The Company accounts for employee stock options as compensation expense, in accordance with ASC 718. ASC 718 requires companies to expense the value of employee stock options and similar awards, and applies to all outstanding and vested stock-based awards.

In computing the impact, the fair value of each option is estimated on the date of grant based on the Black-Scholes options-pricing model utilizing certain assumptions for a risk free interest rate; volatility; and expected remaining lives of the awards. The assumptions used in calculating the fair value of share-based payment awards represent management's best estimates, but these estimates involve inherent uncertainties and the application of management's judgment. As a result, if factors change and the Company uses different assumptions, the Company's stock-based compensation expense could be materially different in the future. In addition, the Company is required to estimate the expected forfeiture rate and only recognize expense for those shares expected to vest. In estimating the Company's forfeiture rate, the Company analyzed its historical forfeiture rate, the remaining lives of unvested options, and the amount of vested options as a percentage of total options outstanding. If the Company's actual forfeiture rate is materially different from its estimate, or if the Company reevaluates the forfeiture rate in the future, the stock-based compensation expense could be significantly different from what we have recorded in the current period. The impact of applying ASC 718 approximated \$145,000 and \$213,000 in additional compensation expense during the nine months ended September 30, 2011 and 2010, respectively. Such amounts are included in research and development expenses and selling, general and administrative expense on the statement of operations.

## Product Warranties

The Company typically warrants its products for two years. Estimated product warranty expenses are accrued in cost of sales at the time the related sale is recognized. Estimates of warranty expenses are based primarily on historical warranty claim experience. Warranty expenses include accruals for basic warranties for products sold. While management believes our estimates are reasonable, an increase or decrease in submitted warranty claims could affect warranty expense and the related current and future liability.

Accrued warranty expenses at December 31, 2010 and September 30, 2011 consist of the following:

|                             |           |
|-----------------------------|-----------|
| Balance, January 1, 2010    | \$2,648   |
| Additions                   | 6,327     |
| Deductions                  | (6,895 )  |
| Balance, December 31, 2010  | \$2,080   |
| Additions                   | 42,695    |
| Deductions                  | (40,079 ) |
| Balance, September 30, 2011 | \$4,696   |

## Provision for Income Taxes

The Company utilizes the asset and liability method of accounting for income taxes pursuant to ASC 740 Accounting for Income Taxes, which requires the recognition of deferred tax assets and liabilities for both the expected future tax impact of differences between the financial statement and tax basis of assets and liabilities, and for the expected future tax benefit to be derived from tax loss and tax credit carryforwards. ASC 740 additionally requires the establishment of a valuation allowance to reflect the likelihood of realization of deferred tax assets. We have reported net operating losses for consecutive years, and do not have projected taxable income in the near future. This significant evidence causes our management to believe a full valuation allowance should be recorded against the deferred tax assets.

## Goodwill

On January 1, 2011, the Company adopted FASB ASU No. 2010-28, Intangibles (Topic 350): When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts. The Guidance calls for reporting units with zero or negative carrying amounts to perform Step 2 of the goodwill impairment test. As of September 30, 2011, the Company's fair value exceeded its carrying value, which was positive; therefore, the Company is not required to perform Step 2.

In accordance with ASC 350, Goodwill and Other Intangible Assets, previously recognized goodwill was tested by management for impairment during 2011 and 2010 utilizing a two-step test. At a minimum, an annual goodwill impairment test is required, or when certain events indicate a possible impairment.

The first part of the test is to compare the Company's fair market value to the book value of the Company. If the fair market value of the Company is greater than the book value, no impairment exists as of the date of the test. However, if book value exceeds fair market value, the Company must perform part two of the test, which involves recalculating the implied fair value of goodwill by repeating the acquisition analysis that was originally used to calculate goodwill, using purchase accounting as if the acquisition happened on the date of the test, to calculate the implied fair value of goodwill as of the date of the test.

The Company has no accumulated impairment losses on goodwill. The Company's impairment analysis is performed on December 31 each year, on the Company's single reporting unit. Using the Company's market capitalization (based on Level 1 inputs), management determined that the estimated fair market value substantially exceeded the company's book value as of September 30, 2011 and December 31, 2010. Based on this, no impairment was recorded as of September 30, 2011 or December 31, 2010.

#### New Accounting Pronouncements:

In May 2011, the FASB issued Accounting Standards Update ("ASU") 2011-04, "Fair Value Measurement – Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs," addressing how to measure fair value and what disclosures to provide about fair value measurements. This amendment is largely consistent with the existing GAAP guidance, but aligned the international guidance and eliminated unnecessary wording differences between GAAP and International Financial Reporting Standards ("IFRS"). The amendment is effective for interim and annual periods beginning after December 15, 2011, and should be applied prospectively. The implementation of this standard will not affect the Company's financial condition, results of operations, or cash flows.

In June 2011, the FASB issued ASU 2011-05, "Statement of Comprehensive Income," which revises the manner in which entities present comprehensive income in their financial statements, requiring entities to report components of comprehensive income in either (1) a continuous statement of comprehensive income or (2) two separate but consecutive statements. The amendments are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2011 and should be applied retrospectively. The implementation of this standard will not affect the Company's financial condition, results of operations or cash flows.

In September 2011, the FASB issued ASU 2011-08, "Intangibles – Goodwill and Other (Topic 350): Testing Goodwill for Impairment," which adds a new option entities can use to determine whether it is necessary to apply the traditional two step goodwill impairment test, based on qualitative factors. If the entity elects to use the option, it must assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If so, the existing quantitative calculations in steps one and two continue to apply. However, if after assessing the totality of the qualitative factors, an entity determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step impairment test is unnecessary. Under the amendments, an entity has the option to bypass the qualitative assessment for any reporting unit in any period and proceed directly to performing the first step of the two-step goodwill impairment test. An entity may resume performing the qualitative assessment in any subsequent period. The amendments are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2011 and should be applied prospectively. The implementation of this standard will not affect the Company's financial condition, results of operations or cash flows.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

The information in this Item is not being disclosed by Smaller Reporting Companies pursuant to Regulation S-K.

ITEM 4. CONTROLS AND PROCEDURES

(a) Evaluation of Disclosure Controls and Procedures. Under the supervision and with the participation of its Principal Executive Officer and Principal Financial Officer, management has evaluated the effectiveness of the Company's disclosure controls and procedures as of the end of the period covered by this report pursuant to Rule 13a-15(b) under the Securities Exchange Act of 1934 (the Exchange Act). Based on that evaluation, the Principal Executive Officer and Principal Financial Officer have concluded that, as of the end of the period covered by this report, the Company's disclosure controls and procedures are effective in ensuring that information required to be disclosed in the Company's Exchange Act reports is (1) recorded, processed, summarized and reported in a timely manner, and (2) accumulated and communicated to the Company's management, including its Principal Executive Officer and Principal Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

(b) Changes in Internal Controls. There were no material changes in the Company's internal control over financial reporting as of the end of the period covered by this report as such term is defined in Rule 13a-15(f) of the Exchange Act.

PART II — OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

None.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. RESERVED

None.

ITEM 5. OTHER INFORMATION

None.

- 25 -

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ITEM 6. EXHIBITS

- 31.1 Certification by the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification by the Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification by the Chief Executive Officer pursuant to Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification by the Principal Financial Officer pursuant to Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

101.INS \*\* XBRL Instance Document

101.SCH \*\* XBRL Taxonomy Extension Schema Document

101.CAL \*\* XBRL Taxonomy Extension Calculation Linkbase Document

101.DEF \*\* XBRL Taxonomy Extension Definition Linkbase Document

101.LAB \*\* XBRL Taxonomy Extension Label Linkbase Document

101.PRE \*\* XBRL Taxonomy Extension Presentation Linkbase Document

\*\* XBRL (Extensible Business Reporting Language) information is furnished and not filed or a part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, is deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise is not subject to liability under these sections.



SIGNATURES

In accordance with the requirements of the Securities Exchange Act of 1934, the Company caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

POWER EFFICIENCY CORPORATION  
(Company)

Date: November 14, 2011

By: /s/ Steven Strasser  
Chief Executive Officer (principal executive officer)

Date: November 14, 2011

By: /s/ Brian Chan  
Vice President of Finance and Accounting  
(principal financial and accounting officer)

- 27 -

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