

POWER EFFICIENCY CORP  
Form 10-K  
March 30, 2012

**Securities and Exchange Commission**

**Washington, D.C. 20549**

**FORM 10-K**

Annual report under Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the fiscal year ended December 31, 2011

Transition report under Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 000-31805

**Power Efficiency Corporation**

(Exact name of registrant as specified in its Charter)

Delaware 22-3337365  
(State or Other Jurisdiction of Incorporation or Organization) (I.R.S. Employer Identification No.)

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

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

Securities Registered under Section 12(g) of the Exchange Act:

Common Stock, \$.001 Par Value  
(Title of Class)

Check whether the Company: (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act 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

Check if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-K contained in this form, and no disclosure will be contained, to the best of Company's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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 and Regulations S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definition of "accelerated filer and large 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

As of June 30, 2011, the aggregate market value of the common stock held by non-affiliates of the issuer was \$3,545,667. This amount is based on the closing price of \$0.09 per share for the Company's common stock as of such date.

On March 23, 2012 there were 67,533,666 shares of the Company's common stock outstanding.

#### **DOCUMENTS INCORPORATED BY REFERENCE**

None.

In this report, references to "we", "us" or "our" collectively refer to Power Efficiency Corporation.

## **SPECIAL CAUTIONARY NOTICE REGARDING 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,” “forecasts,” “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.

## GLOSSARY OF TERMS

Set forth below are technical terms used in the discussion in this document and explanations of the meanings of those terms.

Alternating Current (AC)	A type of electrical current, the direction of which is reversed at regular intervals or cycles; in the U.S. the standard is 120 reversals or 60 cycles per second; typically abbreviated as AC.
Ampere (amp)	A unit of measure for an electrical current; the amount of current that flows in a circuit; abbreviated as amp.
Current (Electrical)	The flow of electrical energy (electricity) in a conductor, measured in amperes.
Cycle	In an alternating current, the current goes from zero potential (or voltage) to a maximum in one direction, back to zero, and then to a maximum potential (or voltage) in the other direction. The number of complete cycles per second determines the current frequency; in the U.S. the standard for alternating current is 60 cycles.
Efficiency	Efficiency is the ratio of work (or energy) output to work (or energy) input, and cannot exceed 100 percent.
Energy	The capability of doing work.
Horsepower (HP)	A unit for measuring the power of motors or the rate of doing work. One horsepower equals 33,000 foot-pounds of work per minute or 746 watts.
Induction	The production of an electric current in a conductor by the variation of a magnetic field in its vicinity.
Induction Motor	The simplest and most rugged electric motor, it consists of a wound stator and a rotor assembly. The AC induction motor is so named because the electric current flowing in its secondary member (the rotor) is induced by the alternating current flowing in its primary member (stator). The power supply is connected only to the stator. The combined electromagnetic efforts of the two currents produce the force to create rotation.
Inrush Current	The current that flows at the instant of connection of a motor to the power source. Usually expressed as a multiple of motor full-load current.
Kilowatt (kW)	A standard unit of electrical power equal to one thousand watts.
Load	The demand on an energy producing system. The energy consumption or requirement of a piece or group of equipment.
Motor	A machine supplied with external energy that is converted into force and/or motion.

Power	The rate at which work is done, typically measured in watts or horsepower.
Power Factor	The ratio of watts to volt-amperes of an AC electric circuit.
Soft-start	Soft-start is the regulation of the supply voltage from an initial low value to full voltage during the starting process.
Torque (Motor)	The rotating force provided by a motor. The units of torque may be expressed as pound-foot, pound-inch (English system), or newton-meter (metric system).

Torque (Starting)	This torque is what is available to initially get the load moving and begin its acceleration.
Transformer	An electromagnetic device that changes the voltage of alternating current electricity; it consists of an induction coil having a primary and secondary winding and a closed iron core.
Voltage	The amount of electromotive force, measured in volts that exists between two points.
Watt	The amount of power required maintaining a current of one ampere at a pressure of one volt when the two are in phase with each other. One horsepower is equal to 746 watts.

## **PART I**

### Item 1. Description of Business.

#### (a) Business Development

##### **Formation**

Power Efficiency Corporation (the “Company”) was incorporated in Delaware on October 19, 1994. From inception through 1997, the Company was a development stage entity that was engaged in the design, development, marketing and sale of proprietary solid state electrical components designed to reduce energy consumption in alternating current induction motors. Alternating current induction motors are commonly found in industrial and commercial facilities throughout the world.

#### (b) Business of the Company

##### **The Company’s Principal Products and Technology**

In the late 1990s the Company commenced the sale of its initial product, which was based on analog technology and reduces energy consumption in alternating current induction motors in certain applications. This product has been known by several names, including the *Power Commander*® and *Power Genius*. In 2005 the Company began development of a digital product that would overcome many of the commercial limitations of the analog product. In 2008, limited models of the first-generation of the digital product were launched. In mid-2009 the Company launched a line of products up to 300 horsepower that had certification from Underwriters Laboratories (“UL”) and/or Canadian Standards Associate (“CSA”) and its second-generation digital circuitry was launched. Going forward, the Company has chosen to call its products Motor Efficiency Controllers (“MEC”).

The Company has developed patented and patent-pending technologies for effectively controlling the energy usage of an electric motor. The Company has been granted two United States Patents, the first 1998 and the second in 2010. Over the past four years the Company has undertaken extensive study and computer modeling of motors and their energy use, and has developed digital technologies for its controllers. In the process, the Company has discovered what it believes are significant innovations and has completed numerous patent filings around these new inventions in the US and other major world economies. The Company has branded these collective patented and patent pending technologies as *E-SAVE Technology*® and has a registered trademark on this name.

The Company has developed technologies and products for use on three-phase and single-phase motors. Three-phase power and motors are generally found in industrial and commercial buildings for larger applications than single-phase power and motors.

The Company's marketing efforts initially focused on the three-phase version but it is also now marketing the single-phase product. The Company's digital Three-Phase MEC is designed to have the following functionality:

1. Start a motor
2. Provide a soft start for the motor, bringing it gradually from rest to full speed
3. Provide various motor protection capabilities, such as sensing current overload, phase loss, under- and over-voltage, and more
4. Save energy when the motor is at full speed but is less than fully loaded

The Company's digital Single-Phase MEC is designed to have the following functionality:

1. Start a motor
2. Provide a soft start for the motor, bringing it gradually from rest to full speed
3. Save energy when the motor is at full speed but is less than fully loaded

Three-Phase and Single-Phase MECs are unique particularly because of their energy savings capabilities. The product reduces energy consumption by electric motors by electronically sensing and controlling the amount of energy the motor consumes. A motor with an MEC installed only uses the energy it needs to perform its work task, thereby typically reducing its energy use. The result is a reduction of energy consumption typically ranging from 15% - 35% in applications that do not always run at peak load levels. The amount of energy savings depends on a variety of factors, including the load on the motor and the motor's characteristics.



The Company's management believes its Motor Efficiency Controllers offer certain advantages over competing products for the following reasons:

**Motor and Equipment Life:** The MEC extends motor life by reducing the stress and strain on the motor and surrounding equipment, and reduces the amperage to the motor, which results in cooler running.

**Successful Utility and Customer Tests:** The MEC has been successfully tested by numerous electric utilities and customers. For example, Paragon Consulting Services, a contractor for Nevada Power Company, the electric utility for southern Nevada, performed 8 field tests on escalators and one on an elevator in major Las Vegas casinos. The tests resulted in average energy savings of over 30% on the escalators and 20% on the elevator.

**Utility Incentive Financing:** The three-phase product has qualified for rebate incentive financing, most frequently called "rebates," from many electric utilities. This financing is generally paid to the end user of the MEC as an incentive to invest in energy saving products. As such, this financing effectively decreases the cost of the Company's MEC for end users. The utilities that have approved the Company's products for incentive financing include: NV Energy (formerly Nevada Power Company and Sierra Pacific Power Company), the Los Angeles Department of Water and Power, Southern California Edison, Sacramento Municipal Utility District, Anaheim Utilities, the New York Power Authority, Excel Energy and San Diego Gas and Electric.

**Acceptance by Original Equipment Manufacturers:** The Company's products have been approved and installed by numerous original equipment manufacturers ("OEMs") in the escalator and granulator industries.

### ***Three-Phase MEC***

The Company initially focused its marketing efforts for the Three-Phase MEC in the elevator and escalator industry, although the Company is also actively marketing this product to industrial markets, such as recycling, mining, plastics, and manufacturing. Industries that operate equipment such as conveyor systems, crushing equipment, stamping presses, granulators, grinders, shredders and other motor driven equipment with varying loads, are believed to be viable target markets for the Three-Phase MEC. The Company is seeking to target markets with appropriate applications and market access, using direct sales, OEMs, distributors and independent representatives to address these markets.

### ***Single-Phase Product***

Like the Company's three-phase product described above, the Company's single-phase product reduces energy consumption in electric motors by sensing and controlling the amount of energy the motor consumes. Many motors commonly used in home appliances and other consumer goods are single-phase AC motors. Since the single-phase product is much smaller, has a much lower price point, and can be incorporated directly into a broad variety of applications, the Company believes it is a product most suitable for installation at the OEM level.

### ***Product Development***

The Company has devoted significant time and resources in the past several years toward developing “digital” versions of its three-phase and single-phase products. Through this process, the Company has transformed its technology so that its key technological breakthroughs are primarily incorporated in algorithms and software on a microchip. The Company believes the digital versions of its products have several distinct advantages over the older analog versions, including:

Motor starter and motor protection capabilities similar to standard solid state starters sold by large motor control companies. The analog product could not start a motor and provided no motor protection, so the customer had to purchase these items at additional costs for components and installation. The digital MEC instead incorporates all these functions and therefore replaces a standard solid state motor control.

Increased ease of installation and reduced technical support requirements. For example, instead of approximated and manual adjustments during installation, which can require technical support from the Company, the digitized unit will allow more simplified and precise adjustments by customers and third party installers.

Reduced product size, which is important for many installations.

Input-output communications capabilities, so the device can communicate with external control systems.

Increased functionality. The Company expects to be able to add new functionality to the products. These new functions may include such things as:

- o Recording and reporting of actual energy savings;
- o Prediction of maintenance problems by reading and reporting on changes in the motor’s operating characteristics; and
- o More secure intellectual property protection through the use of secured chips and software.

## Marketing and Sales

The Company's marketing efforts have historically been concentrated in the elevator and escalator industry, primarily to OEMs of elevator and escalator equipment and end users that own this equipment. With UL approval in mid-2009, the Company began targeting industrial markets, such as mining, aggregates and plastics. End users of the Company's products include retail chains, hotels, airports, transit systems, and mining, plastics and manufacturing companies.

The Company sells products into the elevator and escalator market primarily to and through global OEM resellers. The elevator and escalator market is dominated by four global companies, Otis Elevator, Schindler, ThyssenKrupp and KONE. Collectively these companies are believed to have over 80% of the world market for new equipment and service contracts.

The Company signed formal supply agreements for North America with ThyssenKrupp and KONE in the middle of 2009 and with Schindler in late 2010. Many of these global OEMs have their own private label versions of the Company's products. These private label products are made by the Company exclusively for a particular OEM. The Company also sells to and completes projects with Otis Elevator, although there is no formal agreement.

In 2010, the Company began targeting the Asian operations of these global OEMs. In the first half of 2010, the Company completed a sale to the Sands China Limited, owner of the Venetian Macau, Sands Macau and Four Seasons Macau. This sale was the Company's first major project in Asia. In the fourth quarter of 2011, the Company opened a wholly owned subsidiary, Power Efficiency Asia, Limited ("PE Asia") in Hong Kong. The Company plans to utilize PE Asia as its sales and marketing arm in Asia.

The Company is focused on penetrating industrial markets through independent representatives and distributors who will in turn sell to OEMs of industrial equipment and end users. The Company significantly increased these industrial market activities in late 2009 after receiving UL certification, since this certification is required by many industrial concerns.

In 2010, the Company signed a private label agreement with one of the largest industrial distributors in the U.S. This distributor began offering the Company's three phase product through its website in late 2010 and in its 2011 catalog, its largest sales channel. Also in 2011, the Company began developing new products for this distributor featuring E-Save Technology®.

The Company's longer term goal is to be a high value supplier of technologies, with numerous OEMs and other resellers engaged with high volume sales and/or licensing agreements.

## **Manufacturing and Distribution**

The Company's strategy is to assemble internally products that sell at lower volumes, such as MECs for very large motors, and to outsource the manufacturing of higher volume products, such as smaller units and circuit boards. The Company believes this strategy allows for high quality production, cost efficiencies, and the capability to rapidly increase production volumes. Management believes this strategy has the ability to meet the Company's production needs.

## **Competition**

Power Efficiency believes the principal competitive factors in the Company's markets include innovative product development, return on investment from energy savings, product quality, product performance, utility rebate acceptance, established customer relationships, name recognition, distribution and price.

***Three-Phase Competition.*** The Company's Three-Phase MEC's principal capabilities include being a motor starter, providing a soft start and protection for the motor, and reducing the motor's electricity consumption once the motor is at full speed. The Company believes its products are unique primarily because of the last capability – energy savings.

The first capabilities - starting, soft starting and protecting a motor - are commonly found in existing motor control products. There are billions of dollars of motor starters and soft starts sold every year. These products are typically manufactured and marketed by large motor control companies, many of which have longer operating histories, established markets and far greater financial, advertising, research and development, manufacturing, marketing, personnel and other resources than the Company currently has or may reasonably be expected to have in the foreseeable future. This competition may have an adverse effect on the ability of the Company to commence and expand its operations or operate in a profitable manner.

There are also several small companies that reportedly make products that combine motor starting, soft starting and energy savings. The Company is unaware of any large company that makes a product of this nature. Although the Company has not completed any formal market study, the Company believes its Three-Phase MEC has the following competitive advantages over other products:

- It combines soft start features with energy savings features in a single integrated unit that is CSA, UL and CE certified and has achieved energy savings levels of up to 15% to 35% in independent, third party testing;
- It has proprietary technology, protected by two U.S. patents. Two additional patent filings on new innovations are pending approval of the U.S. Patent and Trademark Office;
- It has been tested extensively by utilities with documented energy savings and approval for incentive financing rebates;

- It is accepted by OEMs in the escalator and granulator industries.

**Single-Phase Competition.** There have been several companies that have, with different technologies, attempted to exploit this market due to the enormous opportunity in single-phase motor applications. These products include among others, “Green Plug” (voltage clamping), “Power Planner” (digital microchip) and “Econelectric” (power factor control). The Company has made numerous innovations in the past three years that it believes overcome many of the problems with these and the Company’s earlier designs. The Company has filed for a patent on these innovations and has reduced the product in size and cost to the point it can be sold to OEMs of applicable appliances and other equipment driven by single-phase AC motors.

**Premium Efficiency Motors.** Motors are rated by their efficiency at or near full load. However, when motors, including “premium efficiency motors” are lightly loaded, they become very inefficient. Management believes that the energy savings gain attributable to premium efficiency motors is materially lower than that of its MEC on underloaded motor applications. Furthermore, the Company’s products are able to save energy on underloaded premium efficiency motors, so that such motors and the Company’s technology are not mutually exclusive.

### **Source of Supply and Availability of Raw Materials**

The MEC has been designed to use standard, off-the-shelf, easily acquired components, except for the custom made circuit boards. Such off-the-shelf components are basic items readily available worldwide at competitive prices. They come in standard and miniature versions and offer the Company latitude in product design and production. Although the Company believes most of the key components required for the production of its products are currently available in sufficient production quantities from multiple sources, there can be no assurance they will remain so readily available or at comparable prices.

### **Customers**

The Company currently does business with approximately 35 customers. Of this number, four customers presently account for approximately 72% of the Company's gross revenues. These customers and their respective gross revenue percentages are KONE – 32%; Schindler – 22%; IPEG – 8%; and Otis Elevator Company – 10%. The Company is, and may continue to be, dependent upon a limited number of customers. Accordingly, the loss of one or more of these customers may have a material adverse effect upon the Company's business.

### **Patents and Proprietary Rights**

The Company currently relies on a combination of trade secrets, non-disclosure agreements and patent protection to establish and protect its proprietary rights in its products. There can be no assurance these mechanisms will provide the Company with any competitive advantages. Furthermore, there can be no assurance others will not independently develop similar technologies, duplicate or "reverse engineer" the proprietary aspects of the Company's technology.

The Company has three U.S. patents issued with respect to its products. The first, "Balanced and Synchronized Phase Detector for an AC Induction Motor Controller," No. 5,821,726, was issued on October 13, 1998 and expires in 2017. This patent covers improvements to the technology under the NASA License Agreement (described below), which were developed by the Company. Management believes this patent protects the Company's intellectual property position beyond the expiration of the NASA License Agreement. The second patent, "Method, System, and Apparatus for Controlling an Electric Motor," No. 7,768,221 B2, was issued on August 3, 2010 and expires in 2027. This patent covers the Company's core algorithm for controlling the energy use of a three phase motor. This patent has been filed in many major world economies. The third patent, "Open Loop Method for Controlling Power," No. 7,911,173 B2 was issued on March 22, 2011 and expires in 2030. This patent covers some the Company's technologies used in controlling the energy use of a three phase motor. This patent has also been filed in many major world economies.

The Company has filed three utility patents on new inventions associated with the development of its digital products, two of which have resulted in a granted patent from the U.S. patent Office. The other patent filing is still pending approval by the U.S. Patent Office and other countries' patent offices. The Company is continually making improvements to its products and technologies, and anticipates making additional patent filings on new inventions when warranted.

The Company has obtained U.S. Trademark registration of the *E-Save Technology*® mark.

### ***NASA License Agreement***

The Company had been the exclusive United States licensee of certain power factor controller technology owned by the United States of America, as represented by NASA. This license agreement covered the United States and its territories and possessions and did not require the Company to pay royalties to NASA in connection with the Company's sale of products employing technology utilizing the licensed patents. The Company's rights under the license agreement were non-transferable and were not to be sublicensed without NASA's consent. The license agreement was terminated on December 16, 2002 upon expiration of all of the licensed patents.

The Company believes its products and other proprietary rights do not infringe any proprietary rights possessed by third parties. There can be no assurance, however, that third parties will not assert infringement claims in the future, the defense costs of which could be substantial.

### **Government Regulation**

The Company is not required to be certified by any government agencies. However, most of the Company's products are manufactured to comply with specific codes that meet industry accepted safety standards. Presently, many of the Company's products are certified to comply with UL 508 Industrial Control Equipment and the Company has also received certification meeting CSA (Canadian Standards Association) B44.1/ASME-17.5 Elevator and Escalator Electrical Equipment for many of the Company's products. Many of the Company's products are also CE marked. The Department of Commerce does not require the Company's technology to be certified for export. The Company's industrial code is 421610 and the SIC code is 5063.

### **Deregulation of Electrical Energy**

Sales of the Company's product are not dependent on deregulation of the electrical energy market as the Company's product can be sold in regulated and deregulated markets.

### **Research and Development**

The Company intends to continue its research and development effort to introduce new products based on its energy saving technology. Towards this end, the Company spent \$1,110,670 and \$722,753 in fiscal years 2011 and 2010, respectively, on research and development activities, virtually none of which was borne by customers. A major focus of the Company's foreseeable research and development activities will be on completing additional features and refinements to the three-phase and single phase products. The Company also anticipates the possibility of working with OEMs that make or purchase motor control equipment, in order to develop products with features or specifications they require.

### **Effect of Environmental Regulations**

The Company is not aware of any federal, state, or local provisions regulating the discharge of materials into the environment or otherwise relating to the protection of the environment with which compliance by the Company has had, or is expected to have, a material effect upon the capital expenditures, earnings, or competitive position of the Company.

### **Employees**

At the date of this document, the Company employs thirteen people. Of this number, two are engaged in accounting and finance, three in operations and general management, four in sales and marketing, and four in product research and development, engineering and manufacturing. At such time as business conditions dictate, the Company may hire additional personnel for, among other things, increased engineering, marketing and sales. The Company has no collective bargaining agreements and considers its relationship with its employees to be good. The Company utilizes consultants in the areas of marketing, product and technology development and finance on a regular basis.



(c) Reports to Security Holders

The Company is a smaller reporting company, and as such files Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q under the scaled disclosure requirements and Current Reports on Form 8-K on a regular basis with the SEC.

The public may read and copy any materials the Company files with the SEC at the SEC's Public Reference Room at 100 F Street, N.E., Washington, D.C. 20549. The public may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC maintains an internet site that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC at <http://www.sec.gov>.

Item 1A. Risk Factors.

RISKS RELATED TO OUR BUSINESS

**Unless We Achieve Profitability and Related Positive Cash Flow, We May Not Be Able To Continue Operations, And Our Auditors Have Questioned Our Ability To Continue As A "Going Concern".**

The Company has suffered recurring losses from operations, and experienced a deficiency of cash of approximately \$3,100,000 and \$2,700,000 from operations for the years ended December 31, 2011 and 2010, respectively. For the years ended December 31, 2011 and December 31, 2010, we had net losses of \$3,610,078 and \$3,275,960, respectively. In our Auditors' Report on our December 31, 2011 financial statements included in this report, our auditors have stated that these factors raise substantial doubt about our 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, 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.

**We Have A Limited Operating History, Have Experienced Recurring Losses And Have Limited Revenue.**

To date, and due principally to a lack of working capital, our operations have been limited in scale. Although we have established relationships with suppliers, and have received contracts for our products, we may experience difficulties in production scale-up, product distribution, and obtaining and maintaining working capital until such time as our operations have been scaled-up to acceptable commercial levels. We have not had a profitable quarter in the past three years and we cannot guarantee we will ever operate profitably. In addition, we have limited revenue. For the year ended December 31, 2011, our total revenues were \$450,360, and for the year ended December 31, 2010, our total revenues were \$576,797.

**We Do Not Have A Bank Line Of Credit.**

At the present time, we do not have a bank line of credit, which further restricts our financial flexibility.

**We Will Require Additional Funds To Meet Our Cash Operating Expenses And Achieve Our Current Business Strategy.**

The Company has negative working capital and will be dependent upon additional financing to meet capital needs and repay outstanding debt. We cannot guarantee additional financing will be available on acceptable terms, if at all. We also need additional financing to raise the capital required to fully implement our business plan. Our current operating expense level is approximately \$250,000 to \$300,000 per month. Management is seeking to raise additional capital through equity issuance, debt financing or other types of financing. However, there are no assurances that sufficient capital will be raised.

When our operations require additional financing, if we are unable to obtain it on reasonable terms, we would be forced to restructure, file for bankruptcy or cease operations, any of which could cause you to lose all or part of your investment in us.

**Our Management Group Owns Or Controls A Significant Number Of The Outstanding Shares Of Our Common Stock And Will Continue To Have Significant Ownership Of Our Voting Securities For The Foreseeable Future.**

As of the date of this report, management controls approximately sixty eight percent (68%) of our issued and outstanding Common Stock and voting equivalents and as much as seventy two percent (72%) of our Common Stock on a fully diluted basis. As a result, these persons will have the ability, acting as a group, to greatly influence our affairs and business, including the election of directors and, subject to certain limitations, approval or preclusion of fundamental corporate transactions. This concentration of ownership of our common stock may:

- delay or prevent a change in the control;
- impede a merger, consolidation, takeover, or other transaction involving the Company; or
- discourage a potential acquirer from making a tender offer or otherwise attempting to obtain control of the Company.

**Our Business Depends Upon The Maintenance Of Our Proprietary Technology, And We Rely, In Part, On Contractual Provisions To Protect Our Trade Secrets And Proprietary Knowledge.**

The Company depends upon its proprietary technology, relying principally upon trade secret and patent law to protect this technology. The Company also regularly enters into confidentiality agreements with key employees, customers, potential customers, and vendors and limits access to and distribution of trade secrets and other proprietary information. However, these measures may not be adequate to prevent misappropriation of our technology. Additionally, our competitors may independently develop technologies substantially equivalent or superior to our technology. In addition, the laws of some foreign countries do not protect our proprietary rights to the same extent as the laws of the United States. We also are subject to the risk of adverse claims and litigation alleging infringement of intellectual property rights of others.

Confidentiality agreements to which we are party may be breached, and we may not have adequate remedies for any breach. Our trade secrets may also be known without breach of such agreements or may be independently developed by competitors. Our inability to maintain the proprietary nature of our technology and processes could allow our competitors to limit or eliminate any competitive advantages we may have.

**We Are Dependent On Third-Party Suppliers.**

Although we believe most of the key components required for the production of our products are currently available in sufficient production quantities from multiple sources, they may not remain so readily available. It is possible that other components required in the future may necessitate custom fabrication in accordance with specifications developed or to be developed by us. Also, in the event that we, or our contract manufacturer, as applicable, are unable to develop or acquire components in a timely fashion, our ability to achieve production yields, revenues and net income can be expected to be adversely affected

**We Are Developing And Commercializing New Energy Saving Technologies And Products Which Will Involve Uncertainty And Risks Related To Product Development And Market Acceptance.**

Our success is dependent, to a large degree, upon our ability to fully develop and commercialize our technology and gain industry acceptance of our products based upon our technology and its perceived competitive advantages. Accordingly, our prospects must be considered in light of the risks, expenses and difficulties frequently encountered in connection with the establishment of a new business in a highly competitive industry, characterized by frequent new product introductions. We anticipate that we will incur substantial expense in connection with the development and testing of our proposed products and expect these expenses to result in continuing and significant losses until such time, if ever, that we are able to achieve adequate levels of sales or license revenues.

**We Have Limited Experience in Direct Sales.**

Our products have been distributed primarily through OEMs. We have recently begun pursuing an expanded distribution strategy designed to reduce our reliance on OEMs. Pursuant to this strategy, we are increasing our direct sales efforts into new markets. Our future growth and profitability will depend upon the successful development of business relationships with additional OEMs, growth in direct sales, and sales through select resellers and reps to penetrate the market with our products.

**We Currently Depend On A Small Number Of Customers And Expect To Continue To Do So.**

The Company currently does business with approximately 35 customers. Of this number, four customers accounted for approximately 72% of our gross revenues in 2011. We are, and may continue to be, dependent upon a small number of customers. Accordingly, the loss of one or more of these customers is likely to have a material adverse effect on our business.

**Most Of Our Current And Potential Competitors Have Greater Name Recognition, Financial, Technical And Marketing Resources, And More Extensive Customer Bases And Industry Relationships Than We Do, All Of Which Could Be Leveraged To Gain Market Share To Our Detriment, Particularly In An Environment Of Rapid Technological Change.**

We compete against a number of companies in the electric motor energy savings market, many of which have longer operating histories, established markets and far greater financial, advertising, research and development, manufacturing, marketing, personnel and other resources than we currently have or may reasonably expect to have in the foreseeable future. This competition may have an adverse effect on our ability to expand our operations or operate profitably. The motor control industry is also highly competitive and characterized by rapid technological change. Our future performance will depend in large part upon our ability to become and remain competitive and to develop, manufacture and market acceptable products in these markets. Competitive pressures may necessitate price reductions, which can adversely affect revenues and profits. If we are not competitive in our ongoing research and development efforts, our products may become obsolete, or be priced above competitive levels. However, management believes, based upon their performance and price, our products are attractive to customers. We cannot guarantee that competitors will not introduce comparable or technologically superior products, which are priced more favorably than our products.

**Changes In Retail Energy Prices Could Affect Our Business.**

We have found that a customer's decision to purchase an MEC (or similar product) is primarily driven by the payback on the investment resulting from the increased energy savings. Although management believes that current retail energy prices support an attractive return on investment for our products, the future retail price of electrical energy may not remain at such levels, and price fluctuations reducing energy expense could adversely affect product demand.

**Loss Of Key Personnel Could Have Significant Adverse Consequences.**

We currently depend on the services of Steve Strasser, our Chief Executive Officer. The loss of the service of this person could have an adverse effect on our business. As discussed under “Management”, we have entered into a long-term employment contract with Mr. Strasser, but such contract does not guarantee he will remain with us.

**We Do Not Have “Key Man” Life Insurance.**

The Company presently does not have any key man life insurance policies. As soon as practicable following the commencement of profitable operations (which may never occur), we intend to purchase key man life insurance on the life of our principal executive officer, Steven Strasser. Upon purchase of such insurance, we intend to pay the premiums and be the sole beneficiary. The lack of such insurance may have a material adverse effect upon our business.

**Delaware Law Limits The Liability Of Our Directors.**

Pursuant to our Certificate of Incorporation, the Company’s directors are not liable to us or our stockholders for monetary damages for breach of fiduciary duty, except for liability in connection with a breach of the duty of loyalty, for acts or omissions not in good faith or which involved intentional misconduct or a knowing violation of law for dividend payments or stock repurchases illegal under Delaware law or any transaction in which a director has derived an improper personal benefit.

**Potential Product Liability Claims May Not Be Fully Covered By Insurance.**

The Company may be subject to potential product liability claims that could, in the absence of sufficient insurance coverage, have a material adverse impact on us. Presently, we have general liability coverage that includes product liability up to \$2,000,000 and umbrella liability up to \$5,000,000. Any large product liability suits occurring early in our growth may significantly and adversely affect our ability to expand the market for our products.

## **RISKS RELATED TO OUR COMMON STOCK AND CAPITAL STRUCTURE**

### **Trading In Our Common Stock Over The Last 12 Months Has Been Limited, So Investors May Not Be Able To Sell As Many Of Their Shares As They Want At Prevailing Prices.**

Prices of our common stock are quoted on the over the counter market. Approximately 25,000 shares were traded on an average daily trading basis for the 12 months ended December 31, 2011. If limited trading in our common stock continues, it may be difficult for shareholders to sell their shares. Also, the sale of a large block of our common stock could depress the market price to a greater degree than a company that typically has a higher volume of trading of its securities.

### **The Limited Public Trading Market May Cause Volatility In Our Stock Price.**

The Company's common stock is currently quoted on a limited basis on the over the counter market under the symbol "PEFF". The quotation of our common stock on the over the counter market does not assure that a meaningful, consistent and liquid trading market exists at all times, and in recent years such market has experienced extreme price and volume fluctuations that have particularly affected the market prices of many smaller companies like us. Our common stock is thus subject to this volatility. Sales of substantial amounts of our common stock, or the perception that such sales might occur, could adversely affect prevailing market prices of our common stock.

### **An Active And Visible Trading Market For Our Common Stock May Not Develop.**

The market for our common stock may become inactive in the future. In the absence of an active trading market:

- Investors may have difficulty buying and selling or obtaining market quotations;
- Market visibility for our common stock may be limited; and
- A lack of visibility for our common stock may have a depressive effect on the market price for our common stock.

The over-the-counter market provides significantly less liquidity than a national securities exchange, and quotes for stocks included on the Over the Counter Markets are not listed in the financial sections of newspapers, as are those for major securities exchanges. The trading price of the common stock is expected to be subject to significant fluctuations in response to variations in quarterly operating results, changes in analysts' earnings estimates, announcements of innovations by the Company or its competitors, general conditions in the industry in which we operate and other factors. These fluctuations, as well as general economic and market conditions, may have a material or adverse effect on the market price of our common stock.

### **Penny Stock Regulations May Impose Certain Restrictions On Marketability Of Our Securities.**

The SEC has adopted regulations which generally define a "penny stock" to be any equity security that has a market price of less than \$5.00 per share or an exercise price of less than \$5.00 per share, subject to certain exceptions. As a result, our common stock is subject to rules that impose additional requirements on broker-dealers who sell such securities to persons other than established customers and accredited investors (generally those with net worth in excess of \$1,000,000 or annual income exceeding \$200,000, or \$300,000 together with their spouse). For transactions covered by these rules, the broker-dealer must make a special suitability determination for the purchase of such securities and have received the purchaser's written consent to the transaction prior to the purchase. Additionally, for any transaction involving a penny stock, unless exempt, the rules require the delivery, prior to the transaction, of a risk disclosure document relating to the penny stock market. The broker-dealer must also disclose the commission payable to both the broker-dealer and the registered representative, current quotations for the securities and, if the broker-dealer is the sole market maker, the broker-dealer must disclose this fact and the broker-dealer's presumed control over the market. Finally, monthly statements must be sent disclosing recent price information for the penny stock held in the account and information on the limited market in penny stocks. Consequently, the "penny stock" rules may restrict the ability of broker-dealers to sell the Company's securities and may affect the ability of investors to sell the Company's securities in the secondary market and the price at which such purchasers can sell any such securities.

Stockholders should be aware that, according to the Commission, the market for penny stocks has suffered in recent years from patterns of fraud and abuse. Such patterns include:

- Control of the market for the security by one or a few broker-dealers that are often related to the promoter or issuer;



· Manipulation of prices through prearranged matching of purchases and sales and false and misleading press releases;

· "Boiler room" practices involving high pressure sales tactics and unrealistic price projections by inexperienced sales persons;

· Excessive and undisclosed bid-ask differentials and markups by selling broker-dealers; and

· The wholesale dumping of the same securities by promoters and broker-dealers after prices have been manipulated to a desired level, along with the inevitable collapse of those prices with consequent investor losses.

The Company's management is aware of the abuses that have occurred historically in the penny stock market.

#### **We May Never Pay Cash Dividends On Our Common Stock.**

We have not paid or declared any dividends on our common stock and do not anticipate paying or declaring any cash dividends on our common stock in the foreseeable future.

#### **Sales Of Common Stock Under Rule 144 May Adversely Affect The Market Price Of Our Common Stock.**

*Possible Resales under Rule 144.* Of the 67,533,666 shares of the Company's common stock outstanding on the date of this report, 53,186,470 shares are freely trading in the market place (the "Free Trading Shares"). The Free Trading Shares are comprised mostly of shares (1) originally issued in private offerings of common stock from June through March 2007, that were later registered in the Company's S-1 Registration Statement (the "Registration Statement"), declared effective on October 10, 2008 and (2) shares originally issued in transactions exempt from registration under the Securities Act.

The remaining 14,347,196 shares of our common stock outstanding are restricted securities as defined in Rule 144 and under certain circumstances may be resold without registration pursuant to Rule 144. These shares include an aggregate of 12,514,802 shares held by Summit Energy Ventures LLC, an entity majority owned by Mr. Strasser, and Steven Strasser individually, and 1,832,394 shares held by directors and insiders.

In addition, the Company had 40,820,283 common stock purchase warrants outstanding and 14,215,562, common stock options outstanding as of the date of this report, including the warrants issued in connection with the private offer and sale of preferred stock units in 2009 and 2010 (See Note 16 to the Financial Statements). The shares issuable on exercise of the options and warrants may, under certain circumstances, be available for public sale in the open market under the Registration Statement or pursuant to Rule 144, subject to certain limitations.

In general, pursuant to Rule 144, after satisfying a six month holding period: (i) affiliated stockholder (or stockholders whose shares are aggregated) may, under certain circumstances, sell within any three month period a number of securities which does not exceed the greater of 1% of the then outstanding shares of common stock or the average weekly trading volume of the class during the four calendar weeks prior to such sale and (ii) non-affiliated stockholders may sell without such limitations, provided we are current in our public reporting obligations. Rule 144 also permits the sale of securities by non-affiliates that have satisfied a one year holding period without any limitation or restriction. Any substantial sale of the common stock pursuant to Rule 144 may have an adverse effect on the market price of the Company's shares.

#### **Exercise Of Outstanding Options And Warrants Will Dilute Ownership Of Outstanding Shares.**

As of the date of this report, the Company has reserved 71,429 shares of common stock for issuance upon exercise of stock options or similar awards which may be granted pursuant to the 1994 Plan, of which no options are outstanding. Furthermore, we have reserved 25,000,000 shares of our common stock for issuance upon exercise of stock options or similar awards which may be granted pursuant to the 2000 Plan, of which options to purchase an aggregate of 14,215,562 shares are outstanding. The outstanding options under the 2000 Plan have a weighted average exercise price of \$0.32. As of the date of this report, we have issued warrants exercisable for 40,820,283 shares of common stock to financial consultants, investors, former employees and other business partners, having a weighted average exercise price of \$0.25 and expiring on various dates from March 2012 to October 2016. Exercise of these options and warrants in the future will reduce the percentage of common stock held by the public stockholders. Furthermore, the terms on which we could obtain additional capital during the life of the options and warrants may be adversely affected, and it should be expected that the holders of the options and warrants would exercise them at a time when we would be able to obtain equity capital on terms more favorable than those provided for by such options and warrants.

**Our Issuance Of “Blank Check” Preferred Stock Could Adversely Affect Our Common Stockholders.**

The Company’s Certificate of Incorporation authorizes the issuance of “blank check” preferred stock with such designations, rights and preferences as may be determined from time to time by the board of directors. Accordingly, our Board of Directors is empowered, without stockholder approval, to issue preferred stock with dividends, liquidation, conversion, voting or other rights that could adversely affect the relative voting power or other rights of the holders of our common stock. In the event of issuance, the preferred stock could be used as a method of discouraging, delaying or preventing a change in control of the Company, which could have the effect of discouraging bids for the Company and thereby prevent stockholders from receiving the maximum value for their shares. From January 20, 2010 through July 30, 2010, the Company sold 4,375 shares of its Series C-1 preferred stock and 326,252 shares of its Series D preferred stock in private offerings of units (See Note 16 to the Financial Statements).

Item 1B. Unresolved Staff Comments.

None

Item 2. Description of Property.

The Company’s corporate office space is located at 5744 Pacific Center Blvd., Suite 311, San Diego, CA 92121. The office lease calls for rent of \$9,298 per month, plus an annual increase equal to 3%, through the end of the lease term in March 2015.

Item 3. Legal Proceedings.

The Company was involved in a lawsuit against a former director (the “Defendant”), who is now CEO of a company offering motor control products. The Company filed this action against the Defendant for misappropriation of trade secrets, false advertising, defamation/libel and other claims primarily arising from the Defendant’s use of the Company’s confidential and proprietary information in the development and marketing of motor control products. The Company sought a temporary restraining order, preliminary injunction, permanent injunction, damages, exemplary damages, attorneys’ fees and costs against the Defendant. The Company’s complaint was filed on August 6, 2009 in the U.S. District Court, District of Nevada. The Defendant agreed to the terms of the Company’s settlement offer on August 7, 2011, and the Company has volunteered to discontinue the lawsuit pursuant to the settlement agreement.

Item 4. Mine Safety Disclosures.

Not applicable.

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**PART II**

Item 5. Market for Common Equity and Related Stockholder Matters.

**Market for Common Stock**

The Company's common stock is traded on the OTCQB tier of the over-the-counter securities market under the symbol "PEFF".

The following table sets forth the high and low bid information for quarterly periods in the two twelve month periods ended December 31, 2011 and December 31, 2010

Twelve months Ended December 31, 2011	High	Low
October 1, 2011 — December 31, 2011	\$0.09	0.01
July 1, 2011 — September 30, 2011	0.10	0.05
April 1, 2011 — June 30, 2011	0.11	0.05
January 1, 2011— March 31, 2011	0.20	0.08
Twelve months Ended December 31, 2010	High	Low
October 1, 2010 — December 31, 2010	\$0.18	0.10
July 1, 2010 — September 30, 2010	0.20	0.12
April 1, 2010 — June 30, 2010	0.28	0.14
January 1, 2010 — March 31, 2010	0.32	0.20

As of March 23, 2012, there were 188 shareholders of record of the Company's common stock.

The Company has not paid dividends on its common stock since its incorporation. The Company does not expect to pay cash dividends on its common stock in the foreseeable future. The Company intends to invest funds otherwise available for dividends, if any, on improving the Company's capital assets.

**EQUITY COMPENSATION PLAN INFORMATION AS OF MARCH 29, 2012**

Number of securities to be issued upon	Weighted average exercise price of	Number of securities remaining
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	exercise of outstanding options, warrants and rights (a)	outstanding options, warrants and rights (b)	available for future issuance under 2000 Stock Option and Restricted Stock Plan (excluding securities reflected in column (a))(c)
2000 Stock Option and Restricted Stock Plan approved by security holders	14,215,562	\$ 0.32	10,784,438
Equity compensation plans not approved by security holders	0	0.00	0
Total	14,215,562	\$ 0.32	10,784,438

The Company maintains a Stock Option Equity Compensation Plan. (See Note 12 to the Financial Statements)

### Recent Sales of Unregistered Securities

During the period covered by this report we did not issue any securities that were not registered under the Securities Act of 1933, as amended, except previously disclosed in a quarterly report on Form 10-Q or a current report on Form 8-K.

### Item 6. Selected Financial Data

We are a “smaller reporting company” as defined by Regulation S-K and, as such, are not providing the information contained in this item pursuant to Regulation S-K.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

## **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 and 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.

### **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.

### **Capitalization**

As of December 31, 2011, the Company had total stockholders' equity of \$661,090 primarily due to the Company's sale of 326,252 shares of Series D Convertible Preferred Stock in a private offering in June and July of 2010, and the Company's sale of 34,625 shares of Series C-1 Convertible Preferred Stock in a private offering in December 2009 through February 2010.

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 year ended December 31, 2011 were marked by a decrease in revenues and an increase in losses from operations that are more fully discussed in the following section "Results of Operations for the Years Ended December 31, 2011 and 2010". Sales cycles for our products are generally lengthy and can range from less than a month to well over one year, depending on customer profile. Larger 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 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 YEARS ENDED DECEMBER 31, 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:

	Year Ended December 31, 2011		Year Ended December 31, 2010	
Revenues	100.0	%	100.0	%
Cost of revenues	84.3		74.5	
Gross profit	15.7		25.5	
Costs and expenses:				
Selling, general and administrative	528.2		436.4	
Research and development	246.6		125.3	
Depreciation and amortization	8.2		7.4	
Total expenses	783.0		569.1	
Loss from operations	(767.3	)	(543.6	)
Other expense	(22.1	)	(15.7	)
Provision for taxes	(11.1	)	(8.7	)
Net loss	(800.5	)	(568.0	)
Dividends paid or payable on Series B, Series C-1 and Series D Preferred Stock	240.2		612.2	
Net loss attributable to common shareholders	(1,040.7	)	(1,180.2	)

## REVENUES

Revenues for the year ended December 31, 2011, were approximately \$450,000, compared to approximately \$577,000 for the year ended December 31, 2010, a decrease of \$127,000 or 22%. This decrease is mainly attributable to a decrease in sales volume in both the elevator and escalator market and the industrial market during the year ended December 31, 2011. Specifically, elevator and escalator sales fell to approximately \$326,000 for the year ended December 31, 2011, from approximately \$422,000 for the year ended December 31, 2010. Industrial and other sales fell to approximately \$124,000 for the year ended December 31, 2011, from \$155,000 for the year ended December

31, 2010. The decrease in elevator and escalator sales and industrial sales during the year ended December 31, 2011 is primarily due to the Company's shift in sales strategy. In 2011, the Company began focusing on breaking into the Asian elevator and escalator market; working with various large and medium sized OEMs. During 2011, the Company signed supply agreements with two medium sized OEMs, as well as entered into global supply agreements with two large OEMs. Also during 2011, the Company shifted its industrial sale focus onto working with a large multi-billion dollar US distributor, with which we entered into a supply agreement, and are currently working with developing new products that utilize E-Save Technology®. For the year ended December 31, 2011, industrial and other sales were approximately 28% of total revenues, and escalator and elevator sales were approximately 72% of total revenues. For the year ended December 31, 2010, industrial and other sales were approximately 27% of total revenues, and escalator and elevator sales were approximately 73% of total revenues.

## **COST OF REVENUES**

Cost of revenues for the year ended December 31, 2011 were approximately \$380,000, compared to approximately \$430,000 for the year ended December 31, 2010, a decrease of \$50,000, or 12%. This decrease is mainly attributable to an overall decrease in sales of 22%, as described above. As a percentage of sales, total cost of revenues increased to approximately 84% for the year ended December 31, 2011, compared to approximately 75% for the year ended December 31, 2010. This increase is mainly attributable to an inventory obsolescence charge of approximately \$45,000 and the \$45,000 in abnormally large warranty costs. The large warranty costs 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.

The inventory obsolescence charge is related to the Company's switch from its 1st generation to its 2nd generation digital products, for products ranging from 22 to 80 amps. These are the Company's highest volume products. As of December 31, 2011 all of our customers were accepting shipments of the 2nd generation products. 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 2012.

## **GROSS PROFIT**

Gross profit for the year ended December 31, 2011 was approximately \$71,000, compared to approximately \$147,000 for the year ended December 31, 2010, resulting in a decrease of \$76,000 or 52%. This decrease is mainly attributable to decreases in sales in both the elevator and escalator and the industrial markets as well as the inventory obsolescence charges and large warranty costs during the year ended December 31, 2011, as described above. As a percentage of revenue, gross profit decreased to approximately 16% for the year ended December 31, 2011, compared to approximately 26% for the year ended December 31, 2010.

## **OPERATING EXPENSES**

### **Selling, General and Administrative Expenses**

Selling, general and administrative expenses were approximately \$2,379,000 for the year ended December 31, 2011, compared to approximately \$2,517,000 for the year ended December 31, 2010, a decrease of \$138,000 or 5%. The decrease in selling, general and administrative expenses compared to the prior year was primarily due to a decrease in stockholder relations expenses of \$101,000, payroll and payroll related expenses of \$79,000, rent expenses of \$51,000, legal and professional fees of \$45,000, and a decrease in insurance expenses of \$20,000. These decreases were partially offset by increases in consulting expenses of \$85,000, travel expenses of \$60,000, and samples and trial unit expenses of \$17,000.

### **Research and Development Expenses**

Research and development expenses were \$1,111,000 for the year ended December 31, 2011, compared to approximately \$723,000 for the year ended December 31, 2010, an increase of \$388,000 or 54%. This increase is mainly attributable to an increase in the Company's product development and certification costs related to the Company's digital controller for both its single-phase and three-phase products of \$81,000, consulting fees of \$74,000, rent of \$70,000, travel expenses of \$65,000, payroll and related payroll expense of \$43,000, and tools and supplies of \$22,000.

### **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 \$828,827 decrease in the fair value of these warrants during year ended December 31, 2010, were reflected as non-operating gains in the Statement of Operations for the year ended December 31, 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 \$3,102,000 and \$2,690,000 from operations for the years ended December 31, 2011 and 2010, respectively. For the years ended December 31, 2011 and December 31, 2010, we had net losses of \$3,610,078 and \$3,275,960, 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 \$1,073,000 at December 31, 2011 and has an immediate need for capital. In our Auditors' Report on our December 31, 2011 financial statements included in this report, our auditors have stated that these factors raise substantial doubt about our 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 and short-term debt. In 2009, the Company received a total of approximately \$1,210,000 in gross proceeds from a private placement of its Series C and Series C-1 preferred stock and warrants to purchase common stock. In 2010, the Company received a total of approximately \$5,395,000 in gross proceeds from private placements of its Series D, Secured Notes (which was subsequently paid off or rolled into its Series D preferred stock offering) and Series C-1 preferred stock and warrants to purchase common stock. In 2011, the Company received a total of \$1,000,000 from the issuance of short-term debt and 2,777,780 warrants to purchase common stock with exercise prices of \$0.09 per share, and 222,222 warrants issued to an investment banker with an exercise price of \$0.09 per share. In January 2012, the Company received a total of \$3,050,000 in gross proceeds from the private placement of its Series D preferred stock, for \$2,500,000 in cash and the exchange of \$550,000 of short-term debt.

Net cash used for operating activities for the year ended December 31, 2011 was \$3,102,307 which primarily consisted of: a net loss of \$3,610,078; less depreciation and amortization of \$36,860, cost of goods sold depreciation of \$8,044, loss on the disposition of fixed assets of \$1,653, warrants and options issued in connection with services from vendors, and to employees and consultants of \$189,503, noncash interest expense related to debt discount and debt issue cost of \$71,299, and inventory obsolescence of \$44,633, decreases in accounts receivable of \$75,806, and prepaid expenses of \$2,045, and increases in inventory of \$51,281 and deposits of \$54,333. In addition, these amounts were partially offset by increases in accounts payable and accrued expenses of \$108,481, deferred tax liability of \$54,892, and deferred rent of \$20,169.

Net cash used for operating activities for the year ended December 31, 2010 was \$2,689,762 which primarily consisted of: a net loss of \$3,275,960; less depreciation and amortization of \$42,709, warrants and options issued in connection with services from vendors, and to employees and consultants of \$326,834, and noncash interest expense related to debt discount of \$818,541, decreases in inventory of \$64,134 and prepaid expenses of \$13,887, and increases in accounts receivable of \$39,923 and deposits of \$10,057. In addition, these amounts were partially offset by a gain on the sale of fixed assets of \$102, change in fair value of warrant liability of \$828,827, and increases in accounts payable and accrued expenses of \$146,692, deferred tax liability of \$49,946, and deferred rent of \$2,364.

Net cash used in investing activities for fiscal year 2011 was \$88,247, compared to \$76,486 in fiscal year 2010. The amount for 2011 consisted of the purchase of fixed assets of \$83,606, costs related to patent applications of \$13,141, and proceeds from the sale of fixed assets of \$8,500. The amount for 2010 consisted of the purchase of fixed assets of \$19,178, costs related to patent applications of \$58,108, and proceeds from the sale of fixed assets of \$800.

Net cash provided by financing activities for fiscal year 2011 was \$1,000,000, which entirely consisted of proceeds from the issuance of notes payable. Net cash provided by financing activities for fiscal year 2010 was \$5,086,291, which consisted of proceeds from the issuance of equity securities of \$4,667,750, proceeds from the issuance of notes payable of \$868,541, partially offset by the repayment of notes payable of \$450,000.

The Company expects to increase 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. The opinion of management is that approximately \$3 – 3.6 million will be required to cover operating expenses, including, but not limited to, marketing, sales, research and operations during the next twelve months. If the Company is unable to obtain funding on reasonable terms or finance its needs through current operations, the Company will 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.

### **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 audited financial statements contained in this Annual Report on Form 10-K, 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 require management to make significant judgments and estimates in the preparation of the Company's annual 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 \$44,633 and \$0 for the years ended December 31, 2011 and 2010, respectively, associated with its switch from its 1<sup>st</sup> generation digital three-phase products to its 2<sup>nd</sup> generation three-phase digital products, ranging from 22 to 80 amps. Management has determined a reserve for inventory obsolescence is not necessary at December 31, 2011 and 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 or 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 \$190,000 and \$267,000 in additional compensation expense during the years ended December 31, 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 2011 consist of the following:

Balance, January 1, 2010	\$2,648
Additions	6,327
Deductions	(6,895 )
Balance, December 31, 2010	2,080
Additions	48,070
Deductions	(44,800)
Balance, December 31, 2011	\$5,350

### **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 December 31, 2011, the Company's fair value exceeded its carrying value, which was positive; therefore, the Company was 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 December 31, 2011 and December 31, 2010. Based on this, no impairment was recorded as of December 31, 2011 or December 31, 2010.

#### **Advertising:**

Advertising costs are expensed as incurred. Advertising expenses were \$972 and \$0 for the years ended December 31, 2011 and 2010, respectively.

#### **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.

#### Item 7A. Quantitative and Qualitative Disclosures About Market Risk

We are a "smaller reporting company" as defined by Regulation S-K and as such, are not providing the information contained in this item pursuant to Regulation S-K.

#### Item 8. Financial Statements and Supplementary Data.

The financial statements of the Company and the notes related to the financial statements, together with the independent registered public accounting firm's report thereon, are set forth beginning on pages F-1 of this report.

#### Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.

None

Item 9A. Controls and Procedures.

(a) Disclosure Controls and Procedures.

Under the supervision and with the participation of its Chief Executive Officer (“CEO”), and Vice President of Finance (“VPF”), 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 CEO and VPF 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 CEO and VPF, as appropriate to allow timely decisions regarding required disclosure.

(b) Changes in Internal Control Over Financial Reporting.

During the year ended December 31, 2011, there were no significant changes in the Company’s internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation, nor were there any significant deficiencies or material weaknesses in the Company’s internal controls. Accordingly, no corrective actions were required or undertaken.

(c) Management’s Report on Internal Control Over Financial Reporting

Our CEO and VPF are responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Rule 13a-15(f) of the Exchange Act.

Internal control over financial reporting is promulgated under the Exchange Act as a process designed by, or under the supervision of, our CEO and VPF and effected by our board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

- Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of our assets;

- Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that our receipts and expenditures are being made only in accordance with authorizations of our management and directors; and
- Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition or disposition of our assets that could have a material effect on the financial statements.

Readers are cautioned that internal control over financial reporting, no matter how well designed, has inherent limitations and may not prevent or detect misstatements. Therefore, even effective internal control over financial reporting can only provide reasonable assurance with respect to the financial statement preparation and presentation.

Our management, under the supervision and with the participation of our CEO and VPF, has evaluated the effectiveness of our internal controls over financial reporting as defined in Exchange Act Rules 13a-15(f) and 15d-15(f) as of the end of the period covered by this Report based upon the framework in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on such evaluation, our management has made an assessment that our internal control over financial reporting is effective as of December 31, 2011.

This annual report does not include an attestation report of the Company's registered public accounting firm regarding ICFR pursuant to a permanent exemption from auditor reporting on ICFR for non-accelerated filers provided by the Dodd-Frank Act of 2010. Management's report on ICFR was not subject to attestation by the Company's registered public accounting firm.

Item 9B. Other Information.

None.

**PART III**

Item 10. Directors, Executive Officers, and Corporate Governance.

**INFORMATION ABOUT THE COMPANY'S EXECUTIVE OFFICERS AND DIRECTORS**

The following table lists the current executive officers and directors and, in the case of directors, their length of service on the board. Each director is elected to hold office for a term expiring at the first annual meeting of stockholders held following such director's election and until his successor has been elected and qualified, or until his prior resignation or removal. All of the Company's current directors were either appointed by the plurality of votes cast by the holders of our common stock present, or represented, at the 2010 Annual Meeting of the Stockholders in May 2010, or elected by the board in 2012.

Name	Age	Director Since	Position
Philip L. Meisel	82	2012	Chairman
Steven Z. Strasser	63	2002	Vice Chairman, Chief Executive Officer
Brian C. Chan	34	2012	Director, Vice President of Finance, and Secretary
Douglas M. Dunn	69	2006	Director
Kenneth Dickey	70	2009	Director, Consultant

**Director Independence**

Our audit committee is comprised of Dr. Dunn; and our compensation committee is comprised of Mr. Dickey, each of whom are independent directors.

**Philip L. Meisel** – Chairman of the Board. Mr. Meisel has had an extensive career as an executive in the chemical, manufacturing and financial industries. He served as the CEO, President and Director of CPS Chemical Co, Inc. for over 40 years. Mr. Meisel earned his Bachelor of Science degree from Union College in Schenectady, New York in 1947. Mr. Meisel has been retired since 1997.

**Steven Strasser** – Vice-Chairman and Chief Executive Officer. Prior to becoming the Company's CEO in October 2004, Mr. Strasser was the Managing Director, founder and majority owner of Summit. Summit is a private equity firm focused on investments in companies with energy efficiency technologies. At Summit, Mr. Strasser spent four

years, from 2001 through 2005, evaluating and investing in energy technology companies and serving on the boards of portfolio companies. Mr. Strasser has been a director since August 2002.

From 1984 through 2000, Mr. Strasser was the founder and CEO of Northwest Power Enterprises. Over its seventeen-year history, Northwest Power Enterprises and its predecessor companies were involved in multiple aspects of the energy development business. Mr. Strasser received law degrees from McGill University, Montreal, Canada and the University of Washington, Seattle, Washington.

**Brian C. Chan** – Vice President of Finance and Accounting, Director, and Secretary. Before joining Power Efficiency Corporation in 2005, Mr. Chan was an accountant at Johnson Jacobson Wilcox, a Las Vegas CPA firm specializing in privately held construction and real estate companies. Prior to Johnson Jacobson Wilcox, Mr. Chan was a staff accountant at Kafoury, Armstrong and Company, a Las Vegas CPA firm that mainly serviced non-profit and governmental entities. Mr. Chan began his career with Smith, Lange and Phillips, a prominent San Francisco CPA firm, where he worked with a variety of small business and high net worth individuals.

Mr. Chan is a licensed CPA in California (inactive), and has a Bachelor of Arts in Business Economics with an emphasis in Accounting from U.C. Santa Barbara.

**Dr. Douglas Dunn** — Dr. Dunn has had an extensive career in research, business and academic leadership. Dr. Dunn served as dean of Carnegie Mellon University's Graduate School of Industrial Administration (now the Tepper School of Business) from July 1996 through June 2002, after which he retired. He began his career at AT&T Bell Laboratories, and his corporate experience culminated in senior positions as a corporate officer leading Federal Regulatory Matters, Regional Government Affairs, and Visual Communications and Multimedia Strategy for AT&T. Dr. Dunn is a board member of Universal Stainless & Alloy Products, Inc. (NasdaqNM: USAP) and Umami Sustainable Seafood, Inc. (OTCBB: UMAM.OB). He holds a Ph.D. in business from the University of Michigan, an MS in industrial management and a BS in physics from the Georgia Institute of Technology.



**Kenneth Dickey**— Mr. Dickey is the co-founder of The Institute of Strategic Mapping, and has spent his extensive career learning how superior results can be achieved from very average businesses and how to translate this winning process into an understandable, reusable format. Mr. Dickey has been retired since February 2002. From October 1999 to February 2002, Mr. Dickey was Vice President Sales-Marketing for Safetronics, where he developed sales and marketing strategies, completed Safetronic’s acquisition of Fincor Electric, a manufacturer of variable frequency drives, and ran that business unit. Prior to this, Mr. Dickey was the President/CEO of Cleveland Motion Control, Dynact Inc., and Motion Science, Inc., from February 1997 to October 1999. Prior to this, Mr. Dickey served as Senior Vice-President Sales for Reliance Electric/Rockwell Automation from 1994 thru 1996. His responsibilities included Sales/Marketing with 76 sales offices (located in the Americas), which generated more than \$900 million in revenue. He also spent 9 years as the Operating General Manager of the Industrial Motor Division at Reliance Electric from 1986 to 1994. Mr. Dickey earned his Bachelor of Science degree in Finance from the University of Akron and an Executive MBA from Case-Western Reserve University.

#### Board of Directors and Committees of the Board

Our business affairs are conducted under the direction of our board of directors. The role of our board of directors is to effectively govern our affairs for the benefit of our stockholders and, to the extent appropriate under governing law, of other constituencies, which include our employees, customers, suppliers and creditors. Our board strives to ensure the success and continuity of our business through the selection of a qualified management team. It is also responsible for ensuring that our activities are conducted in a responsible ethical manner. Our board of directors has two standing committees – an audit committee and a compensation committee.

Our board of directors met eleven times in 2011.

We do not have a policy that requires directors to attend our annual meetings of stockholders.

#### **Audit Committee**

Douglas Dunn currently serves on our audit committee. Dr. Dunn is an independent director as required by Section 301 of the Sarbanes-Oxley Act of 2002, Rule 10A(3)(b)(1) of the Securities Exchange Act of 1934 and Section 121(A) of the New York Stock Exchange Constitution and Rules. Dr. Dunn, the current Chairman of our audit committee, qualifies as a financial expert. Our audit committee, among other things:

- selects the independent auditors, considering independence and effectiveness;

receives the written disclosures and the letter from the independent accountant required by applicable requirements of the Public Company Accounting Oversight Board regarding the independent accountant's communications with the audit committee concerning independence, and has discussed with the independent accountant the independent accountant's independence;

discusses the scope and results of the audit with the independent auditors and reviews with management and the independent auditors our interim and year-end operating results;

discusses with the independent accountant the matters required to be discussed by Statement on Auditing Standards No. 61 (Communications with Audit Committees);

- considers the adequacy of our internal accounting controls and audit procedures;
- reviews and approves all audit and non-audit services to be performed by the independent auditors; and
- administers the whistleblower policy.

The audit committee has the sole and direct responsibility for appointing, evaluating and retaining our independent auditors and for overseeing their work.

## Compensation Committee

Kenneth Dickey currently serves on our compensation committee. Mr. Dickey is an independent director as required by SEC Rules and as defined in Section 121(A) of the American Stock Exchange Constitution and Rules. Mr. Dickey serves as the Chairman of our compensation committee. Our compensation committee, among other things:

- recommends to the board of directors the compensation level of the executive officers;
- reviews and makes recommendations to our board of directors with respect to our equity incentive plans;
- establishes and reviews general policies relating to compensation and benefits of our employees.

## Committee Interlocks and Insider Participation

None of our executive officers currently serve as a member of the board of directors or compensation committee of any entity that has one or more executive officers serving on our board of directors or compensation committee.

## SECTION 16(a) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE

Section 16 of the Securities Exchange Act of 1934, as amended, requires that all executive officers and directors of the Company and all persons who beneficially own more than ten percent of the Company's common stock file an initial report of their ownership of the Company's securities on Form 3 and report changes in their ownership of the Company's securities on Form 4 or Form 5. These filings must be made with the Securities and Exchange Commission and the National Association of Securities Dealers with a copy sent to the Company. To our knowledge, all executive officers, directors and all persons who beneficially own more than ten percent of the Company's common stock have timely filed these filings.

## CODE OF CONDUCT

The Company adopted a code of conduct on August 8, 2008. In early 2006, the Company developed and implemented an official Employee Manual that requires ethical behavior from its employees, and defines the consequences of

unethical behavior by its employees.

Item 11. Executive Compensation.

**Summary Compensation Table**

The following table summarizes compensation information for the last two fiscal years for (i) Mr. Steven Z. Strasser, our Principal Executive Officer, (ii) Brian Chan, our current Principle Financial Officer and (iii) John (BJ) Lackland, our former Principal Financial Officer, who were serving as executive officers at the end of the fiscal year and who we refer to collectively, as the Named Executive Officers.

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## SUMMARY COMPENSATION TABLE

Name and principal position	Year	Salary (\$)	Bonus (\$)	Stock Awards (\$)	Option Awards (\$)	Non-Equity Incentive Plan Compensation (\$)	Nonqualified Deferred Compensation Earnings (\$)	All Other Compensation (\$)	Total (\$)
Steven Z. Strasser <sup>(1)</sup> Chairman and Chief Executive Officer	2011	\$ 300,000	-	-	-	-	-	-	\$ 300,000
	2010	\$ 307,645	-	-	\$ 640,000	-	-	-	\$ 947,645
Brian C. Chan Director and Vice President of Finance	2011	\$ 83,538	-	-	-	-	-	-	\$ 83,538
	2010	\$ 73,900	-	-	-	-	-	-	\$ 73,900
John (BJ) Lackland <sup>(2)</sup> Director and Chief Financial Officer*	2011	\$ 125,000	-	-	-	-	-	-	\$ 125,000
	2010	\$ 201,077	-	-	\$ 320,000	-	-	-	\$ 521,077
			-	-	-	-	-	-	-

\* Mr. Lackland resigned from his position of CFO and from the Board of Directors on August 15, 2011.

## Narrative Disclosure to Summary Compensation Table

During 2004, we hired the following officers: Steven Strasser, Chief Executive Officer, and John (BJ) Lackland, Chief Financial Officer. Effective June 1, 2010, the Company entered into employment agreements with the above officers. These two individuals comprise our current executive officers. The term of each agreement is five years. In the event of a defined change in control of the Company, each agreement will provide for accelerated vesting of stock options and a cash severance payment equal to 2.99 times the executive's then current salary and previous year's bonus. Mr. Lackland resigned on August 15, 2011, and his employment agreement was cancelled immediately. Also on August 15, 2011, the Company promoted Brian Chan to Vice President of Finance and Accounting, and became the Company's Principal Financial Officer.

The following table sets forth the material financial terms of the agreements for each of our executives as of December 31, 2011:

Name	Salary	Bonus <sup>(1)</sup>	Common Stock Options <sup>(2)</sup>
Steven Strasser	\$ 300,000	-	4,000,000

- (1) At the discretion of the disinterested members of the Board.
- (2) Vesting evenly and quarterly over five years.

**Outstanding equity awards**

## OUTSTANDING EQUITY AWARDS AT FISCAL YEAR-END

## OPTION AWARDS

## STOCK AWARDS

Name	Number of Securities Underlying Unexercised Options (#) Exercisable	Number of Securities Underlying Unexercised Options Unexercisable (#)	Equity Incentive Plan Awards:		Option Expiration Date	Number of Shares or Units of Stock That Have Not Vested (#)	Market Value of Shares or Units of Stock That Have Not Vested (\$)	Equity Incentive Plan Awards: Number of Unearned Shares, Units or Other Rights That Have Not Vested (#)	Equity Incentive Plan Awards: Market or Payout Value of Unearned Shares, Units or Other Rights That Have Not Vested (#)
			Number of Securities Underlying Unexercised Options (#)	Option Exercise Price (\$)					
Steven Strasser	277,778	2,500,002	-	\$ 0.18	5/31/2015	-	-	-	-
	122,222	1,099,998	-	\$ 0.18	5/31/2020	-	-	-	-
	2,039,771	-	-	\$ 0.20	5/31/2015	-	-	-	-
	600,000	-	-	\$ 0.65	11/28/2014	-	-	-	-
Brian Chan	150,000	-	-	\$ 0.65	3/27/2015	-	-	-	-
	150,000	-	-	\$ 0.20	5/22/2015	-	-	-	-

**Stock Option Plan Narrative Disclosure**

As of December 31, 2011, we had an aggregate of 19,336,812 shares of Common Stock available for issuance under our stock plans. The following is a description of our plans.

*2000 Stock Option and Restricted Stock Plan, or the 2000 Plan*

The 2000 Plan was adopted by our board of directors and our stockholders in 2000. On July 16, 2009, the 2000 Plan was amended and restated. As of December 31, 2011, no restricted shares of Common Stock have been issued, and 245,000 of the outstanding options to purchase shares of our Common Stock have been exercised pursuant to the 2000 Plan. There are 19,336,812 options outstanding under the 2000 Plan as of December 31, 2011.

*Share Reserve.* Under the 2000 Plan, we have initially reserved for issuance an aggregate of 25,000,000 shares.

*Administration.* The 2000 Plan is administered by the board of directors. The stock option awards qualify as "performance-based-compensation" within the meaning of Section 162(m) of the Internal Revenue Code of 1986, or the Code, with two or more outside directors within the meaning of Section 162(m) of the Code. The board of directors has the power to determine the terms of the awards, including the exercise price, the number of shares subject to each award, the exercisability of the awards and the form of consideration payable upon exercise.

*Eligibility.* Awards under the 2000 Plan may be granted to any of our employees, directors or consultants or those of our affiliates.

*Options.* With respect to non-statutory stock options intended to qualify as "performance-based compensation" within the meaning of Section 162(m) of the Code and incentive stock options, the exercise price must be at least equal to the fair market value of our Common Stock on the date of grant. In addition, the exercise price for any incentive stock option granted to any employee owning more than 10% of our Common Stock may not be less than 110% of the fair market value of our Common Stock on the date of grant. The term of any stock option may not exceed ten years, except that with respect to any participant who owns 10% or more of the voting power of all classes of our outstanding capital stock, the term for incentive stock options must not exceed five years.



*Stock Awards.* The administrator may determine the number of shares to be granted and impose whatever conditions to vesting it determines to be appropriate, including performance criteria. The criteria may be based on financial performance, personal performance evaluations and/or completion of service by the participant. The administrator will determine the level of achievement of performance criteria. Unless the administrator determines otherwise, shares that do not vest typically will be subject to forfeiture or to our right of repurchase, which we may exercise upon the voluntary or involuntary termination of the participant's service with us for any reason, including death or disability.

*Adjustments upon Merger or Change in Control.* The 2000 Plan provides that in the event of a merger with or into another corporation or a "change in control," including the sale of all or substantially all of our assets, and certain other events, our board of directors (or a committee of the board of directors) may, in its discretion, provide for some or all of:

- assumption or substitution of, or adjustment to, each outstanding award;
- acceleration of the vesting of options and stock appreciation rights;
- termination of any restrictions on stock awards or cash awards; or
- cancellation of awards in exchange for a cash payment to the participant.

*Amendment and Termination.* The board of directors has the authority to amend, alter or discontinue the 2000 Plan, subject to the approval of the stockholders, but no amendment will impair the rights of any award, unless mutually agreed to between the participant and the administrator.

*Compensation of Directors Summary Table*

DIRECTOR COMPENSATION

Name (a)	Fees Earned or Paid in		Option Awards (\$)*	Non-Equity Incentive Plan Compensation (\$)	Non-Qualified Deferred Compensation		Total (\$)
	Cash (\$)	Stock Awards (\$)			Earnings (\$)	All Other Compensation (\$)	
Douglas M. Dunn	-	-	\$ 18,000	-	-	-	\$ 18,000
Kenneth Dickey	-	-	\$ 18,000	-	-	-	\$ 18,000
Marc Lehmann**	-	-	\$ 15,000	-	-	-	\$ 15,000
	-	-	\$ 15,000	-	-	-	\$ 15,000

Herman						
Sarkowsky**						
Raphael						
Diamond***	-	-	\$ 20,000	-	-	\$ 20,000

\* Aggregate fair value as of date of grant.

\*\* Messrs. Sarkowsky and Lehmann resigned from the Board of Directors on January 27, 2012.

\*\*\* Mr. Diamond resigned from the Board of Directors on December 22, 2011.

## Narrative to Director Compensation

In March 2011, non-employee directors received options to purchase 100,000 shares of common stock per year for their board service, pro-rated for the quarters in the year they served. Employee directors do not receive compensation for serving on the board of directors. The Chairmen of the audit committee and the compensation committee received an additional 50,000 options per year, pro-rated for the quarters in the year he served. The remaining members of the audit committee and the compensation committee receive an additional 25,000, prorated for the quarters in the year they served. Depending on the anticipated workload and organization, the board of directors may elect to increase the compensation for committee members and/or all non-executive board members.

## Limitation of Liability and Indemnification of Directors and Officers

Our certificate of incorporation provides that the personal liability of our directors shall be limited to the fullest extent permitted by the provisions of Section 102(b)(7) of the General Corporation Law of the State of Delaware, or the DGCL. Section 102(b)(7) of the DGCL generally provides that no director shall be liable personally to us or our stockholders for monetary damages for breach of fiduciary duty as a director, provided that our certificate of incorporation does not eliminate the liability of a director for (i) any breach of the director's duty of loyalty to us or our stockholders; (ii) acts or omissions not in good faith or that involve intentional misconduct or a knowing violation of law; (iii) acts or omissions in respect of certain unlawful dividend payments or stock redemptions or repurchases; or (iv) any transaction from which such director derives improper personal benefit. The effect of this provision is to eliminate our rights and the rights of our stockholders through stockholders' derivative suits on our behalf, to recover monetary damages against a director for breach of her or his fiduciary duty of care as a director including breaches resulting from negligent or grossly negligent behavior except in the situations described in clauses (i) through (iv) above. The limitations summarized above, however, do not affect our or our stockholders' ability to seek non-monetary remedies, such as an injunction or rescission, against a director for breach of her or his fiduciary duty.

In addition, our certificate of incorporation and bylaws provide that we shall, to the fullest extent permitted by Section 145 of the DGCL, indemnify all directors and officers who we may indemnify pursuant to Section 145 of the DGCL. Section 145 of the DGCL permits a company to indemnify an officer or director who was or is a party or is threatened to be made a party to any proceeding because of his or her position, if the officer or director acted in good faith and in a manner he or she reasonably believed to be in or not opposed to the best interests of such company and, with respect to any criminal action or proceeding, had no reasonable cause to believe his or her conduct was unlawful. We have entered into indemnification agreements with our directors and officers consistent with indemnification to the fullest extent permitted under the DGCL.

We maintain a directors' and officers' liability insurance policy covering certain liabilities that may be incurred by our directors and officers in connection with the performance of their duties. The entire premium for such insurance is paid by us.

Insofar as indemnification for liabilities arising under the Securities Act, our directors and officers, and persons controlling us pursuant to the foregoing provisions, we have been informed that in the opinion of the SEC, such indemnification is against public policy as expressed in the Securities Act and is therefore unenforceable.

## Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.

### STOCK OWNERSHIP

The following table sets forth information as to our shares of common stock beneficially owned as of March 23, 2012 by (i) each person known by us to be the beneficial owner of more than five percent of our outstanding common stock, (ii) each of our directors, (iii) each of our executive officers named in the Summary Compensation Table and (iv) all of our directors and executive officers as a group.

<b>Title of Class</b>	<b>Name of Beneficial Owner(1)</b>	<b>Shares Owned</b>	<b>Percent of Shares Owned(16)</b>
Common Stock	Steven Strasser, CEO, Vice Chairman	27,184,420 (2)	33.07 %
Common Stock	Philip Meisel, Chairman of the Board	270,350,000 (3)	80.39 %
Common Stock	Douglas Dunn, Director	1,094,415 (4)	1.60 %
Common Stock	Kenneth Dickey, Director	862,979 (5)	1.26 %
Common Stock	Brian Chan, VP Finance, Director	300,000 (6)	Less than 1 %
Common Stock	Summit Energy Ventures, LLC	6,803,901 (3)	10.07 %
Common Stock	Marc Lehmann	5,830,556 (7)	7.99 %
Common Stock	Herman Sarkowsky	31,753,007 (8)	33.79 %
Common Stock	George Boyadjieff	3,697,661 (9)	5.361 %

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Common Stock	Ron Boyer	10,868,691	(10)	14.87	%
Common Stock	Irwin Helford	9,722,557	(11)	12.90	%
Common Stock	Byron LeBow	7,466,977	(12)	10.29	%
Common Stock	Edward Sher	15,399,328	(13)	18.71	%
Common Stock	Sidney Chan	20,555,556	(14)	23.33	%
Common Stock	Marathon Hard Asset Fund L.P.	4,344,926	(15)	6.29	%
Common Stock	All Executive Officers and Directors as a Group (5 persons)	299,791,814		84.93	%

(1) Information in this table regarding directors and executive officers is based on information provided by them. Unless otherwise indicated in the footnotes and subject to community property laws where applicable, each of the directors and executive officers has sole voting and/or investment power with respect to such shares. The address for each of the persons reported in the table is in care of Power Efficiency Corporation at 5744 Pacific Center Blvd., Suite 311, San Diego, CA 92121.

(2) Includes 1,600,000 shares of Common Stock held directly, 12,500,000 shares of Common Stock subject to the conversion of 125,000 shares of Series D Preferred Stock, 250,000,000 shares of Common Stock subject to the conversion of 250 shares of Series E Preferred Stock, and 6,250,000 shares of Common Stock subject to warrants presently exercisable or which will become exercisable within 60 days of the date hereof. Mr. Meisel's warrants expire on June 20, 2015.

(3) Includes 6,803,901 shares of Common Stock held by Summit Energy Ventures, LLC, in which Steven Strasser is one of two members, 5,710,901 shares of Common Stock held directly, 2,010,000 shares of Common Stock subject to the conversion of 20,100 shares of Series B Preferred Stock, 812,500 shares of Common Stock subject to the conversion of 8,125 shares of Series C-1 Preferred Stock, 3,454,700 shares of Common Stock subject to the conversion of 34,547 shares of Series D Preferred Stock, and 8,392,418 shares of Common Stock subject to options and warrants which are presently exercisable or which will become exercisable within 60 days of the date hereof. Mr. Strasser was also granted an additional 1,730,434 shares of Common Stock subject to options which will become exercisable after 60 days of the date hereof. Mr. Strasser's options and warrants expire on various dates from October, 2012 through August, 2020. The business address for Summit Energy Ventures, LLC is: 1 Hughes Center Drive, #1004-N, Las Vegas, NV 89169.

(4) Includes 119,415 shares of Common Stock, 100,000 shares of Common Stock subject to the conversion of 1,000 shares of Series B Preferred Stock, and 875,000 shares of Common Stock subject to options and warrants presently exercisable or which will become exercisable within 60 days of the date hereof. Dr. Dunn's options expire on various dates from May, 2016 through March, 2021.

(5) Includes 112,979 shares of Common Stock, 125,000 shares of Common Stock subject to the conversion of 1,250 shares of Series C-1 Preferred Stock, and 625,000 shares of Common Stock subject to options and warrants presently exercisable or which will become exercisable within 60 days of the date hereof. Mr. Dickey's options expire on various dates from February, 2012 through March, 2021.

(6) Includes 300,000 shares of Common Stock subject to options presently exercisable. Mr. Chan's options expire on various dates from March, 2015 through May 2015.

(7) Includes 400,000 shares of Common Stock held directly, 3,125,000 shares of Common Stock subject to the conversion of 3,125 shares of Series D Preferred Stock, and 2,305,556 shares of Common Stock subject to options and warrants presently exercisable or which will become exercisable within 60 days of the date hereof. Mr. Lehmann's options and warrants expire on various dates from June, 2015 through October, 2016. Mr. Lehmann's business address is: Riverloft Capital, 300 W. 41st Street, Suite 201-A, Miami Beach, FL 33140.

(8) Includes 5,319,700 shares of Common Stock held directly, 1,100,000 shares of Common Stock subject to the conversion of 11,000 shares of Series B Preferred Stock, 1,350,000 shares of Common Stock subject to the conversion of 1,350 shares of Series D Preferred Stock, 20,000,000 shares of Common Stock subject to the conversion of 20 shares of Series E Preferred Stock, and 3,983,307 shares of Common Stock subject to options presently exercisable or which will become exercisable within 60 days of the date hereof. Mr. Sarkowsky's options expire on various dates from October, 2012 through August, 2020. Mr. Sarkowsky's business address is: 1201 3rd Avenue, Suite 5450, Seattle, WA 98101.

(9) Includes 2,247,661 shares of Common Stock held directly, 400,000 shares of Common Stock subject to the conversion of 4,000 shares of Series B Preferred Stock, and 1,050,000 shares of Common Stock subject to options and warrants presently exercisable. Mr. Boyadjieff's options and warrants expire on various dates from October, 2012 through February, 2020. Mr. Boyadjieff's business address is: 18772 Colony Circle, Villa Park, CA 92861.

(10) Includes 5,332,458 shares of Common Stock held directly, 3,000,000 shares of Common Stock subject to the conversion of 30,000 shares of Series B Preferred Stock and 2,536,233 shares of Common Stock subject to warrants presently exercisable. Mr. Boyer's warrants expire on various dates from October, 2012, through May, 2015. Mr. Boyer's business address is: 6129 SW Sheridan St., Portland, OR 97225.

(11) Includes 1,890,125 shares of Common Stock held directly, 200,000 shares of Common Stock subject to the conversion of 2,000 shares of Series B Preferred Stock, 625,000 shares of common stock subject to the conversion of 6,250 shares of Series C-1 Preferred Stock, 675,000 shares of Common Stock subject to the conversion of 6,750 shares of Series D Preferred Stock, 5,000,000 shares of Common Stock subject to the conversion of 5 shares of Series E Preferred Stock, and 1,332,432 shares of Common Stock subject to warrants presently exercisable. Mr. Helford's warrants expire on various dates from October, 2012 through October, 2016. Mr. Helford's business address is: 1 Hughes Center Drive, #1804, Las Vegas, NV 89169

(12) Includes 2,455,744 shares of Common Stock held directly, 800,000 shares of Common Stock subject to the conversion of 8,000 shares of Series B Preferred Stock, 375,000 shares of common stock subject to the conversion of 3,750 shares of Series C-1 Preferred Stock, 1,350,000 shares of Common Stock subject to the conversion of 13,500 shares of Series D Preferred Stock, and 2,486,233 shares of Common Stock subject to warrants presently exercisable. Mr. LeBow's warrants expire on various dates from March, 2012 through May, 2015. Mr. LeBow's business is: 1 Hughes Center Drive #1104-N, Las Vegas, NV 89169.

(13) Includes 609,593 shares of Common Stock held directly, 200,000 shares of Common Stock subject to the conversion of 2,000 shares of Series B Preferred Stock, 312,500 shares of common stock subject to the conversion of 3,125 shares of Series C-1 Preferred Stock, 1,350,000 shares of Common Stock subject to the conversion of 13,500 shares of Series D Preferred Stock, 10,000,000 shares of Common Stock subject to the conversion of 10 shares of Series E Preferred Stock, and 2,589,735 shares of Common Stock subject to warrants presently exercisable. Mr. Sher's warrants expire on various dates from December, 2012 through October 2016. Mr. Sher's business is: 3111 Bel Air Dr. #21A, Las Vegas, NV 89109.

(14) Includes 20,000,000 shares of Common Stock subject to the conversion of 20 shares of Series E Preferred Stock, and 555,556 shares of Common Stock subject to warrants presently exercisable. Mr. Chan's warrants expire on October 2016. Mr. Chan's business is: 9 Avenida De Magnolia, Rancho Palos Verdes, CA 90275.



(15) Includes 2,844,926 shares of Common Stock, 1,000,000 shares of Common Stock subject to the conversion of 10,000 shares of Series B Preferred Stock, and 500,000 shares of Common Stock subject to warrants presently exercisable. Marathon Hard Asset Fund L.P.'s warrants expire on various dates from November, 2012 through December, 2012. The business address for Marathon Hard Asset Fund L.P. is: One Ferry Building, Suite 255, San Francisco, CA 94111.

(16) The percentage for Common Stock includes all shares of Common Stock subject to options and warrants exercisable within 60 days of the date hereof.

### Item 13. Certain Relationships, Related Transactions and Director Independence.

#### **Relationship with Steven Strasser and Summit**

Mr. Strasser, our CEO, owns 99.5% of Summit. As of March 29, 2012, Summit owned 6,803,901 shares of our common stock. In addition, Mr. Strasser owns beneficially 27,184,420 shares of common stock (including those shares beneficially owned by Summit) issued or issuable on the exercise of options and warrants, the conversion of Series B Preferred Stock, the conversion of Series C-1 Preferred Stock, and the conversion of Series D Preferred Stock, exercisable within 60 days of March 18, 2012.

On June 21, 2010, Mr. Strasser purchased 34,547 shares of Series D Preferred Stock and 1,727,350 warrants to purchase the Company's common stock for \$552,000 in cash and cancellation of indebtedness.

On May 13, 2010, the Company issued secured notes payable to Mr. Strasser, totaling \$200,000. The secured notes bear interest at 12% per annum, payable semiannually. The secured notes and related accrued interest were converted into Series D Preferred Stock on June 21, 2010.

On March 30, 2010, the Company issued unsecured notes payable to Mr. Strasser, totaling \$250,000. The unsecured notes bear interest at 5%, payable upon maturity. \$200,000 of these unsecured notes were converted into secured notes on May 13, 2010, and the remaining \$50,000 plus related interest was paid off in full on May 26, 2010.

On February 24, 2010, Mr. Strasser purchased 1,875 shares of Series C-1 Preferred Stock and 93,750 warrants to purchase the Company's common stock for \$75,000 in cash.



On December 11, 2009, Mr. Strasser exchanged 6,250 shares of Series C Preferred Stock into 6,250 shares of Series C-1 Preferred Stock and 312,500 warrants to purchase the Company's common stock.

On September 29, 2009, Mr. Strasser purchased 350,000 shares of common stock, 2,500 shares of Series B Preferred Stock, and 203,062 warrants to purchase the Company's common stock for \$90,000 in cash, from another shareholder.

On August 12, 2009, Mr. Strasser purchased 6,250 shares of Series C Preferred Stock and 312,500 warrants to purchase the Company's common stock for \$250,000 in cash.

#### Item 14. Principal Accountant Fees and Services.

##### (1) Audit Fees.

The aggregate fees in fiscal years 2011 and 2010 for professional services rendered by the principal independent registered accountant for the audit of the Company's annual financial statements and review of financial statements included in the Company's Form 10-K or services that are normally provided by the accountant in connection with statutory and regulatory filings or engagements for those fiscal years were \$85,637 and \$95,784, respectively.

##### (2) Audit-Related Fees.

The aggregate fees billed in fiscal years 2011 and 2010 for assurance and related services by the principal independent registered accountant that are reasonably related to the performance of the audit or review of the Company's financial statements and are not reported under Item 14(1) above were \$0 for both years.

##### (3) Tax Fees.

The aggregate fees billed in fiscal years 2011 and 2010 for professional services rendered by the principal independent registered accountant for tax compliance, tax advice, and tax planning were \$6,663 and \$5,750, respectively.

(4) All Other Fees

The aggregate fees billed in fiscal years 2011 and 2010 for products and services provided by the principal independent registered accountant, other than the services reported in Items 14(1) through 14(3) above were \$0 for both years.

(5) Audit Committee Approval

During fiscal year 2011 and 2010, the Audit Committee pre-approved all engagements and fees for services the principal independent registered accountant provided since it was formally formed.

**PART IV**

Item 15. Exhibits.

(a) Exhibits

**EXHIBIT INDEX**

**Description of Document**

**Exhibit**

Description

**Number**

3.1 Certificate of Incorporation of the Company, incorporated by reference to Exhibit 3.1 to the Company's Annual Report on Form 10-SB filed on October 20, 2000.

3.2 Amendment to the Certificate of Incorporation of the Company dated June 5, 2002, incorporated by reference to Exhibit 3.1 to Company's Current Report on Form 8-K filed on June 18, 2002.

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Amendment to the Certificate of Incorporation of the Company dated July 6, 2005, incorporated by reference to Exhibit 3.3 to the Company's Form SB-2 Registration Statement filed October 25, 2005.

3.4 Amendment to the Certificate of Incorporation of the Company dated October 13, 2005, incorporated by reference to Exhibit 3.4 to the Company's Form SB-2 Registration Statement filed October 25, 2005.

3.5 Amended and Restated By-laws of the Company dated March 23, 2004, incorporated by reference to Exhibit 3.1 to Company's Quarterly Report on Form 10-QSB filed on May 14, 2004.

3.6 Certificate of Amendment of Certificate of Designation of Series A Convertible Preferred Stock of Power Efficiency Corporation, incorporated by reference to Exhibit 4.2 to Company's Current Report on Form 8-K filed on May 25, 2003.

3.7 Certificate of Certificate Eliminating Reference To A Series Of Shares Of Stock From the Certificate of Incorporation of the Company, dated October 22, 2007, incorporated by reference to Exhibit 3.7 to the Company's Amendment No. 2 to Form S-1 filed on August 29, 2008.

3.8 Certificate of Designations of Preferences, Rights and Limitations of Series B Convertible Preferred Stock of Registrant dated October 23, 2007, incorporated by reference to Exhibit 3.8 to the Company's Amendment No. 2 to Form S-1 filed on August 29, 2008.

3.9 Certificate of Designation of the Company's Series C Preferred Stock, incorporated by reference to Exhibit 3.1 to the Company's Current Report on Form 8-K filed August 21, 2009.

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- 3.10 Amendment to the Company's Certificate of Incorporation, filed with the Delaware Secretary of State on May 26, 2010, incorporated by reference to Exhibit 3.1 to the Company's Current Report on Form 8-K Filed on May 26, 2010
- 3.11 Certificate of Designation of the Company's Series D Preferred Stock, filed with the Delaware Secretary of State, incorporated by reference to Exhibit 3.1 to the Company's Current Report on Form 8-K Filed on June 24, 2010
- 4.1 Form of Placement Agent Warrant issued pursuant to Exhibit 10.45, incorporated by reference to Exhibit 3.2 to Company's Current Report on Form 8-K Filed on July 19, 2005
- 4.2 Form of Investor Warrant, incorporated by reference to Exhibit 3.1 to Company's Current Report on Form 8-K filed on July 19, 2005
- 4.3 Specimen common stock certificate of the Company, incorporated by reference to Exhibit 4.5 to the Company's Form SB-2/A Registration Statement filed December 8, 2005.
- 4.4 Agreement dated April 22, 2005, between the Company and Summit Energy Ventures, LLC, for the issuance of preferred stock and warrants, incorporated by reference to Exhibit 4.6 to the Company's Form SB-2 Registration Statement filed October 25, 2005.
- 4.5 Agreement dated April 22, 2005, between the Company and Commerce Energy Group, Inc., for the issuance of preferred stock and warrants, incorporated by reference to Exhibit 4.7 to the Company's Form SB-2 Registration Statement filed October 25, 2005.
- 4.6 Form of Equity Warrant, incorporated by reference to Exhibit 4.1 to the Company's Current Report on Form 8-K, filed January 24, 2007
- 4.7 Form of Equity Warrant, incorporated by reference to Exhibit 4.1 to the Company's Current Report on Form 8-K, filed March 8, 2007
- 4.8 Form of Warrant, issued to certain investors in the Company's private placement of units on January 21, 2008, incorporated by reference to Exhibit 4.8 to the Company's Amendment No. 2 to Form S-1 filed on August 29, 2008.
- 4.9 Form of Warrant, incorporated by reference to Exhibit 3.1 to the Company's Current Report on Form 8-K filed August 21, 2009.
- 4.10 Form of Warrant, incorporated by reference to Exhibit 4.1 to the Company's Current Report on Form 8-K Filed on June 24, 2010
- 10.1 United States Patent #5,821,726, incorporated by reference to Exhibit 10(g) to Company's Annual Report on Form 10-SB filed on October 20, 2000.
- 10.2 1994 Stock Option Plan, incorporated by reference to Exhibit 10(i) to Company's Annual Report on Form 10-SB filed on October 20, 2000.
- 10.3 Patent License Agreement (DN-858) with NASA, incorporated by reference to Exhibit 10.10 to Company's Amended Annual Report on Form 10-SB/A filed on October 26 2001.

- 10.4 Patent License Agreement (DE-256) with NASA incorporated by reference to Exhibit 10.11 to Company's Amended Annual Report on Form 10-SB/A filed on October 26 2001.
- 10.5 Settlement and Release Agreement with NASA incorporated by reference to Exhibit 10.12 to Company's Amended Annual Report on Form 10-SB/A filed on October 26 2001.
- 10.6 Modification No. 1 to Patent License Agreement (DE-256) with NASA, incorporated by reference to Exhibit 10.13 to Company's Amended Annual Report on Form 10-SB/A filed on October 26 2001.

- 10.7 Product Warranty, incorporated by reference to Exhibit 10.16 to Company's Amended Annual Report on Form 10-SB/A filed on October 26 2001.
- 10.8 Test Report from Medsker Electric, Inc., incorporated by reference to Exhibit 10.17 to Company's Amended Annual Report on Form 10-SB/A filed on October 26 2001.
- 10.9 Test Report from Oak Ridge National Laboratory, incorporated by reference to Exhibit 10.18 to Company's Amended Annual Report on Form 10-SB/A filed on October 26 2001.
- 10.10 Test Report from Oregon State University - The Motor Systems Resource Facility, incorporated by reference to Exhibit 10.19 to Company's Amended Annual Report on Form 10-SB/A filed on October 26 2001.
- 10.11 Test Report from Otis Elevator Co., incorporated by reference to Exhibit 10.20 to Company's Amended Annual Report on Form 10-SB/A filed on October 26 2001.
- 10.12 Certificate of Amendment of Warrant, incorporated by reference to Exhibit 10.4 to Company's Current Report on Form 8-K filed May 25, 2003.
- 10.13 Settlement Agreement and Mutual General Release with Stephen L. Shulman and Summit Energy Ventures, LLC dated October 3, 2003, incorporated by reference to Exhibit 10.5 to Company's Quarterly Report on Form 10-QSB filed November 14, 2003.
- 10.14 Amendment to the Amended and Restated Stockholders' Agreement among Anthony Caputo, Nicholas Anderson, Philip Elkus, Stephen Shulamn, Performance Control, LLC, Summit Energy Ventures, LLC and Power Efficiency Corporation dated September 22, 2003, incorporated by reference to Exhibit 10.7 to Company's Quarterly Report on Form 10-QSB filed November 14, 2003.
- 10.15 Business Property Lease with Arens Investment Company dated November 1, 2003, incorporated by reference to Exhibit 10.36 to Company's Annual Report on Form 10-KSB filed March 10, 2004.
- 10.16 Letter agreement with Pali Capital, Inc. dated February 25, 2004, incorporated by reference to Exhibit 10.40 to Company's Annual Report on Form 10-KSB filed March 10, 2004.
- 10.17 Amended and Restated 2000 Stock Option and Restricted Stock Plan dated February 23, 2004, incorporated by reference to Exhibit 10.41 to Company's Annual Report on Form 10-KSB filed March 10, 2004.
- 10.18 Amended and Restated 1994 Stock Option Plan, incorporated by reference to Exhibit 10.42 to Company's Annual Report on Form 10-KSB filed March 10, 2004.
- 10.19 Single Phase Licensing Agreement with Commerce Energy Group, incorporated by reference to Exhibit 10.1 to Company's Quarterly Report on Form 10-QSB filed November 15, 2004.
- 10.20 Business Property Lease Amendment involving Glenborough LLC and Northwest Power Management, Inc. dated February 7, 2005, incorporated by reference to Exhibit 10.48 to the Company's Annual Report on Form 10-KSB filed on March 31, 2005.
- 10.21 Settlement and Consulting Agreement with Keith Collin dated September 27, 2004, incorporated by reference to Exhibit 10.49 to the Company's Annual Report on Form 10-KSB filed on March 31, 2005.

Placement Agency Agreement dated as of June 1, 2005, between the Company and Joseph Stevens & Co., Inc.,  
10.22 incorporated by reference to Exhibit 10.51 to the Company's Form SB-2 Registration Statement filed October  
25, 2005.

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- 10.24 Consulting Agreement with George Boyadjieff, dated June 9, 2005, incorporated by reference to Exhibit 10.54 to the Company's Form 10-KSB filed on March 31, 2006
- 10.25 Consulting Agreement with Steven Blum dated February 21, 2006, incorporated by reference to Exhibit 10.55 to the Company's Form 10-KSB filed on March 31, 2006
- 10.26 Consulting Agreement with CEO Cast, Inc, dated January 2, 2006, incorporated by reference to Exhibit 10.56 to the Company's Form 10-KSB filed on March 31, 2006
- 10.27 Letter Agreement with USBX Advisory Services, LLC, dated January 6, 2006, incorporated by reference to Exhibit 10.57 to the Company's Form 10-KSB filed on March 31, 2006
- 10.28 Employment Agreement with Steven Strasser dated June 1, 2005, incorporated by reference to Exhibit 8.1 to the Company's Current Report of Form 8-K filed July 13, 2005.
- 10.29 Employment Agreement with John Lackland dated June 1, 2005, incorporated by reference to Exhibit 8.2 to the Company's Current Report on Form 8-K filed on July 13, 2005.
- 10.30 Interim Financing Agreement with EMTUCK, LLC dated April 18, 2006, incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed on April 24, 2006.
- 10.31 Promissory Note granted to EMTUCK, LLC dated April 19, 2006, incorporated by reference to Exhibit 10.2 to the Company's Current Report on Form 8-K filed on April 24, 2006.
- 10.32 Security Agreement with EMTUCK, LLC dated April 19, 2006, incorporated by reference to Exhibit 10.3 to the Company's Current Report on Form 8-K filed on April 24, 2006.
- 10.33 Form of EMTUCK Warrant, incorporated by reference to Exhibit 10.4 to the Company's Current Report on Form 8-K filed on April 24, 2006.
- 10.34 Promissory Note granted to EMTUCK, LLC dated May 19, 2006, incorporated by reference to Exhibit 10.2 to the Company's Current Report on Form 8-K filed on May 26, 2006.
- 10.35 Form of Pali Note Extension Consent Letter dated October 23, 2006, incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed on October 27, 2006.
- 10.36 Form of Securities Purchase Agreement, dated November 30, 2006, incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed on December 5, 2006.
- 10.37 Form of Note, dated November 30, 2006, incorporated by reference to Exhibit 4.1 to the Company's Current Report on Form 8-K filed on December 5, 2006.
- 10.38 Form of Debt Warrant, incorporated by reference to Exhibit 4.2 to the Company's Current Report on Form 8-K filed on December 5, 2006.
- 10.39 Form of Equity Warrant, incorporated by reference to Exhibit 4.3 to the Company's Current Report on Form 8-K filed on December 5, 2006.



- 10.40 Form of Securities Purchase Agreement, incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed on January 24, 2007.
- 10.41 Consulting Agreement amendment with George Boyadjieff, dated June 9, 2007, incorporated by reference to the Quarterly Report on Form 10-QSB filed on August 13, 2007.
- 10.42 Manufacturing Services Agreement, dated September 6, 2007 by and among the Company and Sanima-Sci Corporation, incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed on September 13, 2007.

- 10.43 Consulting Agreement amendment with George Boyadjieff, dated June 9, 2007, incorporated by reference to Exhibit 10.1 to the Company's Quarterly Report on Form 10-QSB filed on August 13, 2007.
- 10.44 Manufacturing Services Agreement, dated September 6, 2007 by and among the Company and Sanima-Sci Corporation, incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed on September 12, 2007.
- 10.45 Securities Purchase Agreement, dated as of October 27, 2007 by and between the Company and certain Investors, incorporated by reference to Exhibit 10.45 to the Company's Amendment No. 2 to Form S-1 filed on August 29, 2008.
- 10.46 Securities Purchase Agreement, incorporated by reference to Exhibit 3.1 to the Company's Current Report on Form 8-K filed August 21, 2009.
- 10.47 Form of Unsecured Promissory Note granted to Steven Strasser, dated March 30, 2010, incorporated by reference to Exhibit 10.47 to the Company's Annual Report on Form 10-K for the year ended December 31, 2009, filed on March 31, 2010.
- 10.48 Form of Securities Purchase Agreement, incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K Filed on June 24, 2010.
- 10.49 Employment Agreement with Steven Strasser dated August 13, 2010, incorporated by reference to Exhibit 10.1 to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2010 filed on August 16, 2010.
- 10.50 Employment Agreement with BJ Lackland dated August 13, 2010, dated August 13, 2010, incorporated by reference to Exhibit 10.2 to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2010 filed on August 16, 2010.
- 31.1 Certification of Steven Strasser pursuant to Section 302 of the Sarbanes-Oxley Act of 2002; filed herewith
- 31.2 Certification of Brian Chan pursuant to Section 302 of the Sarbanes-Oxley Act of 2002; filed herewith
- 32.1 Certification of Steven Strasser pursuant to Section 906 of the Sarbanes Oxley Act of 2002; filed herewith
- 32.2 Certification of Brian Chan pursuant to Section 906 of the Sarbanes Oxley Act of 2002; filed herewith
- 99.1 Press Release, dated March 31, 2011, announcing year end 2010 results; filed herewith

## SIGNATURES

In accordance with Section 13 or 15(d) of the Exchange Act, the Company caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

### POWER EFFICIENCY CORPORATION

Dated: March 29, 2012 By: /s/ STEVEN STRASSER  
Steven Strasser, President and Chief  
Executive Officer and Vice-Chairman of the  
Board (principal executive officer)

Dated: March 29, 2012 By: /s/ BRIAN CHAN  
Brian Chan, Vice President of Finance and  
Director (principal financial officer)

In accordance with the Exchange Act, this report has been signed below by the following persons on behalf of the Company and in the capacities and on the dates indicated.

Dated: March 29, 2012 By: /s/ Philip L Meisel  
Philip L Meisel, Chairman of the Board

Dated: March 29, 2012 By: /s/ Douglas Dunn  
Dr. Douglas Dunn, Director

Dated: March 29, 2012 By: /s/ Kenneth Dickey  
Kenneth Dickey, Director

**POWER EFFICIENCY CORPORATION**

**FINANCIAL STATEMENTS**

**DECEMBER 31, 2011 AND 2010**

**POWER EFFICIENCY CORPORATION**

DECEMBER 31, 2011 AND 2010

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors

Power Efficiency Corporation

Las Vegas, Nevada

We have audited the accompanying balance sheets of Power Efficiency Corporation as of December 31, 2011 and 2010, and the related statements of operations, stockholders' equity and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Power Efficiency Corporation at December 31, 2011 and 2010 and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 2 to the financial statements, the Company has suffered recurring losses and has generated negative cash flows from operations, among other matters, which raises substantial doubt about its ability to continue as a going concern. Management's plans in regard to these matters are also described in Note 2. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

/s/BDO USA, LLP

Las Vegas, Nevada

March 29, 2012

**F-1**

POWER EFFICIENCY CORPORATION  
BALANCE SHEETS

	December 31,	
	2011	2010
<b>ASSETS</b>		
<b>CURRENT ASSETS:</b>		
Cash	\$377,053	\$2,567,607
Accounts receivable, net of allowance of \$8,047 in 2011 and \$28,861 in 2010	30,260	106,066
Inventories	223,767	217,119
Prepaid expenses	26,061	22,550
Total Current Assets	657,141	2,913,342
<b>PROPERTY AND EQUIPMENT, net</b>	<b>96,175</b>	<b>64,847</b>
<b>OTHER ASSETS:</b>		
Deposits	91,304	36,971
Patents, net	152,269	141,907
Goodwill	1,929,963	1,929,963
Total Other Assets	2,173,536	2,108,841
	<b>\$2,926,852</b>	<b>\$5,087,030</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>CURRENT LIABILITIES:</b>		
Accounts payable	\$572,738	\$512,158
Accrued expenses	222,911	\$175,010
Notes payable, net	934,257	-
Total Current Liabilities	1,729,906	687,168
<b>LONG-TERM LIABILITIES:</b>		
Deferred rent	31,451	11,282
Deferred tax liability	504,405	449,513
Total Long-Term Liabilities	535,856	460,795
Total Liabilities	2,265,762	1,147,963
<b>COMMITMENTS AND CONTINGENCIES (Note 13)</b>		
<b>STOCKHOLDERS' EQUITY:</b>		
Series B, Series C-1 and Series D Convertible Preferred Stock, \$0.001 par value 10,000,000 shares authorized, 479,002 shares issued and outstanding in 2011 and 500,877 shares issued and outstanding in 2010, liquidation preference of \$13,255,032 in aggregate	479	501



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Common stock, \$0.001 par value, 350,000,000 shares authorized, 66,833,666 shares issued and outstanding in 2011 and 49,005,733 shares issued and outstanding in 2010	66,834	49,006
Additional paid-in capital	48,133,570	46,737,632
Accumulated deficit	(47,539,793)	(42,848,072)
Total Stockholders' Equity	661,090	3,939,067
	\$2,926,852	\$5,087,030

*See notes to financial statements.*

**F-2**

POWER EFFICIENCY CORPORATION  
STATEMENTS OF OPERATIONS

	Year Ended December 31,	
	2011	2010
REVENUES	\$450,360	\$576,797
COST OF GOODS SOLD	379,589	429,947
GROSS PROFIT	70,771	146,850
COSTS AND EXPENSES:		
Selling, general and administrative	2,378,777	2,516,934
Research and development	1,110,670	722,753
Depreciation and amortization	36,860	42,709
Total Costs and Expenses	3,526,307	3,282,396
LOSS FROM OPERATIONS	(3,455,536 )	(3,135,546 )
OTHER INCOME (EXPENSE):		
Interest (expense) income	(99,650 )	(919,295 )
Change in fair value of warrant liability	-	828,827
Total Other Income (Expenses), Net	(99,650 )	(90,468 )
LOSS BEFORE PROVISION FOR TAXES	(3,555,186 )	(3,226,014 )
PROVISION FOR TAXES	(54,892 )	(49,946 )
NET LOSS	\$(3,610,078 )	\$(3,275,960 )
DIVIDENDS PAID OR PAYABLE ON SERIES B, SERIES C-1 AND SERIES D CONVERTIBLE PREFERRED STOCK	1,081,643	3,531,130
NET LOSS ATTRIBUTABLE TO COMMON SHAREHOLDERS	\$(4,691,721 )	\$(6,807,090 )
BASIC AND FULLY DILUTED LOSS PER COMMON SHARE	\$(0.09 )	\$(0.15 )
WEIGHTED AVERAGE COMMON SHARES OUTSTANDING BASIC AND FULLY DILUTED	52,538,740	45,477,040

*See notes to financial statements.*

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POWER EFFICIENCY CORPORATION  
 STATEMENTS OF STOCKHOLDERS' EQUITY  
 YEAR ENDED DECEMBER 31, 2011 AND 2010

	Common Stock		Preferred Stock		Additional	Accumulated	Total
	Shares	Amount	Shares	Amount	Paid-in Capital	Deficit	Stockholders' Equity
Balance, January 1, 2010	44,825,883	\$44,826	170,250	\$ 170	\$36,797,628	\$(36,040,982)	\$ 801,642
Issuances of Series C-1 preferred stock, net of related expenses	-	-	4,375	4	116,586	-	116,590
Preferred stock dividends recognized on beneficial conversion features of Series C-1 preferred stock issuances	-	-	-	-	41,309	(41,309 )	-
Warrants issued with Series C-1 preferred stock	-	-	-	-	58,410	-	58,410
Warrants issued with secured debt	-	-	-	-	818,542	-	818,542
Issuances of Series D preferred stock for cash, net of related expenses	-	-	326,252	327	3,437,085	-	3,437,412
Preferred stock dividends recognized on beneficial conversion features of Series D preferred stock issuances	-	-	-	-	2,602,369	(2,602,369 )	-
Warrants issued with Series D preferred stock	-	-	-	-	1,655,597	-	1,655,597
Common stock issued to vendors	252,101	252	-	-	59,747	-	59,999
Common stock issued upon cashless exercise of options and warrants	42,000	42	-	-	(42 )	-	-
Warrants and options issued to employees and consultants	-	-	-	-	266,835	-	266,835
Preferred stock dividends paid or payable in common stock	3,885,749	3,886	-	-	883,566	(887,452 )	-
Net loss	-	-	-	-	-	(3,275,960 )	(3,275,960 )
Balance, December 31, 2010	49,005,733	49,006	500,877	501	46,737,632	(42,848,072)	3,939,067
Conversion of Series D preferred stock into	2,187,500	2,188	(21,875 )	(22 )	(2,166 )	-	-

common stock							
Investor warrants issued with secured debt	-	-	-	-	131,487	-	131,487
Fee warrants issued with secured debt	-	-	-	-	11,111	-	11,111
Warrants and options issued to employees and consultants	-	-	-	-	189,503	-	189,503
Preferred stock dividends paid or payable in comon stock	15,640,433	15,640	-	-	1,066,003	(1,081,643 )	-
Net loss	-	-	-	-	-	(3,610,078 )	(3,610,078 )
Balance, December 31, 2011	66,833,666	\$66,834	479,002	\$ 479	\$48,133,570	\$(47,539,793)	\$ 661,090

*See notes to financial statements.*

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POWER EFFICIENCY CORPORATION  
STATEMENTS OF CASH FLOWS

	Year Ended December 31,	
	2011	2010
<b>CASH FLOWS PROVIDED BY (USED FOR):</b>		
<b><u>OPERATING ACTIVITIES:</u></b>		
Net loss	\$(3,610,078)	\$(3,275,960)
Adjustments to reconcile net loss to net cash used for operating activities:		
Depreciation and amortization	36,860	42,709
Cost of goods sold depreciation	8,044	-
(Gain) loss on disposition of fixed assets	1,653	(102 )
Warrants and options issued in connection with services from vendors and to employees and consultants	189,503	326,834
Change in fair value of warrant liability	-	(828,827 )
Noncash interest expense related to debt discount and debt issue cost	71,299	818,541
Inventory obsolescence	44,633	-
Changes in certain assets and liabilities:		
Accounts receivable	75,806	(39,923 )
Inventories	(51,281 )	64,134
Prepaid expenses	2,045	13,887
Deposits	(54,333 )	(10,057 )
Accounts payable and accrued expenses	108,481	146,692
Deferred tax liability	54,892	49,946
Deferred rent	20,169	2,364
Net Cash Used in Operating Activities	(3,102,307)	(2,689,762)
<b><u>INVESTING ACTIVITIES:</u></b>		
Costs related to patent applications	(13,141 )	(58,108 )
Purchase of property, equipment and other assets	(83,606 )	(19,178 )
Proceeds from the sale of property, equipment and other assets	8,500	800
Net Cash Used in Investing Activities	(88,247 )	(76,486 )
<b><u>FINANCING ACTIVITIES:</u></b>		
Proceeds from issuance of equity securities, net of related costs	-	4,667,750
Proceeds from issuance of notes payable	1,000,000	868,541
Repayment of notes payable	-	(450,000 )
Net Cash Provided by Financing Activities	1,000,000	5,086,291
<b>INCREASE (DECREASE) IN CASH</b>	<b>(2,190,554)</b>	<b>2,320,043</b>
<b>CASH</b>		
Beginning of year	2,567,607	247,564
End of year	\$377,053	\$2,567,607

*See notes to financial statements.*

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POWER EFFICIENCY CORPORATION  
NOTES TO FINANCIAL STATEMENTS  
DECEMBER 31, 2011 AND 2010

NOTE 1 - NATURE OF BUSINESS:

Power Efficiency Corporation ("Power Efficiency" and/or the "Company"), is incorporated in Delaware. Power Efficiency designs, develops, markets and sells proprietary solid state electrical devices designed to reduce energy consumption in alternating current induction motors. Alternating current induction motors are commonly found in industrial and commercial facilities throughout the world. The Company currently has one principal and proprietary product: the three phase Motor Efficiency Controller, which is used in industrial and commercial applications, such as rock crushers, granulators, and escalators. Additionally, the Company has developed a digital single phase controller in preparation for working with Original Equipment Manufacturers ("OEMs") to incorporate the technology into their equipment.

The Company's primary customers have been OEMs and commercial accounts located throughout the United States of America and various countries.

Power Efficiency's wholly owned subsidiary Design Efficient Energy Services, LLC, a Delaware limited liability company, was formed to obtain energy grants and rebates for customers of the Company from state governmental bodies. Design Efficient Energy Services, LLC has been inactive since inception.

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 \$3,102,307 deficiency of cash from operations for the year ended December 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 \$1,073,000 at December 31, 2011 and has an immediate need for capital.

These factors, among others, 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 9 and Note 18). 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.

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POWER EFFICIENCY CORPORATION  
 NOTES TO FINANCIAL STATEMENTS  
 DECEMBER 31, 2011 AND 2010

NOTE 3 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:

Use of Estimates:

The preparation of 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 date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results may differ from those estimates.

Inventories:

Inventories are valued at the lower of cost or market using the first-in, first-out cost flow assumption. 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 \$44,633 for the year ended December 31, 2011, associated with its switch from its 1<sup>st</sup> generation to its 2<sup>nd</sup> generation three-phase digital products. Management has determined a reserve for inventory obsolescence was not necessary at December 31, 2011 or 2010.

As of December 31, inventories are comprised as follows:

	2011	2010
Raw materials	\$218,394	\$170,251
Finished Goods	5,372	46,868
Inventories	\$223,767	\$217,119

Accounts Receivable:

The Company carries its accounts receivable net of 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. The Company recorded an allowance for doubtful accounts of \$8,047 and \$28,861 as of December 31, 2011 and 2010, respectively.

Research and Development:

Research and development expenditures are charged to expense as incurred.

Property, Equipment and Depreciation:

Property and equipment are stated at cost. Maintenance and repairs are expensed as incurred, while betterments are capitalized. Depreciation is computed using the straight-line method over the estimated useful lives of the assets, which range from 3 to 7 years. Property and equipment are reviewed for impairment whenever events or circumstances indicate that the carrying amount of assets is not recoverable.

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POWER EFFICIENCY CORPORATION  
NOTES TO FINANCIAL STATEMENTS  
DECEMBER 31, 2011 AND 2010

Patents:

Costs associated with applying for U.S. patents based upon technology developed by the Company are capitalized. At the time the patented technologies are used in the business, the asset will be amortized on a straight line basis, over the remaining term of the patent. If no patent is issued, these costs will be expensed in the period when it is determined that no patent will be issued.

Deferred Rent:

The Company accounts for rent expense on a straight-line basis for financial reporting purposes. The difference between cash payments and rent expense is included in deferred rent.

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.

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POWER EFFICIENCY CORPORATION  
NOTES TO FINANCIAL STATEMENTS  
DECEMBER 31, 2011 AND 2010

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 pervasive 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. The Company bills customers for freight. Actual 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 to the Company as a reduction in its cost of goods sold. The Company does not grant price concessions to its OEMs, resellers or distributors.

Loss Per Common Share:

Loss per common share is determined by dividing net loss available to common stockholders by the weighted average number of common shares outstanding during the year. Diluted loss per common share is equivalent to basic loss per common share and is presented on the statement of operations.

For the year ended December 31, 2011, convertible preferred stock of 47,900,200, on as converted to common basis, and warrants and options to purchase 61,684,478 shares of common stock ,at per share exercise prices ranging from \$0.05 to \$19.25, were not included in the computation of diluted loss per share because inclusion would have been anti-dilutive. For the year ended December 31, 2010, convertible preferred stock of 51,241,873, on an as converted to common basis, and warrants and options to purchase 68,478,324 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.

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.

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POWER EFFICIENCY CORPORATION  
 NOTES TO FINANCIAL STATEMENTS  
 DECEMBER 31, 2011 AND 2010

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 \$190,000 (included approximately \$2,400 in warrant costs to consultants that is not a component of ASC 718) and \$267,000 in additional compensation expense during the years ended December 31, 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 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 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 2011 consist of the following:

Balance, January 1, 2010	\$2,648
Additions	6,327
Deductions	(6,895 )
Balance, December 31, 2010	2,080
Additions	48,070
Deductions	(44,800)
Balance, December 31, 2011	\$5,350

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.

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POWER EFFICIENCY CORPORATION  
NOTES TO FINANCIAL STATEMENTS  
DECEMBER 31, 2011 AND 2010

Goodwill:

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.

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 December 31, 2011, the Company's fair value exceeded its carrying value, which was positive; therefore, the Company was not required to perform Step 2. The Company's impairment analysis is performed on December 31 each year, on the Company's single reporting unit.

Advertising:

Advertising costs are expensed as incurred. Advertising expenses were \$972 and \$0 for the years ended December 31, 2011 and 2010, respectively.

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.

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POWER EFFICIENCY CORPORATION  
 NOTES TO FINANCIAL STATEMENTS  
 DECEMBER 31, 2011 AND 2010

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 - PREPAID EXPENSES:

As of December 31, prepaid expenses assets are comprised as follows:

	2011	2010
Prepaid insurance	\$9,065	\$6,793
Other prepaid expenses	16,996	15,757
Prepaid expenses	\$26,061	\$22,550

NOTE 5 - PROPERTY AND EQUIPMENT:

At December 31, property and equipment is comprised as follows:

	2011	2010
Machinery and equipment	\$186,034	\$169,151
Office furniture and equipment	4,180	20,113
	190,214	189,264
Less: Accumulated depreciation	94,039	124,417
Property and equipment, net	\$96,175	\$64,847

Depreciation for the years ended December 31, 2011 and 2010 amounted to \$42,125 and \$40,166, respectively.

**NOTE 6 - GOODWILL:**

The Company has no accumulated impairment losses on goodwill. 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 December 31, 2011 and December 31, 2010. Based on this, no impairment exists as of December 31, 2011 and December 31, 2010.

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POWER EFFICIENCY CORPORATION  
 NOTES TO FINANCIAL STATEMENTS  
 DECEMBER 31, 2011 AND 2010

NOTE 7 - INTANGIBLE ASSETS:

Intangible assets subject to amortization consist of the following at December 31:

	2011	2010
Patents	\$172,532	\$159,391
Less: Accumulated amortization	20,263	17,484
Intangible Assets, Net	\$152,269	\$141,907

Amortization expense in 2011 and 2010 amounted to \$2,779 and \$2,543, respectively.

During 2011 and 2010, the Company capitalized approximately \$13,000 and \$58,000 in legal costs related to patent filings, respectively. The Company will begin amortizing these costs over the lives of the patents, once the patented technologies are used in the business.

Amortization expense expected in the succeeding five years for the Company's existing patents is as follows:

2012	\$2,779
2013	2,779
2014	2,779
2015	2,779
2016	2,779
Thereafter	138,374
Total	\$152,269

NOTE 8 - CONCENTRATIONS OF CREDIT RISKS:

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 December 31, 2011 and 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, 2011 approximated \$127,000.

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Sales and accounts receivable currently are from a relatively small number of customers of the Company's products. The Company closely monitors extensions of credit.

Four customers accounted for approximately 72% of 2011 sales and 90% of accounts receivable at December 31, 2011. Kone accounted for 32% of 2011 sales and 35% of accounts receivable at December 31, 2011. Schindler accounted for 22% of 2011 sales and 3% of accounts receivable at December 31, 2011. IPEG accounted for 8% of 2011 sales and 34% of accounts receivable at December 31, 2011. Otis accounted for 10% of 2011 sales and 18% of accounts receivable at December 31, 2011.

Four customers accounted for approximately 80% of 2010 sales and 80% of accounts receivable at December 31, 2010. Kone accounted for 32% of 2010 sales and 16% of accounts receivable at December 31, 2010. Schindler accounted for 26% of 2010 sales and 60% of accounts receivable at December 31, 2010. Energy Systems Group accounted for 14% of 2010 sales and 0% of accounts receivable at December 31, 2010.

International sales as a percentage of total revenues were 19% and 25% for each of the years ended December 31, 2011 and 2010, respectively.

NOTE 9 - NOTES PAYABLE:

On October 4, 2011, the Company entered into a financing transaction in which it issued an aggregate of \$1,000,000 in senior secured bridge notes (collectively the "Bridge Notes", individually a "Bridge Note"), before discount. The Bridge Notes bear interest of 10% per annum, payable upon maturity. The Bridge 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 Bridge Notes have the right to convert the amounts due plus all accrued but unpaid interest under the Bridge Notes into any subsequent financing while such Bridge Note is outstanding, on the same terms as such new financing, at the sole discretion of the note holder. Upon the occurrence of an "Event of Default" (as defined in the Bridge Note) the holder could have, upon written notice to the Company, elected to declare the entire principal amount of the Bridge Note then outstanding together with accrued unpaid interest thereon due and payable. Upon receipt of such notice, the Company would have twenty business days to cure the Event of Default, and if uncured on the twenty first business day, all principal and interest would have become immediately due and payable. Many of the investors were either directors, affiliates or pre-existing stockholders of the Company.



The Company also issued 2,777,780 warrants (the “Bridge Warrants”) to purchase common stock of the Company to the holders of the Bridge Notes. The Bridge Warrants have a per share exercise price of \$0.09 and expire on various dates through October 3, 2016. The common stock issuable upon exercise of the Bridge Warrants has piggyback registration rights, and can be included in the Company’s next registration statement. The Bridge Warrants have a cashless exercise provision, but only if the registration statement on which the common stock issuable upon exercise of the Bridge Warrants is not then effective. A value of \$131,487 was allocated to the Bridge Warrants based upon relative fair value, which was recorded as a debt discount, and is being amortized over the life of the Bridge Notes.

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In addition, the Company issued 222,222 warrants to purchase common stock of the Company to an investment bank in connection with the Bridge Notes. These warrants have a per share exercise price of \$0.09, expire on October 3, 2016, and have a cashless exercise provision. The value of these warrants was \$11,111, which was recorded as a component of prepaid expenses, and is being amortized over the life of the Bridge Notes.

On various dates in May and June, 2010, the Company entered into financing transactions in which the Company issued a total of \$1,637,083, before discount, of its one year, senior, secured promissory notes (collectively the "Secured Notes", individually a "Secured Note"). The Secured Notes bore interest of 12% per annum. Interest due under the Secured Notes was payable semiannually, with the principal and final interest payment due in May and June, 2011. The Company had the option prepay the principal and interest due on this Secured Note, at any time, in whole or in part without penalty or premium, plus 8 months of interest at the time of prepayment. The Secured Notes had a first priority security interest in all of the assets of the Company. Upon the occurrence of an "Event of Default" (as defined in the Secured Note, included herein as an exhibit) the holder could have, upon written notice to the Company, elected to declare the entire principal amount of the Secured Note then outstanding together with accrued unpaid interest thereon due and payable. Upon receipt of such notice, the Company would have twenty business days to cure the Event of Default, and if uncured on the twenty first business day, all principal and interest would have become immediately due and payable. All of the investors in the Secured Notes were officers or pre-existing stockholders of the Company.

The Company also issued 7,117,762 warrants (the "Debt Warrants") to purchase common stock of the Company to the holders of the Secured Notes during 2010. The Debt Warrants have a per share exercise price of \$0.23 and expire on various dates between May and June, 2015. The common stock issuable upon exercise of the Debt Warrants has piggyback registration rights, and can be included in the Company's next registration statement. The Debt Warrants have a cashless exercise provision, but only if the registration statement on which the common stock issuable upon exercise of the Debt Warrants is not then effective. In addition, the investors of the Secured Notes that held warrants from prior investments with the Company had the exercise price of some or all of such warrants reduced to \$0.23 per share. As a result, the Company reduced the prices on an aggregate of 9,993,593 warrants from per share exercise prices ranging from \$0.24 to \$0.60. A value of \$818,542 was allocated to the Debt Warrants and the warrant price reduction based upon relative fair value, which was recorded as a debt discount, and was amortized over the life of the Secured Notes. The Secured Notes and related accrued interest were paid off in full or converted to Series D convertible preferred stock on June 21, 2010 (See Note 15), and all remaining debt discount was expensed as interest expense.

Of the aggregate \$1,637,083 Secured Notes, Secured Notes consisting of \$200,000 from Steven Strasser, the Company's Chairman, Chief Executive Officer and the Company's largest beneficial shareholder, replaced an existing unsecured promissory note of the Company.

In March and April 2010, the Company issued unsecured notes (the “Unsecured Notes”) to Steven Strasser, the Company’s CEO, totaling \$250,000. The Unsecured Notes bore interest at 5%, payable upon maturity. The Unsecured Notes were set to mature two months after issuance. \$200,000 of Unsecured Notes were exchanged for Secured Notes on May 13, 2010, and the remaining \$50,000 plus related accrued interest was paid off in full on May 26, 2010.

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NOTE 10 - PROVISION FOR TAXES:

The income tax provision is summarized as follows:

	Year Ended December 31, 2011	Year Ended December 31, 2010
Current		
Federal	\$ -	\$ -
State	-	-
Total current	-	-
Deferred		
Federal	52,760	48,308
State	2,132	1,638
Total deferred	54,892	49,946
Total tax expense	\$ 54,892	\$ 49,946

Deferred income taxes reflect the net tax effects of (a) temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes, and (b) operating losses and tax credit carryforwards.

The tax effects of significant items comprising the Company's deferred taxes are as follows:

	December 31, 2011	December 31, 2010
Deferred tax assets:		
Accrued expenses	\$ 14,022	\$ 10,145
Net operating losses	12,700,152	11,395,587
Stock based compensation	603,204	564,852
Tax credits	48,390	48,390
Total deferred tax assets	13,365,768	12,018,974

Deferred tax liabilities:		
Goodwill	(504,405 )	(449,513 )
Fixed asset basis differences	(4,205 )	(6,466 )
Total deferred tax liabilities	(508,610 )	(455,979 )
Preliminary net deferred tax asset	12,857,158	11,562,995
Less: valuation allowance for deferred tax asset	(13,361,563 )	(12,012,508 )
Net deferred tax liability	\$(504,405 )	\$(449,513 )

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The valuation allowance increased by \$1.3 million during 2011 and \$1.1 million during 2010 primarily due to losses from current operations.

As of December 31, 2011 and 2010, the Company has available, on a federal tax basis, net operating loss carryforwards of approximately \$35.8 million and \$32.4 million, respectively. These net operating losses expire beginning 2020 through 2031.

FASB ASC 740-10 (SFAS 109) requires that the tax benefit of net operating losses, temporary differences and credit carryforwards be recorded as an asset and that management assesses whether realization is “more likely than not.” Realization of the future tax benefits is dependent of the Company’s ability to generate sufficient taxable income within the carryforward period. Because of the Company’s history of operating losses, management believes that the recognition of the deferred tax assets arising from the above mentioned future tax benefits is currently not likely to be realized and, accordingly, has provided a valuation allowance.

A reconciliation of the statutory tax rates for the years ended December 31 is as follows:

	2011	2010
Statutory rate	(34 )%	(34 )%
State income taxes – all states	(1 )%	(1 )%
Non-deductible stock based compensation	1 %	1 %
Non-deductible interest	1 %	10 %
Change in fair value of warrant liability	- %	(9 )%
Change in apportioned state income tax rate	(3 )%	- %
Change in valuation allowance	38 %	35 %
Effective tax rate	2 %	2 %

The Company accounts for uncertain tax positions under the provisions of FASB ASC 740-10 (FIN 48). 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.

In the event of a change in control, under IRS section 382, the utilization of our Federal net operating loss carryforwards would be limited.

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NOTE 11 - WARRANTS:

Warrant activity during the years ended December 31, 2011 and 2010 follows:

	Warrants	Average Exercise Price
Warrants outstanding at January 1, 2010	31,387,469	0.43
Issued during 2010	24,487,362	0.20
Exercised during 2010	(6,489,747 )	0.39
Warrants outstanding at December 31, 2010	49,385,084	\$ 0.32
Issued during 2011	3,100,002	0.09
Canceled or Expired in 2011	(10,137,420)	0.36
Warrants outstanding at December 31, 2011	42,347,666	\$ 0.29

During 2011, the Company issued the following warrants: 2,777,780 warrants to noteholders, in connection with the Company's private offering of senior secured bridge notes (see Note 9), which were valued at approximately \$131,487 and recorded as a component of equity, with a corresponding debt discount, and amortized to interest expense over the life of the notes; 222,222 warrants as consulting fees to investment bank, which were valued at approximately \$11,111 and recorded as debt issue cost, and amortized to interest expense over the life of the notes, and 100,000 warrants as consulting fees to an R&D consultant, which were valued at approximately \$2,400 and expensed in research and development expenses.

During 2010, the Company issued the following warrants: 16,531,350 warrants to investors, in connection with the Company's private offerings of convertible preferred stock (see Note 16), which were valued at approximately \$1,694,000 and recorded as a component of equity; 838,250 warrants as consulting fees to an investment bank, which were valued at approximately \$119,000 and recorded as a component of equity; and 7,117,762 warrants to note holders, in connection with the Company's secured debt offering (see Note 9), which were valued at approximately \$819,000 and recorded as a component of equity, with a corresponding debt discount, and amortized to interest expense over the life of the notes.

The fair value of each warrant is estimated on the date of grant based on the Black-Scholes option 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 judgment.

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The fair value of warrants granted is estimated on the date of grant based on the weighted-average assumptions in the table below. The risk-free interest rate is based on the U.S. Treasury rates at the date of grant with maturity dates approximately equal to the term of the respective warrant agreements. The historical daily stock volatility of the Company's common stock (the Company's only class of publically traded stock) over the contractual life of the stock warrant is used as the basis for the volatility assumption.

	Years ended December 31,	
	2011	2010
Weighted average risk-free rate	0.90% - 1.08 %	1.60% - 2.45 %
Average contractual life in years	5	5
Expected dividends	None	None
Volatility	152	% 148% - 208 %

**Warrant Liability:**

On January 1, 2009, the Company adopted FASB ASC 815, *Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity's Own Stock* (Prior authoritative literature: FASB EITF 07-5, *Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity's Own Stock* ("EITF 07-5")). 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 FASB ASC 815 (EITF 07-5) 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 adopting ASC 815 (EITF 07-5), the Company recorded a \$1,052,099 cumulative adjustment to opening accumulated deficit and a reduction to paid-in capital of \$1,433,954 on January 1, 2009. In each subsequent period, the Company adjusted the warrant liability to equal the fair value of the warrants at the balance sheet date. Changes in the fair value of warrants classified as a liability are recognized in earnings. The warrant liability was valued at \$0 and \$828,827 as of December 31, 2010 and December 31, 2009, respectively, resulting in non-cash gains of \$828,827 for the year ended December 31, 2010 and non-cash losses of \$514,089 for the year ended December 31, 2009, in our statement of operations. All of these warrants had expired as of December 31, 2010.

Also, on August 12, 2009 and October 5, 2009, the Company issued 1,168,750 warrants to purchase the Company's common stock, in conjunction with its sale of Series C Convertible Preferred Stock. The warrant agreements drafted for these warrants inadvertently contained an anti-dilution provision, which required the warrants to be classified as a liability. As a result, the Company initially classified \$181,562 as a warrant liability. The Company reclassified these warrants to paid-in capital upon receiving consent from each of the holders of these warrants to correct the warrant agreements to remove the anti-dilution provision. The fair value of the warrants on the dates of reclassification totaled

\$248,680, resulting in an additional non-cash loss of \$67,118 in our statement of operations for the year ended December 31, 2009. On December 11, 2009, the warrant agreements were amended and the \$248,680 was reclassified to paid-in capital.

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The Company has estimated the fair value of its warrant liability using the Black-Scholes option pricing model (Level 3 inputs) containing the following assumptions: volatility 121%, risk-free rate 1.78%, term equivalent to the remaining life of the warrants. The Company recorded a non-cash expense related to these warrants of \$514,089 for the year ended December 31, 2009, which was recorded in other income (expense).

The following reconciles the warrant liability for the years ended December 31, 2010:

Beginning balance, January 1, 2010	\$828,827
Changes in fair value	(828,827)
Ending balance, December 31, 2010	\$-

NOTE 12 - STOCK OPTION PLAN:

Stock Option Plan activity during the years ended December 31, 2011 and 2010 follows:

	Shares	Average Exercise Price	Aggregate Intrinsic Value*
Options outstanding and exercisable at January 1, 2010	17,474,896	\$ 0.34	\$ -
Granted during 2010	10,850,000	0.19	-
Cancelled during 2010	(9,006,656 )	0.27	-
Exercised during 2010**	(75,000 )	0.11	6,000
Options outstanding and exercisable at December 31, 2010	19,243,240	\$ 0.30	\$ -
Granted during 2011	5,900,000	0.09	-
Cancelled during 2011	(5,806,428 )	0.19	-
Options outstanding and exercisable at December 31, 2011	19,336,812	\$ 0.27	\$ -

\* The aggregate intrinsic value represents the amount by which the market price of the Company's common stock exceeds the average exercise price of outstanding options on a specific date, multiplied by the amount of outstanding options on that date. If the average exercise price on the specific date exceeds the market price of the Company's common stock, the intrinsic value is \$0.

\*\* All options were exercised under an approved cashless exercise, which resulted in a net issuance of 42,000 shares of the Company's common stock.

Weighted average remaining contractual life at December 31, 2011 and 2010 for all options is 5.82 and 6.51 years, respectively.

In 2000, the Company adopted the 2000 Stock Option and Restricted Stock Plan (the "2000 Plan"). On July 16, 2009, the 2000 Plan was amended and restated. The 2000 Plan, as restated and amended, provides for the granting of options to purchase up to 25,000,000 shares of common stock. 245,000 options have been exercised cashlessly, resulting in the issuance of 120,781 common shares, to date. There are 19,836,812 options outstanding under the 2000 Plan as of December 31, 2011.

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During 2011, the Company granted 5,900,000 stock options to directors and employees at exercise prices approximating fair market value of the stock on the date of each grant. Such issuances to directors and employees were valued at \$591,000, utilizing the assumptions described below. Stock options issued to directors for the requisite one year term vested evenly per quarter during 2011. Stock options issued to employees vest evenly over five years from the date of issuance. Total stock options expensed during 2011, including stock options granted in prior years vested during the current year, totaled \$189,503, of which \$20,458 was expensed and included in research and development expenses, and \$169,045 was expensed and included in selling, general and administrative expenses. The fair market value of stock options issued as of December 31, 2011 that has not been expensed is \$4,785,756, and will be expensed over 2.85 years, the weighted average period over which it is expected to be recognized.

During 2010, the Company granted 10,850,000 stock options to directors and employees at exercise prices approximating fair market value of the stock on the date of each grant. Such issuances to directors and employees were valued at \$1,859,000, utilizing the assumptions described below. Stock options issued to directors for their requisite one year term vested evenly per quarter during 2010. Stock options issued to employees vest evenly over five years from the date of issuance. Total stock options expensed during 2010, including stock options granted in prior years which vested during the current year, totaled \$266,835, of which \$3,888 was expensed and included in research and development expenses, and \$262,947 was expensed and included in selling, general and administrative expenses. The fair market value of stock options issued as of December 31, 2010 that has not been expensed is \$4,408,845, and will be expensed over 3.43 years, the weighted average period over which it is expected to be recognized.

In 1994, the Company adopted a Stock Option Plan (the "1994 Plan"). The 1994 Plan provides for the granting of options to purchase up to 71,429 shares of common stock. No options have been exercised to date. There are no options outstanding under the 1994 Plan, and the Company does not plan to issue any more options under this plan.

**Share Based Compensation Payments:**

The fair value of each option grant was estimated on the date of grant using the Black-Scholes option pricing model with the following weighted-average assumptions used for grants:

	Years ended December 31,	
	2011	2010
Weighted average risk-free rate	0.96% - 2.07 %	1.35% - 3.32 %
Average expected life in years	6	6
Expected dividends	None	None
Volatility	149% - 157 %	154% - 160 %

Forfeiture rate 52 % 46 %

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The fair value of options granted is estimated on the date of grant based on the weighted-average assumptions in the table above. The assumption for the expected life is based on evaluations of historical and expected exercise behavior. The risk-free interest rate is based on the U.S. Treasury rates at the date of grant with maturity dates approximately equal to the expected life at the grant date. The historical daily stock volatility of the Company's common stock (the Company's only class of publicly traded stock) over the estimated life of the stock warrant is used as the basis for the volatility assumption.

The Company accounts for employee stock options as compensation expense, in accordance with FASB ASC 718. FASB ASC 718 requires companies to expense the value of employee stock options and similar awards over the requisite service period.

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 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 materially different from what we have recorded in the current period.

**NOTE 13 - COMMITMENTS AND CONTINGENCIES:**

**Leases:**

The Company leases a facility which houses office space, manufacturing and warehousing space, and a research and development space in San Diego, California. The lease includes a base rent payment of \$9,298 per month, plus annual increases equal to 3% of base rent. The term of the lease is 48 months.

The Company leases a facility which houses office space and warehousing space in Las Vegas, Nevada. The lease includes a base rent payment of \$6,580 per month, plus an increase of 8% for year two. The term of the lease is 26 months.



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.

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Minimum future rentals are as follows:

Year	
2012	\$174,921
2013	103,921
2014	103,921
2015	25,981
	\$408,744

Rent expense, including base rent and additional charges, for the years ended December 31, 2011 and 2010 was \$229,538 and \$210,720, respectively.

**Patent License Agreements:**

The Company was an exclusive licensee pursuant to a patent license agreement of certain power factor controller technology owned by the United States, as represented by the National Aeronautics and Space Administration (NASA). This license agreement covered the United States of America and its territories and possessions on an exclusive basis and foreign sales on a non-exclusive basis. Such license agreement did not require the Company to pay royalties to NASA in connection with the Company's sale of products employing technology utilizing the licensed patents. The agreement terminated on December 16, 2002 upon the expiration of all of the licensed patents.

The Company filed and received three patents (No. 5,821,726, No. 7,768,221 B2, and 7,911,173 B2) on the Company's technology, that expires in 2017, 2027 and 2028, respectively and that management believes will protect the Company's intellectual property position. The Company has also filed three utility patents for new inventions associated with the development of its digital products, which are all pending approval with the U.S. Patent and Trademark Office. The legal costs incurred in applying for these patents are capitalized and presented in the balance sheet.

**Litigation:**

The Company was involved in a lawsuit against a former director (the "Defendant"), who is now CEO of a company offering motor control products. The Company filed this action against the Defendant for misappropriation of trade secrets, false advertising, defamation/libel and other claims primarily arising from the Defendant's use of the Company's confidential and proprietary information in the development and marketing of motor control products. The

Company sought a temporary restraining order, preliminary injunction, permanent injunction, damages, exemplary damages, attorneys' fees and costs against the Defendant. The Company's complaint was filed on August 6, 2009 in the U.S. District Court, District of Nevada. The Defendant agreed to the terms of the Company's settlement offer on August 7, 2011, and the Company has volunteered to discontinue the lawsuit pursuant to the settlement agreement. This settlement agreement did not impact the Company's financial statement for the years ended December 31, 2011 and 2010.

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**Employment Agreements:**

On June 1, 2010, the Company entered into an employment and compensation agreement with Steven Strasser, the Company's Chief Executive Officer. The agreement is for a term of five years, with a base salary for the first year of the agreement of \$300,000 with bonuses at the discretion of the compensation committee of the board of directors. The agreement with this Chief Executive Officer also provides, among other things, for reimbursement of certain business expenses and for certain payments to be made to this Chief Executive Officer in the event of a change in control. This Chief Executive Officer also received 2,777,780 incentive stock options in June 2010, which vest over a five year period and have an exercise price of \$0.20, and 1,222,220 non-qualified stock options which vest over a five year period and have an exercise price of \$0.18 (see Note 11). The agreement also provides for certain non-competition and nondisclosure covenants. As of December 31, 2011, a total of 1,200,000 stock options are vested, and 2,800,000 stock options are unvested, and all remain outstanding. Of these stock options, 2,777,780 expire on August 31, 2015, and 1,222,220 expire on August 31, 2020.

On June 1, 2010, the Company entered into an employment and compensation agreement with John Lackland, the Company's Chief Financial Officer. The agreement was for a term of five years, with a base salary for the first year of the agreement of \$200,000 with bonuses at the discretion of the compensation committee of the board of directors. This Chief Financial Officer was also granted 2,000,000 incentive stock options in June 2010, which vested over a five year period and have an exercise price of \$0.18 (see Note 11). On August 15, 2011, this Chief Financial Officer resigned from the Company and terminated this employment and compensation agreement. As of December 31, 2011, all 2,000,000 stock options have been cancelled.

**NOTE 14 - RELATED PARTY TRANSACTIONS:**

On October 4, 2011, the Company entered into a financing transaction in which it issued \$1,000,000 in Bridge Notes (see Note 9). In this transaction, Marc Lehmann, a director of the Company as of that date, invested \$200,000, and Herman Sarkowsky, a director of the Company as of that date, invested \$200,000.

On June 21, 2010, the Company entered into a financing transaction in which it issued 313,752 units, each unit consisting of one share of the Company's Series D Preferred Stock and 50 warrants to purchase the Company's common stock for \$5,020,000, which consisted of \$3,601,200 in cash and \$1,418,800 in cancellation of indebtedness. In this transaction, Steven Strasser, the Company's CEO, purchased 34,547 units for \$500,000 in cash and \$52,000 in cancellation of indebtedness, and John Lackland, the Company's former CFO, purchased 1,875 units for \$30,000 in cancellation of indebtedness (see Note 16).

On various dates in May and June, 2010, the Company entered into financing transactions in which the Company issued \$1,637,083, before discount, of its Secured Notes and warrants. In this transaction, Steven Strasser, the Company's CEO invested \$200,000 (see Note 9).

In March and April 2010, the Company issued Unsecured Notes to Steven Strasser, the Company's CEO, totaling \$250,000 (see Note 9).

On January 20, 2010 and February 24, 2010, the Company entered into a financing transaction in which it issued 4,375 units, each unit consisting of one share of the Company's Series C-1 Preferred Stock and a warrant to purchase up to 50 shares of the Company's common stock for \$175,000 in cash. In this transaction, Steven Strasser, the Company's CEO purchased 1,875 units for \$75,000 in cash (See Note 16).

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**NOTE 15 - SUPPLEMENTAL DISCLOSURE OF CASH FLOWS INFORMATION:**

Cash paid during the year ended December 31, for:

	2011	2010
Interest	\$10,000	\$-
Income/franchise taxes	\$21,271	\$18,460

Non-cash investing and financing activities during the year ended December 31, for:

	2011	2010
Common stock issued upon conversion of Series D Preferred Stock	\$2,188	\$-
Warrants issued for debt issue cost related to Bridge Notes	\$11,111	\$-
Preferred stock dividends paid or payable in common stock	\$1,081,643	\$887,452
Common stock issued upon cashless exercise of options and warrants	\$-	\$42
Exchange of Secured Notes to Series D Preferred Stock	\$-	\$1,237,083
Exchange of accrued interest related to Secured Notes to Series D Preferred Stock	\$-	\$98,967
Exchange of accrued wages to Series D Preferred Stock	\$-	\$82,750
Preferred stock dividend recognized for beneficial conversion features of preferred stock issuances	\$-	\$2,643,678

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**NOTE 16 - CONVERTIBLE PREFERRED STOCK:**

On June 21, 2010, the Company issued and sold 313,752 units, each unit consisting of one share of the Company's Series D convertible preferred stock, par value \$.001 per share, and 50 warrants to purchase shares of the Company's common stock at an exercise price of \$0.19 per share. This resulted in the sale and issuance of an aggregate of 313,752 shares of Series D preferred stock and warrants to purchase up to 15,687,600 shares of the Company's common stock for \$5,020,000, which consisted of \$3,601,200 in cash and \$1,418,800 in cancellation of indebtedness, which included \$1,237,083 of the Secured Notes, \$98,967 of accrued interest related to the Secured Notes, and \$82,750 of accrued wages. The securities were issued pursuant to Regulation D of the Securities Act of 1933, as amended. Of the aggregate \$5,020,000 invested, a value of \$1,573,590 was allocated to the 15,687,600 Series D warrants and recorded as a component of paid-in capital. The conversion feature of the Series D preferred stock at the time of issuance was determined to be beneficial on June 21, 2010, the date of the transaction. The Company recorded additional preferred stock dividends of \$2,514,856 related to the beneficial conversion feature. In this transaction, Steven Strasser, the Company's CEO, purchased 34,547 units for \$500,000 in cash and \$52,750 in cancellation of indebtedness, and John Lackland, the Company's former CFO, purchased 1,875 units for \$30,000 in cancellation of indebtedness (see Note 14). In addition, the issuance of the Series D preferred stock also triggered an anti-dilution provision on a portion of the Company's existing warrants that were classified as liabilities on June 21, 2010. This resulted in an increase in the fair value of these warrants of \$3,858.

On July 30, 2010, the Company sold 12,500 units under its Series D preferred stock offering, resulting in the issuance of an aggregate of 12,500 shares of Series D preferred stock and warrants to purchase up to 625,000 shares of the Company's common stock for \$200,000 in cash. Of the aggregate \$200,000 invested, a value of \$62,513 was allocated to the 625,000 Series D warrants and recorded as a component of paid-in-capital. The conversion feature of the Series D preferred stock at the time of issuance was determined to be beneficial on July 30, 2010, the date of the transaction. The Company recorded additional preferred stock dividends of \$87,513 related to the beneficial conversion feature.

The Series D preferred stock has an annual dividend equal to 8% of the aggregate \$5,220,000 stated value of the preferred stock, payable annually in cash or stock, at the discretion of the Company's board of directors. Upon any liquidation, dissolution, or winding up of the Company, whether voluntary or involuntary, before any distribution or payment is made to the holders of any stock of the Company, the holders of Series D preferred stock are entitled to be paid out of the assets of the Company, proportionally with any other series of preferred stock, an amount per share of Series D preferred stock equal to the stated value (as adjusted for any stock dividends, combinations, splits, recapitalizations and the like with respect to such shares), plus all accrued but unpaid dividends (whether declared or not) on such shares of Series D preferred stock for each share of Series D preferred stock held by them. The conversion price for the Series D preferred stock is \$0.16 per share, and the Series D preferred stock is subject to mandatory conversion of 100 common shares per 1 Series D preferred share, in the event the average closing price of the Company's common stock for any ten day period equals or exceeds \$0.50 per share and the average daily trading volume is at least 50,000 shares of common stock per day during such ten-day period, such conversion to be effective

on the trading day immediately following such ten day period. Series D preferred stock shall vote with the shares of Common Stock on an as converted basis from time to time, and not as a separate class, at any duly called annual or special meeting of stockholders of the Company. The holders of our Series D preferred stock have no pre-emptive rights, and the Company cannot amend the Series D preferred stock's Certificate of Designation without first obtaining the approval of 75% of the holders of the outstanding Series D preferred stock.

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Wilmington Capital Securities, LLC (the "Placement Agent"), a registered broker dealer, acted as the sole placement agent for the Series D preferred stock offering. For its services, the Placement Agent received commission and non-accountable fees totaling \$113,120 and 688,250 warrants (the "Placement Agent Warrants"). The Placement Agent Warrants have a per share exercise price of \$0.19 and expire five years from the date of issuance. The value of the Placement Agent Warrants was \$118,605 and was recorded as a component of equity for the year ended December 31, 2010.

On January 20, 2010 and February 24, 2010, the Company issued and sold 4,375 units, each unit consisting of one share of the Company's Series C-1 preferred stock, par value \$.001 per share, and 50 warrants to purchase shares of the Company's common stock at an exercise price of \$0.40 per share, resulting in the sale and issuance of an aggregate of 4,375 shares of Series C-1 preferred stock and warrants to purchase up to 218,750 shares of the Company's common stock for \$175,000 in cash. The securities were issued pursuant to Regulation D of the Securities Act of 1933. Of the aggregate \$175,000 invested, a value of \$57,884 was allocated to the 218,750 Series C-1 warrants and recorded as a component of paid-in capital. The conversion feature of the Series C-1 preferred stock at the time of issuance was determined to be a beneficial conversion feature on January 20, 2010 and February 24, 2010, the dates of the transactions. The Company recorded additional preferred stock dividends of \$41,309 related to the beneficial conversion feature. In this transaction, Steven Strasser, the Company's CEO purchased 1,875 units for \$75,000 in cash (see Note 14).

Each share of Series C-1 Preferred Stock is convertible into 100 shares of the Company's common stock, subject to adjustment under certain circumstances. The Series C-1 Preferred Stock is convertible at the option of the holder at any time. The Series C-1 Preferred Stock is also subject to mandatory conversion in the event the average closing price of the Company's common stock for any ten day period equals or exceeds \$1.00 per share, such conversion to be effective on the trading day immediately following such ten day period. The Series C-1 Preferred Stock has a dividend equal to 8% of the aggregate \$1,210,000 stated value of the Series C-1 Preferred Stock, payable annually in cash or stock, at the discretion of the Company's board of directors. Upon any liquidation, dissolution, or winding up of the Company, whether voluntary or involuntary, before any distribution or payment is made to the holders of any stock of the Company, the holders of Series C-1 Stock are entitled to be paid out of the assets of the Company, proportionally with any other series of preferred stock, an amount per share of Series C-1 Stock equal to the stated value (as adjusted for any stock dividends, combinations, splits, recapitalizations and the like with respect to such shares), plus all accrued but unpaid dividends (whether declared or not) on such shares of Series C-1 Stock for each share of Series C-1 Stock held by them. The conversion of the Series C Preferred Stock into units sold in the offering of Series C-1 Preferred Stock and the conversion feature of the Series C-1 Preferred Stock at the time of issuance were determined to be beneficial conversion features on December 11, 2009, the date of the transaction. The Company recorded additional preferred stock dividends of approximately \$590,000 related to the beneficial conversion feature.

On various dates from October 29, 2007 through January 21, 2008, the Company issued and sold 140,000 units, each unit consisting of one share of the Company's Series B Preferred Stock, par value \$.001 per share, and a warrant to purchase 50 shares of the Company's common stock, resulting in the sale and issuance of an aggregate of 140,000 shares of Series B Preferred Stock and warrants to purchase, initially, up to 7,000,000 shares of the Company's common stock, with exercise prices of \$0.60 per share, in a private offering (the "Preferred Offering") for \$7,000,000 in cash and cancellation of indebtedness. Many of the purchasers of units were either officers, directors or pre-existing stockholders or noteholders of the Company.

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Each share of Series B Preferred Stock is initially convertible into 100 shares of the Company's common stock, subject to adjustment under certain circumstances. The Series B Preferred Stock is convertible at the option of the holder at any time. The Series B Preferred Stock is also subject to mandatory conversion in the event the average closing price of the Company's common stock for any ten day period equals or exceeds \$1.00 per share, such conversion to be effective on the trading day immediately following such ten day period. The Series B Preferred Stock has a dividend equal to 8% of the aggregate \$7,000,000 stated value of the Series B Preferred Stock, payable annually in cash or stock, at the discretion of the Company's board of directors. Upon any liquidation, dissolution, or winding up of the Company, whether voluntary or involuntary, before any distribution or payment is made to the holders of any stock of the Company, the holders of Series B Stock are entitled to be paid out of the assets of the Company, proportionally with any other series of preferred stock, an amount per share of Series B Stock equal to the stated value (as adjusted for any stock dividends, combinations, splits, recapitalizations and the like with respect to such shares), plus all accrued but unpaid dividends (whether declared or not) on such shares of Series B Stock for each share of Series B Stock held by them.

On June 20, 2011, the Company declared as stock dividend of 4,091,100 shares of common stock, valued at \$409,110, payable to all of the holders of its Series D Preferred Stock. The dividend was paid on June 20, 2011. As of December 31, 2011, the Company has \$219,241 in dividends payable accrued for its Series D Preferred Stock, which is classified as additional paid-in-capital.

On December 11, 2011 the Company declared a stock dividend of 2,216,000 shares of common stock, valued at \$110,800, payable to all of the holders of its Series C-1 Preferred Stock. The dividend was paid on December 23, 2011. As of December 31, 2011, the Company has \$5,848 in dividends payable accrued for its Series C-1 Preferred Stock, which is classified as additional paid-in capital.

On November 1, 2011, the Company declared a stock dividend of 9,333,333 shares of common stock, valued at \$560,000, payable to all of the holders of its Series B Preferred Stock. The dividend was paid on December 21, 2011. As of December 31, 2011, the Company has \$93,333 in dividends payable accrued for its Series B Preferred Stock, which is classified as additional paid-in capital.

As of December 31, 2010, the Company has \$217,507 in dividends payable accrued for its Series D Preferred Stock, which is classified as additional paid-in capital. This dividend becomes due on June 21, 2011.

On December 11, 2010 the Company declared a stock dividend of 774,642 shares of common stock, valued at \$108,449, payable to all of the holders of its Series C-1 Preferred Stock. The dividend was paid on December 21, 2010. As of December 31, 2010, the Company has \$5,848 in dividends payable accrued for its Series C-1 Preferred Stock, which is classified as additional paid-in capital.

On November 1, 2010, the Company declared a stock dividend of 3,111,107 shares of common stock, valued at \$560,000, payable to all of the holders of its Series B Preferred Stock. The dividend was paid on December 21, 2010. As of December 31, 2010, the Company has \$93,333 in dividends payable accrued for its Series B Preferred Stock, which is classified as additional paid-in capital.

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Series B Preferred Stock Activity during the years ended December 31, 2011 and 2010 are as follows:

	Shares	Par Value
Series B Preferred Stock issued and outstanding at January 1, 2010	140,000	\$ 140
Issued during 2010	-	-
Series B Preferred Stock issued and outstanding at December 31, 2010	140,000	140
Issued during 2011	-	-
Series B Preferred Stock issued and outstanding at December 31, 2011	140,000	\$ 140

Series C-1 Preferred Stock Activity during the years ended December 31, 2011 and 2010 are as follows:

	Shares	Par Value
Series C-1 Preferred Stock issued and outstanding at January 1, 2010	30,250	\$ 30
Issued during 2010	4,375	4
Series C-1 Preferred Stock issued and outstanding at December 31, 2010	34,625	34
Issued during 2011	-	-
Series C-1 Preferred Stock issued and outstanding at December 31, 2011	34,625	\$ 34

Series D Preferred Stock Activity during the years ended December 31, 2011 and 2010 are as follows:

	Shares	Par Value
Series D Preferred Stock issued and outstanding at January 1, 2010	-	\$ -
Issued during 2010	326,252	326
Series D Preferred Stock issued and outstanding at December 31, 2010	326,252	326
Converted to common stock during 2011	(21,875 )	(22 )
Series D Preferred Stock issued and outstanding at December 31, 2011	304,377	\$ 304

NOTE 17 - 401(K) RETIREMENT PLANS:

The Company maintains a 401(k) retirement plan (the 401(k) Plan). The 401(k) Plan is voluntary, and available to all employees who have been with the Company for at least six months. The Company may make discretionary contributions. The Company did not make any contributions in 2011 or 2010.

NOTE 18 – SUBSEQUENT EVENTS:

On January 27, 2012 and January 30, 2012, the Company consummated closings of a private placement offering for an aggregate of 305 shares of Series E Convertible Preferred Stock, par value of \$0.001 per share, and received consideration of \$2,500,000 in cash and \$550,000 through the conversion of previously outstanding Bridge Notes. All of the investors in the Series E preferred stock are pre-existing stockholders and or noteholders of the Company. The remaining \$450,000 of Bridge Notes will mature on March 31, 2012, including all accrued interest.

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