

POWER EFFICIENCY CORP  
Form 10KSB/A  
September 21, 2005

## Securities and Exchange Commission

Washington, D.C. 20549

### FORM 10-KSB/A

Amendment No. 1

ý Annual report under Section 13 or 15(d) of the Securities

Exchange Act of 1934

For the fiscal year ended December 31, 2004

o 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

(Name of Small Business Issuer in its Charter)

Delaware  
(State or Other Jurisdiction of  
Incorporation or Organization)

3900 Paradise Rd. Ste 283  
Las Vegas, NV

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

89109

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(Address of Principal Executive Offices)

(Zip Code)

**(702) 697-0377**

(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 registrant: (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 registrant 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-B contained in this form, and no disclosure will be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB.

The issuer's revenues for the year ended December 31, 2004 were \$284,373.

As of March 11, 2005, the aggregate market value of the common stock held by non-affiliates of the issuer was approximately \$565,913. This amount is based on the closing price of \$0.30 per share for the registrant's stock as of such date.

On March 11, 2005 there were 5,020,477 shares of the registrant's common stock outstanding.

**Documents Incorporated by Reference**

None

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**EXPLANATORY NOTE**

This Amendment No. 2 on Form 10-KSB/A to Power Efficiency Corporation's (the Company or the Registrant) Annual Report on Form 10-KSB for the year ended December 31, 2004 (the Original Filing), which was filed with the Securities and Exchange Commission on March 31, 2005, and as amended on Form 10-KSB/A for the year ended December 31, 2004 (the First Amendment, collectively the Filings), which was filed with the Securities and Exchange Commission on April 6 2005, is being filed to amend the Filings as follows:

Item 6. Management's Discussion and Analysis is amended to properly reflect the Company's Financial Condition, Liquidity and Capital Resources: For the Year Ended December 31, 2004 information.

Item 7. Financial Statements is amended to revise the Cash Flow Statement to properly reflect the Company's cash flows for the year ended December 31, 2004.

This Amendment No. 2 is filed pursuant to the Securities and Exchange Commission Release No. 34-50754 which provides for 45 additional days beyond the date of the Original Filing for the filing of the above.

As a result of these amendments, the certifications pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, as filed as exhibits to the Original Filing, have been re-executed and re-filed as of the date of this Form 10-KSB/A.

Except for the amendments described above, this Form 10-KSB/A does not modify or update other disclosures in, or exhibits to, the Original Filing.

**Item 6. Management's Discussion and Analysis or Plan of Operation**

**OVERVIEW**

The Registrant generates revenues from a single business segment: the design, development, marketing and sale of proprietary solid state electrical components designed to reduce energy consumption in alternating current induction motors.

The Registrant began generating revenues from sales of its patented *Power Commander*® line of motor controllers in late 1995. As of December 31, 2004, the Registrant had total stockholders' equity of \$1,068,330 primarily due to the Registrant's sale of 2,346,233 shares of Series A-1 Convertible Preferred stock to Summit Energy Ventures, LLC in June of 2002 and the conversion of notes payable of approximately \$1,047,000 into 982,504 shares of Series A-1 Convertible Preferred stock in October of 2003. In addition, in August 2000, the Registrant

purchased the assets of Percon, formerly the largest distributor of the Registrant's products. The transaction was accounted for as a purchase and the Registrant's Statements of Operations includes Percon's results of operations since the date of acquisition. The consolidation of the operations of both entities allowed the Registrant to integrate the administrative, sales, marketing and manufacturing operations of Percon. Percon had developed sales contacts with major OEM's in the elevator/escalator industry and transferred those agreements to the Registrant as part of the asset sale.

## **RESULTS OF OPERATIONS: FISCAL YEAR 2004 COMPARED TO FISCAL YEAR 2003**

### **REVENUES**

Revenues for the twelve months ended December 31, 2004, were \$284,373 compared to \$397,673 for the twelve months ended December 31, 2003, a decrease of \$113,300, or 28%. The decrease in revenues was principally attributable to a lack of funding to pursue the Registrant's sales strategy as well as the failure of the Registrant's former management efforts to improve sales. New management has reassessed the Registrant's sales efforts and believes it is taking steps to improve sales by pursuing tighter relationships with important OEM customers, as well as direct and distributor sales to more desirable markets and customers.

### **COST OF REVENUES**

Cost of revenues for the twelve months ended December 31, 2004 were \$258,135 compared to \$360,972 for the twelve months ended December 31, 2003, a decrease of \$102,837 or 28%. The decrease in cost of revenues was primarily attributed to the decrease in revenues and an overall reduction in the cost of materials from the Registrant's suppliers. These improvements were partially off-set by an increase in the inventory obsolescence expense to \$100,000 for the twelve months ended December 31, 2003 compared to \$29,484 for the twelve months ended December 31, 2004, a decrease of \$70,516 or 71%. The decrease in the inventory obsolescence expense was principally attributable to reserves taken for certain inventory components used exclusively in slow moving products.

### **GROSS MARGIN**

Gross margin for the twelve months ended December 31, 2004 was \$26,238 compared to \$36,701 for the twelve months ended December 31, 2003, a decrease of \$10,463 or 29%. This decrease was primarily due to the increase in material, labor, and overhead offset by the inventory obsolescence expense described above. Excluding the inventory obsolescence expense, gross margin as a percentage of revenue for the twelve

months ended December 31, 2004 was 20% compared to 34% for the twelve months ended December 31, 2003. The decrease was primarily attributable to a decrease in sales attributable to a lack of funding as described above, as well as the inventory obsolescence expense described above.

## **OPERATING EXPENSES**

### **Research and Development Expenses**

Research and development expenses were \$327,202 for the twelve months ended December 31, 2004 compared to \$420,376 for the twelve months ended December 31, 2003, a decrease of \$93,174 or 22%. This decrease is primarily attributable to reduced expenses due to the restructuring of the Company's operations in the 3<sup>rd</sup> quarter 2004. Costs incurred were for the development of the low cost, low horsepower Platform A product family, the single-phase controller, and the fast-reaction integrator board.

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

Selling, general and administrative expenses were \$1,886,132 for the twelve months ended December 31, 2004 compared to \$2,392,754 for the twelve months ended December 31, 2003, a decrease of \$506,622 or 21%. The decrease in selling, general and administrative expenses was due primarily to reduced expenses due to the restructuring of the Company's operations in the 3<sup>rd</sup> quarter 2004. These expenses were related for the most part to reduced payroll and related costs, the closing of the Company's Livonia, MI headquarters and settlements with former employees, vendors and consultants.

### **Financial Condition, Liquidity, and Capital Resources: For the Year Ended December 31, 2004**

Since inception, the Registrant has financed its operations primarily through the sale of its equity securities. As of December 31, 2004 the Registrant has received a total of approximately \$6,254,800 from public and private offerings of its equity securities, received approximately \$445,386 under a bank line of credit (which was repaid during 2002), and received \$1,000,000 under a line of credit with a shareholder (which was converted to Series A-1 Preferred Convertible shares during 2003). In October 2004, the Company received \$1,464,806 in debt financing through a debt offering arranged by a placement agent, Pali Capital. Of this total, \$300,000 plus accrued interest was converted from borrowings with the same shareholder as referenced above. As of December 31, 2004 the Registrant had cash and cash equivalents of \$392,471. In February 2005, the Registrant received an additional \$125,000 in debt financing under this same debt offering.

Net cash used for operating activities for the twelve months ended December 31, 2004 was \$1,396,150 which primarily consisted of: a net loss of \$2,465,631; less allowances for inventory obsolescence of \$29,484, depreciation and amortization of \$116,294, loss on disposition of fixed assets of \$31,036, amortization of debt discounts of \$97,000, warrants and options issued in connection with settlements, services from consultants and vendors, the forgiveness of indebtedness and the issuance of debt of \$550,969, an increase in restricted cash related to a note payable of \$219,721, decreases in accounts receivable of \$1,701, inventory of \$143,396 and prepaid expenses and other of \$13,079. In addition, these amounts were partially offset by an increase in accounts payable and accrued expenses of \$142,830 and accrued salaries and payroll taxes of \$84,841.

Net cash used for operating activities for the twelve months ended December 31, 2003 was \$2,028,798 which primarily consisted of: a net loss of \$3,016,717; less allowances for bad debts and customer returns of \$17,000, allowances for inventory obsolescence of \$100,000 and impairment of customer contracts of \$40,948, depreciation and amortization of \$120,700, additional paid in capital related to issuance of stock options of \$77,158, common stock issued for services of \$614,991, interest converted to debt of \$46,896 and decreases in accounts receivable of \$31,511 and inventory of \$43,353. In addition, these amounts were partially offset by an increase in prepaid expenses of \$18,832 and deposits of \$2,646, and decreases in accounts payable and accrued expenses of \$63,866 and accrued salaries and payroll taxes of \$19,294.

Net cash used in investing activities for fiscal year 2004 was \$10,187, compared to \$42,617 in fiscal year 2003. The amount for fiscal year 2004 consisted of the purchase of property, equipment and other assets of \$14,657, which was offset by the proceeds from the sale of property, equipment and other assets of \$4,470. The amount for fiscal year 2003 entirely consisted of the purchase of property, equipment and other assets.

Net cash provided by financing activities for fiscal year 2004 was \$1,513,300 which primarily consisted of proceeds from the issuance of debt securities of \$300,000, from which a \$15,000 fee was paid, the issuance of additional debt securities of \$1,150,000, from which a fee of \$115,000 was paid. These amounts were offset by an increase in deferred financing costs of \$117,885 and the payment on loans from stockholders of \$40,000. Net cash provided by financing activities for fiscal year 2003 was \$2,099,215, which primarily consisted of proceeds from the issuance of equity securities of \$1,131,965, net of costs, and advances from line of credit of \$1,000,000; off-set by deferred financing costs of \$32,750.

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

### **Cash Requirements and Need for Additional Funds**

The Company anticipates a substantial need for cash to fund its working capital requirements. In accordance with the Company's prepared expansion plan, it is the opinion of management that approximately \$1.75 million will be required to cover operating expenses, including, but not limited to, marketing, sales and operations during the next twelve months. This amount does not include the funds required to repay the secured debt issued by the company as described in Note 22 to the Financial Statements and the Company's Forms 8-K filed on March 2, 2005 and November 5, 2004.

On October 16, 2003, the Company entered into an agreement with an investment banker whereby the investment banker would provide the company with investment banking services. The investment banker was retained with the intention of attempting to raise \$10 million or more through a public sale of stock in the first quarter of 2004. Since the agreement was executed, the Company has learned that such a transaction is probably not possible until after the Company has generated substantially greater sales than it has generated in the past. On February 25, 2004, the Company signed a formal letter of agreement with the same investment banker. Under this letter, the Company appointed the investment banker, as its exclusive representative for 120 days, to attempt to raise money for the Company. The investment banker introduced the Company to investors and participated in presentations to investors to purchase the Company's securities. The investment banker was unable to sell any securities during the 120 days, but the Registrant continued to work with the investment banker and sold secured notes in October 2004. The Company paid the investment 10% of the gross proceeds of restricted securities sold during the agreement (excluding those sold to an affiliate) as well as issued an amount of warrants equal to 10% of the total warrants issued to the investors in the secured notes. (See November 5, 2004 8K for additional details.) If the Company is acquired, merged, or enters into a joint venture with an investor introduced by the investment banker, the Company agrees to pay a fee of 3% of the gross proceeds (cash, stock, other assets acquired, or debt assumed). The Company's agreement with the investment banker has now expired and the offering of notes has been closed.

The Company entered into a consulting agreement with an investment advisor on December 1, 2004. The agreement calls for the investment advisor to assist the Company in devising financial and marketing strategies, and also to assist the Company in raising funds on a non-exclusive basis through the offering of debt and/or equity securities. The company shall pay the investment advisor the amount of \$3,000 per month, plus expenses approved by the Company, and issued 300,000 options. The sum of \$3,000 per month will be adjusted to \$5,000 per month once the Board of Directors and the Company agree to adjust the salaries of the Chief Executive Officer, Chief Financial Officer and the General Manager. The agreement contains confidentiality and non-competition provisions. The term of the agreement is 12 months and can be terminated by either party on 90 days notice in writing. As of December 31, 2004, the Company paid the investment advisor \$3,000.

### **Recent Accounting Pronouncements**

See Note 2 Summary of Significant Accounting Policies of the Financial Statements for an explanation of recent accounting pronouncements impacting the Company.

**Item 7. Financial Statements**

**POWER EFFICIENCY CORPORATION**

DECEMBER 31, 2004 AND 2003

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Report of Independent Registered Public Accounting Firm

Financial Statements:

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

Board of Directors and Stockholders

Power Efficiency Corporation

Las Vegas, Nevada

We have audited the accompanying balance sheet of Power Efficiency Corporation, (a Delaware corporation) (the Company) as of December 31, 2004, and the related statements of operations, changes in stockholders' equity, and cash flows for each of the years ended December 31, 2004 and 2003. 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 audit 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 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, 2004 and the results of its operations and its cash flows for the years ended December 31, 2004 and 2003 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 3 to the financial statements, the Company has suffered recurring losses from operations, the Company has experienced a deficiency of cash from operations and lacks sufficient liquidity to continue its operations. These matters raise substantial doubt as to the Company's ability to continue as a going concern. Management's plans in regard to these matters are also discussed in Note 3. The financial statements do not include any adjustments that might result from the outcome of these uncertainties.

/s/Sobel & Co., LLC  
Certified Public Accountants

March 29, 2005

Livingston, New Jersey



**POWER EFFICIENCY CORPORATION**

## BALANCE SHEET

DECEMBER 31, 2004

**ASSETS****CURRENT ASSETS:**

|   |    |                |
|---|----|----------------|
| Cash  | \$ | 392,471        |
| Accounts receivable, net of reserve and allowance of \$21,229 |    | 31,533         |
| Inventories, net  |    | 187,817        |
| Prepaid expenses and other current assets                     |    | 235,102        |
| <b>Total Current Assets</b>                                   |    | <b>846,923</b> |

|                                    |  |               |
|------------------------------------|--|---------------|
| <b>PROPERTY AND EQUIPMENT, Net</b> |  | <b>26,320</b> |
|------------------------------------|--|---------------|

**OTHER ASSETS:**

|                               |  |                  |
|-------------------------------|--|------------------|
| Patents, net                  |  | 6,504            |
| Goodwill                      |  | 1,929,963        |
| Website, net                  |  | 9,775            |
| Deferred financing costs, net |  | 98,718           |
|                               |  | <b>2,044,960</b> |

|  |    |           |
|--|----|-----------|
|  | \$ | 2,918,203 |
|--|----|-----------|

**LIABILITIES AND STOCKHOLDERS EQUITY****CURRENT LIABILITIES:**

|                                       |    |                  |
|---------------------------------------|----|------------------|
| Accounts payable and accrued expenses | \$ | 639,266          |
| Accrued salaries and payroll taxes    |    | 128,467          |
| Notes payable - Pali Capital, Net     |    | 981,801          |
| Notes payable - former officers       |    | 73,889           |
| <b>Total Current Liabilities</b>      |    | <b>1,823,428</b> |

**LONG-TERM LIABILITIES:**

|                               |  |        |
|-------------------------------|--|--------|
| Note payable - former officer |  | 26,445 |
|-------------------------------|--|--------|

|                          |  |                  |
|--------------------------|--|------------------|
| <b>Total Liabilities</b> |  | <b>1,849,873</b> |
|--------------------------|--|------------------|

**COMMITMENTS AND CONTINGENCIES****STOCKHOLDERS EQUITY:**

|  |    |                  |
|--|----|------------------|
| Series A-1 convertible preferred stock, \$.001 par value, 10,000,000 shares authorized, 3,328,737 shares issued and outstanding issued and outstanding |    | 3,329            |
| Common stock, \$.001 par value, 7,142,857 shares authorized, 5,020,477 shares issued and outstanding   |    | 5,020            |
| Additional paid-in capital   |    | 16,386,612       |
| Accumulated deficit  |    | (15,326,631)     |
| <b>Total Stockholders Equity</b>   |    | <b>1,068,330</b> |
|  | \$ | 2,918,203        |

*See report of independent registered public accounting firm and notes to financial statements.*



**POWER EFFICIENCY CORPORATION**

## STATEMENTS OF OPERATIONS

|   | Year Ended December 31, |                |
|---|-------------------------|----------------|
|   | 2004                    | 2003           |
| REVENUES                                      | \$ 284,373              | \$ 397,673     |
| COMPONENTS OF COST OF SALES:                  |                         |                |
| Material, labor and overhead                  | 228,651                 | 260,972        |
| Inventory obsolescence                        | 29,484                  | 100,000        |
| Total Cost of Sales                           | 258,135                 | 360,972        |
| GROSS MARGIN                                  | 26,238                  | 36,701         |
| COSTS AND EXPENSES:                           |                         |                |
| Research and development                      | 327,202                 | 420,376        |
| Selling, general and administrative           | 1,886,132               | 2,392,754      |
| Depreciation and amortization                 | 84,504                  | 120,700        |
| Total Costs and Expenses                      | 2,297,838               | 2,933,830      |
| LOSS FROM OPERATIONS                          | (2,271,600)             | (2,897,129)    |
| OTHER INCOME (EXPENSE):                       |                         |                |
| Interest income                               |                         | 380            |
| Interest expense                              | (156,559)               | (115,468)      |
| Loss on disposition of fixed assets           | (31,036)                |                |
| Total Other Expenses, Net                     | (187,595)               | (115,088)      |
| LOSS BEFORE PROVISION FOR TAXES               | (2,346,221)             | (3,012,217)    |
| PROVISION FOR TAXES                           | (6,436)                 | (4,500)        |
| NET LOSS                                      | \$ (2,465,631)          | \$ (3,016,717) |
| BASIC AND FULLY DILUTED LOSS PER COMMON SHARE | \$ (0.53)               | \$ (2.48)      |
| WEIGHTED AVERAGE COMMON SHARES OUTSTANDING    |                         |                |
| BASIC   | 4,613,726               | 1,215,682      |
| FULLY DILUTED                                 | 10,362,520              | 3,389,557      |

*See report of independent registered public accounting firm and notes to financial statements.*

**POWER EFFICIENCY CORPORATION**

## STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY

YEAR ENDED DECEMBER 31, 2004 AND 2003

|  | Common Stock |          | Preferred Stock |          | Subscription<br>Receivable | Additional<br>Paid-in<br>Capital | Accumulated<br>Deficit | Total<br>Stockholders<br>Equity |
|--|--------------|----------|-----------------|----------|----------------------------|----------------------------------|------------------------|---------------------------------|
|  | Shares       | Amount   | Shares          | Amount   |                            |                                  |                        |                                 |
| Balance, January 1,<br>2003  | 940,088      | \$ 940   | 2,346,233       | \$ 2,346 | \$                         | \$ 11,749,702                    | \$ (9,844,283)         | \$ 1,908,705                    |
| Issuance of common<br>stock  | 684,765      | 685      |                 |          | (181,045)                  | 1,228,037                        |                        | 1,047,677                       |
| Exercise of warrants   | 50,100       | 51       |                 |          |                            | 84,237                           |                        | 84,288                          |
| Conversion of Summit<br>debt to preferred stock  |              |          | 982,504         | 983      |                            | 1,045,913                        |                        | 1,046,896                       |
| Common stock issued<br>for settlement of<br>compensation and<br>other accrued<br>expenses  | 172,582      | 173      |                 |          |                            | 1,034,800                        |                        | 1,034,973                       |
| Non-qualified stock<br>options issued below<br>market  |              |          |                 |          |                            | 77,158                           |                        | 77,158                          |
| Net loss 2003  |              |          |                 |          |                            |                                  | (3,016,717)            | (3,016,717)                     |
| Balance,<br>December 31, 2003  | 1,847,535    | \$ 1,849 | 3,328,737       | \$ 3,329 | \$ (181,045)               | \$ 15,219,847                    | \$ (12,861,000)        | \$ 2,182,980                    |
| Summit exercising all<br>outstanding warrants  | 3,134,102    | 3,134    |                 |          |                            |                                  |                        | 3,134                           |
| Fractional shares<br>one-for-seven reverse<br>split  | 25,260       | 24       |                 |          |                            |                                  |                        | 24                              |
| Common stock issued<br>for services rendered   | 13,580       | 13       |                 |          |                            | 35,796                           |                        | 35,809                          |
| Common stock issued<br>in exchange for<br>subscriptions<br>receivable  |              |          |                 |          | 181,045                    |                                  |                        | 181,045                         |
| Warrants issued in<br>connection with<br>issuance of Notes<br>Payable - Pali Capital   |              |          |                 |          |                            | 580,000                          |                        | 580,000                         |
| Options and Warrants<br>issued in connection<br>with settlements and<br>services from<br>consultants and<br>vendors, the<br>forgiveness of<br>indebtedness and the<br>issuance of debt |              |          |                 |          |                            | 550,969                          |                        | 550,969                         |
| Net loss 2004  |              |          |                 |          |                            |                                  | (2,465,631)            | (2,465,631)                     |
| Balance,<br>December 31, 2004  | 5,020,477    | \$ 5,020 | 3,328,737       | \$ 3,329 | \$                         | \$ 16,386,612                    | \$ (15,326,631)        | \$ 1,068,330                    |

See report of independent registered public accounting firm and notes to financial statements.



**POWER EFFICIENCY CORPORATION**

## STATEMENTS OF CASH FLOWS

|   | Year Ended December 31, |                    |
|---|-------------------------|--------------------|
|   | 2004                    | 2003               |
| <b>CASH FLOWS PROVIDED BY (USED FOR):</b>   |                         |                    |
| <b>OPERATING ACTIVITIES:</b>  |                         |                    |
| Net loss  | (2,465,631)             | (3,016,717)        |
| Adjustments to reconcile net loss to net cash used for operating activities:  |                         |                    |
| Bad debt expense  | 5,493                   | 17,000             |
| Inventory obsolescence reserve  | 29,484                  | 100,000            |
| Impairment of customer contracts  | 20,141                  | 40,948             |
| Depreciation and amortization   | 116,294                 | 120,700            |
| Loss on disposition of fixed assets   | 31,036                  |                    |
| Debt discount related to issuance of debt securities  | 97,000                  |                    |
| Warrants and options issued in connection with settlements, services from former employees, consultants and vendors, the forgiveness of indebtedness and the issuance of debt | 550,969                 |                    |
| Issuance of stock options below market value  |                         | 77,158             |
| Common stock issued for services  | 34,819                  | 614,991            |
| Accrued interest on converted debt  |                         | 46,896             |
| Changes in certain assets and liabilities:  |                         |                    |
| (Increase) decrease in:   |                         |                    |
| Accounts receivable   | 1,701                   | 31,511             |
| Inventory   | 143,369                 | 43,353             |
| Prepaid expenses and other  | 13,079                  | (18,832)           |
| Restricted cash related to payment of indebtedness  | (219,721)               |                    |
| Deposits  | 18,146                  | (2,646)            |
| Increase (decrease) in:   |                         |                    |
| Accounts payable and accrued expenses   | 142,830                 | (63,866)           |
| Accrued salaries and payroll taxes  | 84,841                  | (19,294)           |
| <b>Net Cash Used for Operating Activities</b>   | <b>(1,396,150)</b>      | <b>(2,028,798)</b> |
| <b>INVESTING ACTIVITIES:</b>  |                         |                    |
| Purchase of property, equipment and other assets  | (14,657)                | (42,617)           |
| Proceeds from the sale of property, equipment and other assets  | 4,470                   |                    |
| <b>Net Cash Used for Investing Activities</b>   | <b>(10,187)</b>         | <b>(42,617)</b>    |
| <b>FINANCING ACTIVITIES:</b>  |                         |                    |
| Deferred financing costs  | (117,885)               | (32,750)           |
| Proceeds from issuance of equity securities, net of costs   | 181,045                 | 1,131,965          |
| Proceeds from issuance of debt securities, net of costs   | 1,464,806               |                    |
| Advances from line of credit agreement  |                         | 1,000,000          |
| Loans from stockholders, officers, and former officers  | 25,334                  |                    |
| Payments on loans to stockholders, officers and former officers   | (40,000)                |                    |
| <b>Net Cash Provided by Financing Activities</b>  | <b>1,513,300</b>        | <b>2,099,215</b>   |
| <b>INCREASE IN CASH</b>   | <b>106,963</b>          | <b>27,800</b>      |
| <b>CASH</b>   |                         |                    |
| Beginning of year   | 285,508                 | 257,708            |
| End of year   | 392,471                 | 285,508            |

*See report of independent registered public accounting firm and notes to financial statements.*





**POWER EFFICIENCY CORPORATION**

NOTES TO FINANCIAL STATEMENTS

DECEMBER 31, 2004 AND 2003

NOTE 1 - NATURE OF BUSINESS:

Power Efficiency Corporation ( Power Efficiency and/or the Company ), was incorporated in Delaware on October 19, 1994. Power Efficiency designs, develops, markets and sells proprietary solid state electrical devices designed to effectively 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 two principal and proprietary products: the Three Phase *Power Commander*<sup>®</sup>, which is used in industrial applications, and the Single Phase *Power Commander*<sup>®</sup>, which is used in consumer applications. The Company also engages in research and development of new, related energy saving products.

The Company's primary customers have been original equipment manufacturers (OEM's) and commercial accounts located throughout the United States of America, Mexico, China, and Canada. Since the third quarter of 2003, the Company began to actively market to international distributors and directly to large national accounts.

On September 15, 2003, Power Efficiency formed Design Efficient Energy Services, LLC, a Delaware limited liability company. This entity will primarily be used in the future 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 - 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.

Significant estimates have been made by management in several areas, including the allowance for bad debts, inventories and the valuation of goodwill. Actual results could differ materially from these estimates, making it reasonably possible that a change in these estimates could occur in the near term.

**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.

**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.

**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.

**Website and Amortization:**

Website is stated at cost. Website costs capitalized include application and infrastructure development stage costs and graphics. Amortization is computed on a straight line basis, based upon the estimated useful life of the website which is three years. Website maintenance and hosting costs are charged to expense as incurred.

**Shipping and Handling Costs:**

The Company bills customers for freight. Actual costs for shipping and handling are included as a component of cost of sales.

**Deferred Financing Costs:**

Expenditures incurred in conjunction with debt or equity capital issuances are deferred as other assets. Such costs will be offset against equity proceeds, amortized on a straight line basis, over the life of the debt, or expensed if the offering is not completed.

**Patents:**

Costs associated with applying for U.S. patents based upon technology developed by the Company are capitalized. At the time the patent is awarded, 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.

**Revenue Recognition:**

Revenue from product sales to OEM s and distributors is recognized at the time of shipment to the OEM s and distributors when all services are complete. Returns and other sales adjustments (discounts and shipping credits) are provided for in the same period the related sales are recorded.

**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 share is not presented since giving effect to potential common shares would be anti-dilutive.

**Accounting for Stock Based Compensation:**

The Company has elected to follow Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB25). If the option price under the Stock Option Plans equals or exceeds the fair market value of the common shares on the date of grant, no compensation cost is recognized under the provisions of APB25 for stock options. If the option price under the Stock Option Plans is less than the fair market value of the common stock on the date of grant, compensation cost is recognized for the difference.

The Company adopted the disclosure-only provisions of Statement of Financial Accounting Standards (SFAS) No. 123, Accounting for Stock-Based Compensation, for stock options issued. Under SFAS No. 123, compensation cost is measured at the grant date based on the value of award and is recognized over the service (or vesting period). SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure, amended the disclosure requirements of SFAS No.123 to require prominent disclosures about the method of accounting for stock-based employee compensation and the effect of the method used on reporting results.

The Company utilizes SFAS 123 for accounting for nonemployee stock based compensation. The Company recognized expense based on fair value on the date of grant of awards consistent with the provisions on SFAS 123 as amended by SFAS 148.

**Product Warranties:**

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The Company warrants its products for eighteen months. During the warranty period, the Company's policy is to replace the defective product. The Company has been providing for warranty costs as they are incurred. The Company periodically reviews warranty claims and will establish a reserve for warranty claims when such amount is determinable and necessary based on historical information.

### **Provision for Income Taxes:**

The Company utilizes the asset and liability method of accounting for income taxes pursuant to SFAS No. 109, Accounting for Income Taxes. SFAS No. 109 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. SFAS No. 109 additionally requires the establishment of a valuation allowance to reflect the likelihood of realization of deferred tax assets.

The provision for taxes represents state franchise taxes.

### **Goodwill:**

The Company previously adopted the provisions of SFAS No. 142, Goodwill and Other Intangible Assets. SFAS No. 142 requires that goodwill shall no longer be amortized. There was no goodwill amortization during 2004 or 2003. Goodwill shall be tested for impairment on an annual basis and between annual tests in certain circumstances.

### **Advertising:**

Advertising costs are expensed as incurred. Advertising expenses were \$21,202 and \$4,463 for the years ended December 31, 2004 and 2003, respectively.

### **New Accounting Pronouncements:**

The Financial Accounting Standards Board (FASB) has issued several new standards during 2004. In November 2004, the FASB issued SFAS No. 151, Inventory Costs - an amendment of ARB No. 43. SFAS No. 151 requires idle facility expenses, freight, handling costs, and wasted material (spoilage) costs to be recognized as current period charges. It also requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. SFAS No. 151 will be effective for inventory costs incurred during the fiscal years beginning after June 15, 2005. The Company is evaluating the impact of this pronouncement on its financial statements.

In December 2004, FASB issued SFAS 123(R), Share-Based Payment, which revises SFAS 123, Accounting for Stock-Based Compensation, and supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees. SFAS 123(R) requires fair value recognition of stock option grants in the income statement as an expense and is effective for the first annual reporting period that begins after December 15, 2005. This pronouncement may have a material impact on the Company's operating results. The Company is in the process of evaluating the impact of this pronouncement on its financial statements.

**Financial Statement Reclassifications:**

Certain reclassifications have been made to the 2003 financial statements in order for them to conform to the 2004 financial statement presentation.

**NOTE 3 - 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 has suffered recurring losses from operations, the Company experienced a \$1,400,000 deficiency of cash from operations in 2004 and lacks sufficient liquidity to continue its operations.

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

Continuation of the Company as a going concern is dependent upon achieving profitable operations. Management's plans to achieve profitability include developing new products, 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 22). However, there are no assurances that sufficient capital will be raised.

**NOTE 4 - PREPAID EXPENSES AND OTHER CURRENT ASSETS:**

At December 31, 2004, prepaid expenses and other current assets is comprised as follows:

|   |    |         |
|---|----|---------|
| Restricted cash                           | \$ | 219,721 |
| Prepaid expenses                          |    | 15,381  |
| Prepaid expenses and other current assets | \$ | 235,102 |

In connection with the issuance of certain senior, secured notes (See Note 13), the Company is required by the placement agent, to restrict an amount of cash, in an escrow account, equal to the annual interest payments on those senior, secured notes. The annual interest rate is 15%, and as of December 31, 2004, the Company had \$219,720 in restricted cash, which was transferred to a separate bank account in March 2005.

NOTE 5 - PROPERTY AND EQUIPMENT:

At December 31, 2004, property and equipment is comprised as follows:

|                                |    |        |
|--------------------------------|----|--------|
| Machinery and equipment        | \$ | 14,819 |
| Office furniture and equipment |    | 42,089 |
|                                |    | 56,908 |
| Less: Accumulated depreciation |    | 30,588 |
| Property and Equipment, Net    | \$ | 26,320 |

Depreciation for the years ended December 31, 2004 and 2003 amounted to \$43,254 and \$46,445, respectively.

NOTE 5 PROPERTY AND EQUIPMENT: (Continued)

On November 1, 2004, the Company formally moved the Company's headquarters to Las Vegas, Nevada from Livonia, Michigan and its research and development facilities to Carlstadt, New Jersey. (See Note 20). In connection with this move, the Company incurred losses on disposition of fixed assets of \$31,036.

NOTE 6 - GOODWILL:

In accordance with SFAS No. 142, Goodwill and Other Intangible Assets, previously recognized intangible assets deemed to have indefinite useful lives were tested by management for impairment during fiscal 2004. An annual goodwill impairment test was performed by management in addition to quarterly goodwill impairment tests. The impairment tests consisted of a comparison of the fair value of the intangible asset with its carrying amount. Since the carrying amount of the intangible asset did not exceed its fair value, management concluded no impairment loss was required to be recognized.

NOTE 7 - INTANGIBLE ASSETS:

Intangible assets subject to amortization consists of the following for the year ended December 31, 2004:

|                                |    |        |
|--------------------------------|----|--------|
| Patents                        | \$ | 19,844 |
| Website                        |    | 19,550 |
|                                |    | 39,394 |
| Less: Accumulated amortization |    | 23,115 |
| Intangible Assets, Net         | \$ | 16,279 |

Amortization expense in 2004 and 2003 amounted to \$41,250 and \$74,255, respectively.

Amortization expense expected in the succeeding five years is as follows:

|            |    |        |
|------------|----|--------|
| 2005       | \$ | 7,014  |
| 2006       |    | 3,757  |
| 2007       |    | 498    |
| 2008       |    | 498    |
| 2009       |    | 498    |
| Thereafter |    | 4,014  |
|            | \$ | 16,279 |

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 receivables.

The Company maintains cash balances at a single financial institution. Amounts at this institution are insured by the Federal Deposit Insurance Corporation up to \$100,000. The Company may from time to time maintain balances in excess of the insured limits.

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.



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Four customers accounted for approximately 60% of 2004 sales and 30% of accounts receivable at December 31, 2004. Three customers accounted for approximately 69% of 2003 sales.

International sales as a percentage of total revenues for the years ended December 31, 2004 and 2003 are as follows:

| County | 2004 | 2003 |
|--------|------|------|
| Canada | 12%  |      |
| Sweden | 12%  |      |

NOTE 9 - INVENTORIES:

Inventories at December 31, 2004 consist of the following:

|                |    |         |
|----------------|----|---------|
| Finished goods | \$ | 59,397  |
| Raw materials  |    | 128,420 |
|                | \$ | 187,817 |

NOTE 10 - PROVISION FOR TAXES:

As of December 31, 2004 and 2003, the Company has available, on a federal tax basis, net operating loss carryforwards of approximately \$8,300,000 and \$6,200,000, respectively. These net operating losses expire at varying amounts through 2024. The net operating loss carryforwards result in deferred tax assets of approximately \$2,800,000 and \$2,100,000 at December 31, 2004 and 2003; however, a valuation reserve has been recorded for the full amount due to the uncertainty of realization of the deferred tax assets.

A reconciliation of the statutory tax rates for the years ended December 31, 2004 and 2003 is as follows:

|                             | 2004  | 2003  |
|-----------------------------|-------|-------|
| Statutory rate              | (34)% | (34)% |
| State income tax all states | (6)%  | (6)%  |
| Change in valuation         | (40)% | (40)% |
| Valuation allowance         | 40%   | 40%   |
| Benefit for income taxes    | 0%    | 0%    |

NOTE 11 - WARRANTS:

Warrant activity during the years ended December 31, 2004 and 2003 follows:

|   | Warrants  | Average<br>Exercise<br>Price |
|---|-----------|------------------------------|
| Warrants outstanding at January 1, 2003   | 135,571   | \$ 19.32                     |
| Issued during 2003                        | 43,669    | 0.00                         |
| Exercised during 2003                     | (50,100)  | 1.34                         |
| Expired during 2003                       | (54,143)  | 3.92                         |
| Warrants outstanding at December 31, 2003 | 74,997    | 25.30                        |
| Issued during 2004                        | 2,559,275 | 0.67                         |
| Expired during 2004                       | (53,570)  | 30.38                        |
| Warrants outstanding at December 31, 2004 | 2,580,702 | \$ 0.77                      |

During 2004, in connection with the Company's settlement agreements with former employees, consultants and vendors, the Company issued 700,700 warrants to settle these outstanding liabilities. During 2004, in connection with the Company's issuance of debt, the Company issued 132,693 warrants for commissions, and 1,725,882 warrants to noteholders. Such warrants to noteholders were valued at \$580,000 which was recorded as note discount on the Company's balance sheet. Such warrants issued in connection with the issuance of debt, commissions and settlements were valued at \$230,000 and expensed and included in selling, general and administrative expenses.

During 2003, in connection with the Company's sale of common stock under Regulation S, the Company issued 32,958 warrants for commissions. During 2003, 32,958 warrants were exercised in conjunction with the sale of common stock under Regulation S. 17,143 placement warrants were exercised in connection with the May 16, 2000 Private Placement Memorandum pursuant to Rule 506.

## NOTE 12 - STOCK OPTION PLAN:

Stock Option Plan activity during the years ended December 31, 2004 and 2003 follows:

|  | Shares    | Average<br>Exercise Price |
|--|-----------|---------------------------|
| Options outstanding and exercisable at January 1, 2003   | 419,092   | \$14.00                   |
| Granted during 2003                                      | 336,929   | 6.37                      |
| Cancelled during 2003                                    | (57,143)  | 14.00                     |
| Expired during 2003                                      | (75,843)  | 8.33                      |
| Options outstanding and exercisable at December 31, 2003 | 623,035   | \$11.69                   |
| Granted during 2004                                      | 2,900,500 | 0.65                      |
| Cancelled during 2004                                    | (109,155) | 9.76                      |
| Expired during 2004                                      | (241,648) | 7.28                      |
| Options outstanding and exercisable at December 31, 2004 | 3,172,732 | \$2.00                    |

Weighted average remaining contractual life at December 31, 2004, for all options is 9.2 years.

In 2000, the Company adopted the 2000 Stock Option and Restricted Stock Plan (the 2000 Plan ). On September 8, 2003, the 2000 Plan was amended and restated. The 2000 Plan, as restated and amended, provides for the granting of options to purchase up to 5,000,000 shares of common stock. This was conditional upon consent of the majority of the Series A Preferred stock. This consent was attained on October 11, 2004. No options have been exercised to date.

During 2004, the Company granted 2,461,500 stock options to officers and employees at exercise prices approximating fair market value of the stock on that day. The Company issued 439,000 options during 2004 to consultants for services rendered. Such issuances to consultants were valued at approximately \$110,000, utilizing similar factors as described below, which was expensed and is included in selling, general and administrative expenses.

During 2003, the Company granted 336,929 stock options to officers and employees at exercise prices approximating fair market value of the stock on that day. Where the exercise prices approximated the fair market value of the stock; the Company was not required to recognize compensation expense. In connection with the employment agreements of the President and Chief Executive Officer and the Vice President of Governmental Operations, the Company recongnized additional compensation expense of approximately \$77,000. This additional compensation expense is included in selling, general and administrative expenses.

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 66,232 options outstanding under the 1994 Plan.

There are 3,106,500 options outstanding under the 2000 Plan.

**SFAS No. 123 Disclosures:**

During the year ended December 31, 2004, the Board of Directors authorized the net issuance of 2,461,500 to officers and employees. During the year ended December 31, 2003, the Board of Directors authorized the net issuance of 294,071 (net of 42,858 options that were both issued and cancelled during the year). 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: expected volatility of 100%; risk-free interest rate of 4%; and expected lives of approximately 10.0 years.

Had compensation cost for the Company's stock option plan been recognized based on the fair value at the grant date for awards consistent with the provisions of SFAS No. 123, as amended by SFAS No. 148, the Company's net loss and loss per share for the years ended December 31, 2004 and 2003, would have been as follows.

|                                 | 2004           |    | 2003        |
|---------------------------------|----------------|----|-------------|
| Net loss as reported            | \$ (2,465,631) | \$ | (3,016,717) |
| Required adjustment to net loss | (359,256)      |    | (451,467)   |
| Net loss pro forma              | (2,824,887)    |    | (3,468,184) |

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|                                     |        |        |
|-------------------------------------|--------|--------|
| Loss per common share - as reported | (0.53) | (2.48) |
| Loss per common share - pro forma   | (0.61) | (2.85) |

NOTE 13 - COMMITMENTS AND CONTINGENCIES:

**Leases:**

The Company leases office, warehouse and research facilities under an operating lease. On October 5, 2004, the Company's board of directors formally approved moving the Company's headquarters from Livonia, Michigan to Las Vegas, Nevada and as of November 1, 2004, the Company's facility in Livonia was vacated entirely and all administrative functions have moved to Las Vegas. The Las Vegas, Nevada lease was entered into on July 1, 2004 and extends to June 30, 2007 (see Note 14). The Livonia, Michigan lease was entered into on November 1, 2003 and extends to December 31, 2008. The Ann Arbor, Michigan lease was terminated effective December 15, 2003. The New Hyde Park, New York lease was terminated June 30, 2003. The Company plans on leasing additional office space and facilities in Las Vegas, Nevada and Floral Park, New York in early 2005. (See Note 22).

Minimum future rentals are as follows:

| Year |    |         |
|------|----|---------|
| 2005 | \$ | 72,731  |
| 2006 |    | 69,419  |
| 2007 |    | 25,091  |
|      | \$ | 167,241 |

Rent expense, including base rent and additional charges, for the year ended December 31, 2004 and 2003 was \$81,943 and \$123,833, respectively.

During 2004, the Company temporarily occupied facilities in Carlstadt, New Jersey, for which the Company issued 100,000 stock warrants for payment. (See Note 11). The Company occupied the space on October 15, 2004 and plans to vacate the space in early 2005.

During 2003, the Company also leased office space in Palm Desert, California on a month to month basis from one of the Company's shareholders. Rent expense for this space for the year ended December 31, 2003 was \$18,680.

**Patent License Agreements:**

During 2004, the Company transferred a patent for single phase technology to one of its shareholders, in exchange for an exclusive licensing agreement and for exchanging a \$300,000 short term note for a one year note. The licensing agreement is for ten years with a three year extension, provides the Company an opportunity to buyout the license in the future for the amount of funds invested by the shareholder if the shareholder has not successfully marketed the product utilizing the patented technology, and provides the Company a royalty equivalent to 5% of the net profits from the shareholder's sales of products utilizing the transferred patented technology.

During 2004, the Company wrote off the costs associated with obtaining the patent originally transferred.

**Litigation:**

The Company is currently in litigation with the owners of the Livonia, Michigan property that the Company vacated in 2004. The Company's legal counsel has advised that it is premature to determine the likelihood and extent of any damages. The Company has accrued a reserve for the estimated loss in relation to the settlement of the litigation.

**Subcontractors:**

Power Efficiency currently utilizes three subcontractors to manufacture the Company's controller boards. These subcontractors provide facilities, equipment, supervision and labor required to assemble; wire; check; test; package; and ship the controller boards. These subcontractors are hired on an as needed basis to produce a minimum number of units via a purchase order. Power Efficiency does not incur any liabilities to subcontractors until purchase orders are issued. No purchase orders were issued or outstanding to subcontractors at December 31, 2004. The Company plans to have manufacturing done by turn-key providers and as of December 31, 2004 was in the process of qualifying vendors.

**Investment Advisory Agreements:**

The Company entered into an investment consulting agreement with the former Chief Financial Officer on September 22, 2003. This agreement provides for the former officer to provide consulting services. The Company shall pay (i) the amount of \$4,000 per month, half payable on the 15 day and half payable on the last day of each month, (ii) \$7,000 per month accrued and payable at the rate of 5% of all cash raised through the issuance of debt or equity, and (iii) \$2,000 per month to assist in negotiations with creditors. In addition, the Company will reimburse all reasonable and necessary expenses incurred by the consultant. The agreement contains confidentiality and non-competition provisions. This agreement can be terminated in 30 days by either party by written notices. At December 31, 2004, the Company paid \$25,000 and issued 36,000

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warrants, valued at approximately \$9,000, to satisfy this agreement in full.

The Company entered into an agreement with a registered securities broker dealer in February, 2004. In accordance with this agreement, the registered securities broker dealer serves as the Company's placement agent for the issuance of \$1,464,806 in senior, secured notes. The notes bear interest at 15% per annum and mature on October 27, 2005, and are presented net of unamortized discount of \$483,000 at December 31, 2004. The Company paid \$115,000 and issued 132,693 warrants as commissions to the registered securities broker dealer. Should the Company issue more notes under the same offering, the registered securities broker dealer has a right to receive 10% of the gross proceeds of the notes issued and an amount of warrants equal to 10% of the warrants issued to investors in the notes. However, there will be no fees on notes and warrants issued to any persons or entities that are the Company's directors, affiliates, officers or employees.

The Company entered into a consulting agreement with an investment advisor on December 1, 2004. The agreement calls for the investment advisor to assist the Company in devising financial and marketing strategies, and also to assist the Company in raising funds on a non-exclusive basis through the offering of debt and/or equity securities. The company shall pay the investment advisor the amount of \$3,000 per month, plus expenses approved by the Company, and issued 300,000 options, which resulted in an expense of approximately \$75,000. The sum of \$3,000 per month will be adjusted to \$5,000 per month once the Board of Directors and the Company agree to adjust the salaries of the Chief Executive Officer, Chief Financial Officer and the General Manager. The agreement contains confidentiality and non-competition provisions. The term of the agreement is 12 months and can be terminated by either party on a 90 day notice in writing.

### NOTE 14 - RELATED PARTY TRANSACTIONS:

During the years ended December 31, 2004 and 2003, consulting fees of \$31,000 and \$27,456 were paid to officers/directors/stockholders of the Company, respectively. These amounts are included in research and development and in selling, general and administrative expenses.

On February 25, 2004, the Company released a strategic advisor from an agreement the Company's board of directors ratified on May 23, 2003. In connection with the release agreement, the strategic advisor was issued 35,714 warrants, valued at approximately \$9,000, to satisfy all remaining obligations in full.

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In 2003, the Company incurred costs of \$19,550 for the development of their website. This work was performed by a relative of the Company's former President and Chief Executive Officer. On December 22, 2004, the Company entered into a settlement agreement with the relative of the Company's former President and Chief Executive Officer to pay \$375 and issue 39,000, valued at approximately \$10,000, options as payment for the costs incurred. As of December 31, 2004, this agreement was satisfied in full.

During 2003, the Company incurred legal fees of \$79,185 to a law firm, in which a partner in that firm and the firm are currently stockholders of the Company.

At December 31, 2004, the Company owes this law firm approximately \$40,000. Of this \$40,000, \$15,000 is to be paid shortly after December 31, 2004, and the remaining \$25,000 is to be paid when the Company raises financing of over \$1,000,000. Such amount is included on the balance sheet in accounts payable and accrued expenses.

On November 18, 2004, the Company's board of directors ratified an agreement with a management company, wholly owned by the current Chief Executive Officer of the company. The agreement is cancelable upon 30 days written notice by either party and calls for the Company to pay the management company a fee of \$20,000 per month. The Company also subleases office space in Las Vegas, Nevada from the management company under this agreement. The Company pays for 80% of the rent, general office expenses and utilities for the space, all of which is included in the monthly fee. Also included in the monthly fee are the salaries and benefits for the Chief Executive Officer, Chief Financial Officer and Administrator of the Company. As of December 31, 2004, management fees of \$40,000 was paid by the company.

NOTE 15 - SUPPLEMENTAL DISCLOSURE OF CASH FLOWS INFORMATION:

Cash paid during the year ended December 31, for:

|  | 2004       | 2003         |
|--|------------|--------------|
| Interest   | \$ 2,237   | \$ 3,028     |
| Income Taxes   | \$         | \$           |
| <b>NON-CASH INVESTING AND FINANCING ACTIVITIES:</b>  |            |              |
| Common stock issued in conjunction with the settlement of accounts payable, accrued expenses and the conversion of stockholders note payable | \$ 37,400  | \$ 466,875   |
| Warrants issued in connection with issuance of debt securities   | \$ 580,000 | \$           |
| Common stock issued for services rendered, deferred compensation and options issued below market value                                       | \$         | \$ 206,756   |
| Common stock issued related to an officer's employment contract  | \$         | \$ 418,500   |
| Preferred stock issued for conversion of debt to equity  | \$         | \$ 1,046,896 |



NOTE 16 - NOTES PAYABLE FORMER OFFICERS:

On September 15, 2003, the Company issued a \$115,000 promissory note payable to a former officer at the prime rate (5.25% at December 31, 2004). The note calls for monthly payments of \$5,000, principal and interest, which began on April 15, 2004 and matures on February 15, 2006. During the year ended December 31, 2004, the Company paid \$40,000 in principal.

On December 15, 2004, the Company issued a \$25,334 promissory note payable to a former officer, in connection with a settlement agreement (See Note 17), at 15%. The note calls for monthly payments of \$1,580, principal and interest, beginning January 2005 and matures on June 15, 2006.

NOTE 17 - EMPLOYMENT AND CONSULTING AGREEMENTS:

On October 20, 2004, the Company's Chief Technology Officer signed a salary reduction agreement, which supersedes an employment agreement the Company's board of directors ratified on May 23, 2001. The agreement provides for a salary of \$60,000 per year until such time that the company can reasonably afford to fund its business plan and pay executives higher salaries.

The agreement also provides for severance payments equal to the greater of (i) \$468,000 or (ii) the executive's base salary for the preceding three years, in the event that at any time during the employment term the agreement is terminated by the Company (a) without cause, (b) for

disability, or (c) for death, or if the executive terminates the agreement for cause. The agreement also provides for a payment to the executive upon a change in control equal to the product of the executive's base salary in the year of the change in control times 2.99.

On November 7, 2002, the Company entered into an employment and compensation agreement with the Company's Chief Executive Officer and Chief Financial Officer at the time. This agreement was terminated through a settlement and release agreement dated June 7, 2003. On January 8th 2004, the Company settled this obligation in full by issuing 15,397 shares of common stock to the former officer. This number of shares equaled the amount of deferred compensation divided by the Company's stock price on January 8th, 2004.

On June 12, 2003, the Company entered into an employment agreement with a new Chief Executive Officer. In addition to a base salary, this individual also received 142,857 stock options, which will vest over a five-year period.

On August 27, 2004 this Chief Executive Officer resigned from the Company and the Company reached a settlement agreement that included the payment of some accrued wages and vacation in cash, some payment over time through an unsecured note with a principal balance of \$25,334, and the issuance of 85,000 warrants, valued at approximately \$22,000, for the purchase of the Company's common stock in lieu of cash payment. The warrants expire five years from the date of issuance.

On September 15, 2003, the Company entered into an employment agreement with a new Chief Financial Officer.

In September 2004 this Chief Financial Officer resigned from the Company. The Company reached a settlement and consulting agreement with this then former officer that included payment of a back salary in cash over several months as well as payments of cash and 35,000 warrants, which were valued at approximately \$9,000, for consulting services. In October the former officer also agreed to accept 15,000 warrants in lieu of some of the accrued wages. All warrants issued to this former officer expire five years after issuance.

In September 2004 the Company hired its current Chief Executive Officer and Interim Chief Financial Officer. Their compensation and certain expenses are reimbursed pursuant to an agreement with a management company wholly owned by the Chief Executive Officer. (See Note 14).

#### NOTE 18 - TRANSACTIONS WITH CURRENT AND FORMER OFFICERS:

On September 30, 2003, the Company sold 76,663 shares of common stock to the chief technology officer of the Company, for \$466,875. The purchase price for the shares was paid for by canceling \$466,875 in debt owed by the Company to the officer. Additionally, the Company issued 32,143 shares of common stock to the officer as part of a settlement related to a change of control provision in his employment contract. The individual is an officer of the Company and the issuance of shares was exempt from registration under the Securities Act of 1933, as amended, pursuant to Regulation D. The common stock issued related to the change in control provision resulted in a non-recurring selling, general and administration expense of approximately \$196,000.

On October 16, 2003, the Company settled a dispute with its former president and chief executive officer regarding the early termination of his employment contract. According to the terms of the settlement, the former officer has released the Company from any claims he has against the

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Company in exchange for (i) an immediate payment of \$25,000; (ii) a promissory note for \$115,000 that is to be paid off over a two and one half year period; and (iii) 32,143 shares of the Company's common stock. The former officer is an accredited investor and the issuance of shares was exempt from registration under the Securities Act of 1933, as amended, pursuant to Regulation D. The Company had recorded an estimated settlement amount of approximately \$135,000 for this claim. Therefore, the settlement resulted in a non-recurring selling, general and administrative expense of approximately \$229,000.

### NOTE 19 - ISSUANCE OF SERIES A-1 CONVERTIBLE PREFERRED STOCK:

Pursuant to the original issuance of Series A-1 Convertible Preferred Stock in June 2002, the Company has asked for and received on October 11, 2004, a waiver of certain anti-dilution rights so that the issuance of up to a specific number of options and warrants with exercise prices of no less than \$0.65 per share will not trigger these anti-dilution rights. Had the waiver not been received, in the event that the Company issues shares at a price less than \$1.281 per share, the conversion rights of the Series A-1 Convertible Preferred Stock would have been adjusted so that the Series A-1 Convertible Preferred Stock can convert into such number of shares that Summit would have received had it bought common stock at such lower price. Furthermore, the conversion rights of the Series A-1 Convertible Preferred Stock would also have been adjusted in the event that any shares, warrants, options or promissory note is issued with a price or conversion price less than \$1.281 per share.

In the event of a Liquidation Event, the holders of the Series A-1 Convertible Preferred Stock are entitled to two times the price paid by Summit for such stock. Thereafter, the remaining corporate assets would be distributed among the holders of common stock and Series A-1 Convertible Preferred Stock on a pro rata basis. The existence of the Series A-1 Convertible Preferred Stock's anti-dilution provisions may reduce the percentage of common stock held by the public stockholders. Furthermore, the terms on which the Company could obtain additional capital may be adversely affected by the Series A-1 Convertible Preferred Stock's anti-dilution provisions and superior liquidation preference.

On June 7, 2004, Summit Energy Ventures notified the Company that it had transferred 1,747,587 of the Company's Series A-1 Convertible Preferred Stock and 1,645,404 of the Company's common stock to Commonwealth Energy Corporation, a former member of Summit Energy Ventures LLC. This transfer makes Commonwealth Energy the Company's single largest shareholder.

NOTE 20 - STOCKHOLDERS EQUITY:

During 2004, the Company issued 700,700 warrants to settle outstanding liabilities with former employees, consultants and vendors, 132,693 warrants for commissions related to the issuance of debt, and 1,752,882 warrants to noteholders. (See Note 11).

On February 26, 2004, the Company announced a 1 to 7 reverse stock split to be effective to stockholders of record as of March 1, 2004. All common stock share amounts and information related to the issuance of warrants and options and Per Share amounts have been restated to reflect this reverse stock split.

On December 31, 2003, the Company issued 24,805 shares of common stock for the settlement related to deferred compensation.

On November 6, 2003, the Company issued 982,504 shares of Series A-1 Convertible Preferred Stock for the conversion of \$1,046,896 of debt owed to Summit.

On October 16, 2003, the Company issued 64,286 shares of common stock related to the settlement requirements of a former officer's employment contract.

On September 30, 2003, the Company issued 76,663 shares of common stock to pay for amounts owed to an officer of the Company for notes payable, accounts payable and accrued salaries.

During 2003, the Company issued 40,357 shares of common stock related to the exercising of warrants.

At various dates during 2003, the Company issued 665,803 shares of common stock related to the sale of the Company's common stock.

NOTE 21 - FAIR VALUE OF FINANCIAL INSTRUMENTS:

SFAS No. 107 Disclosure About the Fair Value of Financial Instruments, requires disclosure of fair value information about financial instruments. The carrying amounts reported in the balance sheet for cash, accounts receivable, accounts payable and accrued expenses approximate fair value because of their short term nature. The carrying amounts of notes payable and longer term debt approximates fair value because those financial instruments bear interest at rates that approximate current market rates for loans with similar maturities and credit quality. None of these financial instruments are held for trading purposes.

NOTE 22 - SUBSEQUENT EVENTS (UNAUDITED):

In February 2005, the Company began moving out of its temporary office space located in Carlstadt, New Jersey. The items in this office, including inventory, tools and standard office equipment and furniture, is being sent to three different places. These places include a new office space in Las Vegas, Nevada, a new office space in Floral Park, New York, and a contract manufacturer engaged by the Company to store and produce the Company's product.

In March 2005, the Company will begin subleasing space from Famair, Inc. in Floral Park, New York. The sublease gives the Company space primarily for research, development and technical support activities. The sublease costs the Company \$1,000 per month, which includes all utilities, cleaning, phone and internet, and the term is month-to-month.

On April 11, 2005, the Company will begin leasing roughly 1,500 square feet of office space Las Vegas, Nevada. The lease is between Glenborough IX LLC and a management company owned by the current Chief Executive Officer and was signed on February 7, 2005. On February 10, 2005, the Company's board of directors voted to assume all payments under this lease and indemnify the Chief Executive Officer's management company for all payments and obligations for the lease. The lease includes a payment of \$2,728 per month, which includes all cleaning and utilities, except phone and internet service. The term of the lease is one year.

On February 24, 2005, the Company entered into a financing transaction in which the Company issued \$125,000 in senior, secured notes under the same offering through which the Company issued \$1,464,806 in notes as described in Note 13. This offering was originally intended to close on December 31, 2004 but the placement agent and the Company agreed to keep the offering open past the original closing date. After the February 24 closing the offering was terminated.

The holders of the Notes will promptly be issued 115,385 warrants for every \$100,000 Note. With its issuance of \$125,000 in Notes, the Company will issue, in aggregate, 144,232 warrants. The Company paid a placement agent a commission of \$12,500 and 14,423 warrants with the same rights and provisions as the Warrants issued to the holders of the Notes.

On March 28, 2005 the Company extended by one year the maturity dates of secured debts that were issued on October 27, 2004 and February 24, 2005. The extended notes have a total principal value of \$1,514,806. \$1,414,806 in principal value will now mature on October 26, 2006, and \$100,000 in principal value will now mature on February 23, 2007. No other provisions of the secured notes have changed. Interest on the notes of 15% per year will be paid quarterly until maturity.

**SIGNATURES**

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

**POWER EFFICIENCY CORPORATION**

*Dated: September 16, 2005*

*By: /s/ Steven Strasser  
Steven Strasser, President and  
Chief Executive Officer*

*Dated: September 16, 2005*

*By: /s/ John Lackland  
John Lackland, Interim Chief  
Financial Officer*