

POWER EFFICIENCY CORP  
Form 10KSB  
March 31, 2005

## Securities and Exchange Commission

Washington, D.C. 20549

### FORM 10-KSB

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)

**22-3337365**

(I.R.S. Employer Identification No.)

**3900 Paradise Road, Suite 283**

**Las Vegas, NV**

(Address of Principal Executive Offices)

**89109**

(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**

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(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.

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### 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 Registrant's business objectives and strategy. Such forward-looking statements are based on current expectations, management beliefs, certain assumptions made by the Registrant's management, and estimates and projections about the Registrant's industry. Words such as anticipates, expects, intends, plans, believes, estimates, forecasts, is 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. The PSLRA does not apply to initial public offerings.

Factors that could cause actual events or results to differ materially include, but are not limited to, the following: continued market acceptance of the Registrant's line of *Power Commander*® products; the Registrant's ability to expand and/or modify its line of *Power Commander*® products on an ongoing basis; general demand for the Registrant's products, intense competition from other developers, manufacturers and/or marketers of energy reduction and/or power saving products; the Registrant's negative net tangible book value; the Registrant's negative cash flow from operations; delays or errors in the Registrant's ability to meet customer demand and deliver *Power Commander*® products on a timely basis; the Registrant's lack of working capital; the Registrant's need to upgrade its facilities; changes in laws and regulations affecting the Registrant 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; local and global uncertainties created by the terrorist acts of September 11<sup>th</sup> and the current war against terrorism; 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 Registrant 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 Registrant files from time to time with the Securities and Exchange Commission (the "SEC"), particularly Annual Reports on Form 10-KSB, Quarterly Reports on Form 10-QSB and any Current Reports on Form 8-K.

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## 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 Registrant or the Company ) was incorporated in Delaware on October 19, 1994. From inception through 1997, the Registrant was a development stage entity that sought to become engaged in the design, development, marketing and sale of proprietary solid state electrical components 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.

(b) **Business of the Registrant**

**The Registrant's Principal Products**

In 1995, the Registrant commenced the sale of the *Power Commander*®, its principal and proprietary product that reduces energy consumption in alternating current induction motors in certain industrial applications. In addition, the *Power Commander*® extends motor life, minimizes maintenance, results in cooler running, reduces stress and strain on the motor, and reduces stress and strain on accompanying electrical and mechanical systems. Technology and circuitry included in the Registrant's *Power Commander*® is the subject of a United States Patent granted in 1998. The Registrant offers the *Power Commander*® in two versions, each of which is a distinctly different product having different applications. These two products are:

the Three-Phase *Power Commander*® used in industrial and commercial applications; and

the Single-Phase *Power Commander*® is also used in industrial and commercial applications and is currently in research and development for use in consumer applications such as home appliances and the like.

The Registrant's motor starter product is designed to soft start a motor, save energy, and protect and conserve the motor.

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The Registrant offers the *Power Commander*® in a Three-Phase version and a Single-Phase version. The Registrant's marketing efforts have been initially focused on the Three-Phase *Power Commander*®. Both versions of the *Power Commander*® reduce energy consumption on electrical equipment by electronically sensing and controlling the amount of energy the motor consumes. A motor with a *Power Commander*® installed only uses the energy it needs to perform its work task, thereby increasing its efficiency. The result is a reduction of energy consumption of up to 15% to 35% in certain applications which do not always run at peak load levels.

The Registrant's management believes that the *Power Commander*® line offers certain advantages over competing products for the following reasons:

The *Power Commander*® is the result of field and laboratory engineering refinements undertaken since 1994. These refinements enable the *Power Commander*® to offer a control system which measures and monitors key motor operating conditions and adapts motor operating parameters during rapid changes in motor load, all without excessive vibration, synchronization problems or other material adverse effects to the motor or surrounding electrical and mechanical systems.

Energy savings and motor efficiencies were verified through tests of the *Power Commander*® performed by three independent laboratories. Oak Ridge National Laboratory tested the *Power Commander*® and concluded that significant energy savings due to lower electrical power demand can clearly be obtained in medium-sized and especially large-sized motor applications where the motor is frequently operating with no load. Oak Ridge's conclusions were based on tests that examined energy savings, motor temperature, and soft start impact.

Another independent laboratory at Oregon State University determined that the *Power Commander*® converted electrical energy into mechanical energy at a more efficient rate than a motor without the unit. The test compared energy consumption and torque on a 15HP motor with and without the unit installed.

Finally, Medsker Electric, Inc., an independent electric motor repair and test laboratory, performed a series of inrush current and energy savings tests on the *Power Commander*®. The tests compared the Registrant's product to the products of three competitors. In its conclusions, Medsker stated that the Registrant's *Power Commander*® exhibited twice the energy savings of the next nearest competitor. In addition, Medsker concluded that the *Power Commander*® exhibited the best soft-start performance, reducing the motor inrush current by 71%. Finally, Medsker concluded that the *Power Commander*® was the simplest to install and test, and was the best performer in terms of energy savings and inrush current reduction.

In addition to the tests performed by independent laboratories, the *Power Commander*® was subjected to a performance case study by one of the Registrant's customers, Otis Elevator Company. In the Otis Elevator case study, the *Power Commander*® resulted in reduced energy consumption and lower operating temperatures. The case study examined the effects and energy savings obtained with a *Power Commander*® installed on a 10 horsepower AC induction motor operating a single width, single level escalator.

#### ***Three-Phase Power Commander*®**

The initial market for the Three-Phase *Power Commander*® is the elevator and escalator industry, although the Registrant is actively marketing this product to other industries such as the plastics manufacturing, crude oil, and forest products industries. According to the Freedonia Group, the U.S. elevator and escalator industry is estimated at \$11 billion, and growing at a rate of 6.5% annually. Extrapolating from trade journals (e.g. Elevator World Source Book 2001-2002), there are approximately 854,000 elevators and 45,400 escalators in operation in the U.S. and Canada in 2004. Additionally, approximately 24,725 new elevators and 1,400 new escalators, respectively, are installed annually in the domestic market. The installed base of escalators and the 350,000 elevators that have motor-generator sets are potential candidates for the retrofit of the Three-Phase *Power Commander*®. The Registrant is currently conducting tests with a major hotel chain to determine if the Three-Phase *Power Commander*® will save energy on hydraulic elevators, which represent approximately 373,000 of the total installed base of elevators and is the largest and fastest growing segment of new elevator installations.

Industries that operate other equipment such as conveyor systems, machine tools, mining equipment, crude oil pumps, metal stamping presses, etc., are believed to be viable target markets for the Three-Phase *Power Commander*® and the Registrant is seeking to build its base of Original Equipment Manufacturers ( OEM ), distributors, and manufacturer representatives to address these markets.

#### ***Single-Phase Power Commander*®**

Like the Registrant's Three-Phase *Power Commander*® described above, the Registrant's Single-Phase *Power Commander*® reduces energy consumption in electrical equipment by sensing and controlling the amount of energy the motor consumes. Most motors commonly used



in-home appliances and other consumer goods are single-phase motors.

Since the Single-Phase *Power Commander*® is usable in a broad variety of contexts and can be installed when the motor is assembled with little effort and expense, it is a product suitable for installation at the OEM level or large volume sales and installation. Consequently, the Registrant's marketing plan for the Single-Phase *Power Commander*® is to identify the major OEMs that can best utilize the Single-Phase *Power Commander*®.

The Registrant has an exclusive licensing agreement with one of its shareholders for the single phase technology, which is the back bone of the Single-Phase *Power Commander*®. (See Note 13 to the Financial Statements)

***Registrant's Motor Starter Product***

The Registrant's motor starter product is designed to soft start a motor, which saves energy and protects the motor, and has the capacity to act as a remote-switching device. The expected release date of this product is uncertain at this time as the Registrant's R&D efforts are currently focusing on the development of its medium voltage and single phase controllers.

## Marketing and Sales

The Registrant's marketing efforts for the *Power Commander*® have been concentrated in the elevator and escalator industry; national electrical supply houses; large real estate property management companies; the oilfield supply industry; and public transportation systems. Other customers and end users of the Registrant's products include retail chains, hotels, manufacturers and federal government facilities.

As the Registrant's operations are scaled up and revenues from the sale of the *Power Commander*® grow, the Registrant intends to simultaneously (i) market the *Power Commander*® through OEMs to other compatible industries such as conveyor and production line systems, machine tools and other industrial applications, (ii) expand its direct sales force, develop a network of distributors and manufacturer representatives to reach the end users who receive the most benefit from the Registrant's controllers, and (iii) continue to develop and market new products (medium voltage controller, improved single phase controller, motor starter product) using a direct sales force, distributors and manufacturer representatives.

## Manufacturing

The Registrant has an arrangement with a manufacturer in the electronics industry, Q.C. Corporation d/b/a System Controls. System Controls manufactures units for the Registrant on an as-needed basis. Under the arrangement, the Registrant issues a purchase order to System Controls that outlines, among other things, the number of units to be manufactured and the price per unit. System Controls is under no obligation to accept the order and the Registrant is under no obligation to use System Controls for its manufacturing needs. Management believes the arrangement between the Registrant and System Controls has been mutually beneficial to both parties and expects that the relationship will continue. Management also believes that System Controls has the ability to meet their production needs and the Registrant would be successful in finding alternative manufacturers should System Controls not be available to manufacture product.

Product cost-reduction efforts are, and will remain, an objective of the Registrant. One key element of the program includes an aggressive manufacturing and engineering effort to reduce production cycle times as well as material and processing costs. A second element of the program is to out-source production operations. The Registrant out sources the assembly of printed circuit boards to qualified suppliers with automated assembly and test equipment, which reduces costs and ensures quality. As the product volumes increase, the Registrant expects to recognize favorable purchasing economies, increased labor efficiencies and improved overhead absorption. In addition, the Registrant is continuing to evaluate additional sources of contract manufacturing in order to reduce production costs further.

## Competition

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

The Registrant competes against a number of 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 Registrant 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 Registrant to commence and expand its operations or operate in a profitable manner.

**Three-Phase Competition.** Although the Registrant has not completed any formal market study, the Registrant believes its Three-Phase *Power Commander*® has the following competitive advantages:

The *Power Commander*® is the only device management is aware of that combines soft start features with energy savings features in a single integrated unit that is CSA and CE certified and achieves energy savings levels of up to 15% to 35%;

The *Power Commander*® analog circuitry is proprietary and protected by a patent; and

Energy saving motor controllers claimed to be competitive with the *Power Commander*® (i.e., Fairford, Power Boss and Power Planner) utilize technologies inferior to the Registrant's technology because (i) their products achieve lower levels of energy savings in comparable applications compared to the *Power Commander*® (see Part I, Item 1 Description of Business, for a description of the independent tests performed on the Registrant's products); and (ii)

their digital design produces extensive harmonic distortion.

**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 Green Plug (voltage clamping), Power Planner (digital microchip) and Econelectric (power factor control).

**High Efficiency Motors.** Insofar as high efficiency motor replacement is concerned, management believes that the energy savings gain attributable to high efficiency motors is materially lower than that of the *Power Commander*® on underloaded motor applications. In addition, the in-rush amperage needed to start an energy efficient motor is many times higher than that needed to start a conventional motor. This factor is made worse because the purchase of a new motor does not provide a soft starting capability without the purchase of a separate soft start device.

**Motor Starter Competition.** The Registrant believes that expected competition in the motor starter market will be more intense than that for the *Power Commander*® because:

The potential market for the Registrant's motor starter product is much larger than that for motor controllers in general and the *Power Commander*® in particular;

Competitors in the motor starter field are more numerous and generally much larger compared to competitors in the motor controller field; and

The motor starter is a staple product type and is currently being sold by nearly all companies in the electrical component business.

However, Management believes it has a competitive advantage in this market because the *Power Commander*® is the only device management is aware of that combines soft start features with energy savings features in a single integrated unit that achieves energy savings levels of up to 15% to 35%.

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

The *Power Commander*® motor controller and the Registrant's motor starter product have both been designed to use standard, off-the-shelf, easily acquired components. Such components are basic items that are readily available worldwide at competitive prices. They come in standard and miniature versions and offer the Registrant large latitude in product design. Both the *Power Commander*® motor controller and the motor

starter use a combination of components. Although the Registrant believes that 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 that they will remain so readily available.

### **Customers**

The Registrant currently does business with approximately 30 customers. Of this number, four, including KONE, Inc., The George Washington University, The May Department Stores, and Weibermachine, presently account for approximately 60% of the Registrant's gross revenues. In light of the Registrant's intentions to focus its business on OEMs in the elevator, oil field pump and manufacturing industries, the Registrant is, 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 upon the Registrant's business.

### **Patents and Proprietary Rights**

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

The Registrant has one U.S. patent issued with respect to its products. The 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 Registrant. Management believes this patent protects the Registrant's intellectual property position beyond the expiration of the NASA License Agreement because:

the circuitry covered by the Registrant's patent more effectively reduces the motor vibration; and

the circuitry eliminates most of the balance and synchronization problems that are created by other energy saving motor controllers, including those that would eventually use the licensed NASA technology upon the expiration of the underlying NASA patents.

The Registrant has additional proprietary technology being assessed for patent filing.

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

The Registrant 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 Registrant to pay royalties to NASA in connection with the Registrant's sale of products employing technology utilizing the licensed patents. The Registrant's rights under the license agreement were non-transferable and were not to be sublicensed without NASA's consent. The license agreement terminated on December 16, 2002 with the expiration of all of the licensed patents.

The Registrant believes that 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.

The Registrant has obtained U.S. Trademark registration of the *Power Commander*® mark.

#### **Government Regulation**

The Registrant is not required to be certified by any government agencies. However, the Registrant's products are manufactured to comply with specific Underwriters' Laboratory codes that meet national safety standards. Presently, the Registrant's products comply with UL 508 Industrial Control Equipment and the Registrant has also received certification meeting CSA (Canadian Standards Association) CSA-B44.1-96/ASME-17.5-1996 Elevator and Escalator Electrical Equipment. Registrant's products are also CE compliant. The CE certificate number is C1282PEC1.TLS.doc. The Department of Commerce does not require the Registrant's technology to be certified for export. The Registrant's industrial code is 421610 and the SIC code is 5063.

**Deregulation of Electrical Energy**

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

**Research and Development**

The Registrant intends to continue its research and development effort to introduce new products based on the *Power Commander*® solid-state technology. Towards this end, the Registrant spent \$338,955 and \$420,376 in fiscal years 2004 and 2003, respectively, on research and development activities, virtually none of which was borne by customers. A major focus of the Registrant's foreseeable research and development activities will be on digitization and motor starter and single phase unit commercialization.

**Effect of Environmental Regulations**

The Registrant 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 Registrant has had, or is expected to have, a material effect upon the capital expenditures, earnings, or competitive position of the Registrant.

## **Employees**

At the date of this document, the Registrant employs 5 people on a full time basis. Of this number, one is engaged in accounting and finance, one in operations management, one in sales and marketing and two in research, development and technology support. In addition, the Registrant has a management agreement with Northwest Power Management that provides additional human resources, including the Registrant's Chief Executive Officer, Interim Chief Financial Officer and an administrator (See Note 14 to the Financial Statements). At such time as business conditions dictate, the Registrant may hire additional personnel for, among other things, increased production, marketing and sales. The Registrant has no collective bargaining agreements and considers its relationship with its employees to be good. The Registrant utilizes consultants in the areas of manufacturing engineering, marketing and financing and strategy on an ongoing basis.

## **RISK FACTORS**

### *Limited Capitalization*

As of the date of this document, the Registrant continues to have limited working capital and will be dependent upon additional financing to meet its capital needs. There can be no assurance that any additional financing will be available on acceptable terms, if at all. The Registrant needs additional capital to expand its operations and fully implement its business plan.

### *Limited Operating History, Manufacturing and Distribution Arrangements*

To date, and principally attributable to a lack of working capital, the Registrant's operations have been limited in scale. Although the Registrant has an arrangement with a production facility, has established relationships with suppliers, and received contracts for its products, the Registrant may experience difficulties in production scale-up, inventory management, product distribution and obtaining and maintaining working capital until such time as the Registrant's operations have been scaled-up to normal commercial levels. There can be no assurance that the Registrant will operate profitably.

### *Registrant's License From NASA Has Expired*

The basic technology upon which the Registrant's products are based is derived from a patent license agreement by and between the Registrant and NASA, which expired on December 16, 2002. The license expired upon expiration of NASA's underlying patents, at which time anyone, including the Registrant, became free to use the underlying NASA technology. The Registrant has also made certain improvements to the basic technology covered by the NASA license, which may place the Registrant in a competitively superior position. No assurance can be given, however, that others will not seek to improve the basic technology in a manner similar to that of the Registrant.

### *Supplier Dependence*



Although the Registrant believes that 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 that they will 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 the Registrant. Also, in the event that the Registrant, or its contract manufacturer, as applicable, is unable to develop or acquire components in a timely fashion, the Registrant's ability to achieve production yields, revenues and net income would be adversely affected.

***Sales and Marketing Risks***

The Registrant's products have been distributed primarily through OEMs. The Registrant's future growth and profitability will depend upon the successful development of business relationships with additional OEMs, manufacturing representatives and distributors and their ability to penetrate the market with the Registrant's products.

***Competition and Rapid Technological Change***

The Registrant competes against a number of 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 Registrant 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 Registrant to expand its operations or operate profitably. The motor control industry is highly competitive and characterized by rapid technological change. The Registrant's future performance will depend in large

part upon its 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 the Registrant is not competitive in its ongoing research and development efforts, its products may become obsolete, or be priced above competitive levels. Although management believes that, based upon their performance and price, the Registrant's products are attractive to customers; there can be no assurance that competitors will not introduce comparable or technologically superior products, which are priced more favorably than the Registrant's products.

#### ***Retail Price of Electrical Energy***

A customer's decision to purchase the *Power Commander*® 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 the Registrant's products, there can be no assurances that future retail pricing of electrical energy will remain at such levels.

#### ***No Cash Dividends on Common Stock***

The Registrant has not paid or declared any dividends on its common stock and does not anticipate paying or declaring any cash dividends on its common stock in the foreseeable future.

#### ***Possible Resales under Rule 144***

Of the 5,020,477 shares of the Registrant's common stock outstanding on March 11, 2005, 1,596,890 shares are freely trading in the market place (the Free Trading Shares). The Free Trading Shares are comprised mostly of shares that were originally issued in transactions that were exempt from registration under the Securities Act, which shares were, over time, resold pursuant to Rule 144, as set forth below.

The remaining 3,423,587 shares of the Registrant's common stock outstanding are restricted securities as defined in Rule 144 under the Securities Act and under certain circumstances may be resold without registration pursuant to Rule 144.

In addition, as of March 1, 2005 the Registrant has approximately 2,689,355 common stock purchase warrants outstanding and has approximately 2,989,731 common stock options outstanding. Neither the granting of options nor the issuance of warrants have been registered under the Securities Act, but may, under certain circumstances, be available for public sale in the open market pursuant to Rule 144, subject to certain limitations.

In general, under Rule 144, a person (or persons whose shares are aggregated) who has satisfied a one-year holding period 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. Rule 144 also permits, under certain circumstances, the sale of securities, without any limitation, by a person who is not an Affiliate, as such term is defined in Rule 144(a)(1), of the Registrant and who has satisfied a two-year holding period. Any substantial sale of the Registrant's common stock pursuant to Rule 144 may have an adverse effect on the market price of the Registrant's shares.

*Common Stock Price Volatility*

The Company's common stock is traded on the National Association of Securities Dealers' Over the Counter Bulletin Board (OTCBB), under the symbol PEFF. There can be no assurance that a regular market for the Company's common stock will be sustained. The OTCBB offers less trading liquidity than NASDAQ. Quotes for securities traded on the OTCBB are not as widely available as are those for NASDAQ. Therefore, this lack of readily available price information may impair the ability of holders of common stock to resell their securities. The trading prices of the common stock could be subject to wide fluctuations in response to quarterly variations in the Company's operating results, announcements by the Company or others, developments affecting the Company, or other events or factors. In addition, the stock market has experienced extreme price and volume fluctuations in recent years. These fluctuations have had a substantial effect on the market price for many companies, often unrelated to the operating performance of such companies, and may adversely affect the market price for the Company's common stock.

***Potential Effect of Penny Stock Rules on Liquidity of Shares***

If the Registrant's securities are not listed on The Nasdaq Stock Market or certain other national securities exchanges and the price thereof is below \$5.00, then subsequent purchases of such securities will be subject to the requirements of the penny stock rules, absent the availability of another exemption. The SEC has adopted rules that regulate broker-dealer practices in connection with transactions in penny stocks. Penny stocks generally are equity securities with a price of less than \$5.00 (other than securities registered on certain national securities exchanges or quoted on The Nasdaq Stock Market). The penny stock rules require a broker-dealer to deliver a standardized risk disclosure document required by the SEC, to provide the customer with current bid and offer quotations for the penny stock, the compensation of the broker-dealer and its salesperson in the transaction, monthly account statements showing the market value of each penny stock held in the customer's account, to make a special written determination that the penny stock is a suitable investment for the purchaser and receive the purchaser's written agreement to the transaction. The Registrant is currently subject to the penny stock rules and, therefore, these disclosure requirements may have the effect of reducing the level of trading activity in the Registrant's common stock.

***Limitation on Directors' Liabilities under Delaware Law***

Pursuant to the Registrant's Certificate of Incorporation, directors of the Registrant are not liable to the Registrant or its 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 involve 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.

***Outstanding Options and Warrants***

As of March 1, 2005, the Company has reserved 71,429 shares of its common stock for issuance upon exercise of stock options or similar awards which may be granted pursuant to the Company's 1994 Stock Option Plan (hereinafter the "1994 Plan"), of which options to purchase an aggregate of 66,232 shares are outstanding. Furthermore, as of the same date the Company has reserved 5,000,000 shares of its common stock for issuance upon exercise of stock options or similar awards which may be granted pursuant to the Company's 2000 Stock Option and Restricted Stock Plan (hereinafter the "2000 Plan"), of which options to purchase an aggregate of 3,356,500 shares are outstanding. The outstanding options have a weighted average exercise price of \$2.00. As of March 1, 2005, the Company has issued warrants exercisable for 2,689,355 shares of common stock to financial consultants, investors, former employees and other business partners, having a weighted average exercise price of \$0.77 and expiring on various dates from August 1, 2005 to December 31, 2011.

Exercise of these options and warrants issued by the Registrant in the future will reduce the percentage of common stock held by the public stockholders. Furthermore, the terms on which the Company 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 the Company would be able to obtain equity capital on terms more favorable than those provided for by such options and warrants.

***Issuance of Convertible Preferred Stock with Anti-Dilution Provisions and Superior Liquidation Preference***

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In 2002, the Registrant issued 2,346,233 shares of Series A-1 Convertible Preferred Stock to Summit Energy Ventures for a purchase price of \$2,500,000. In October 2003, the Registrant issued an additional 982,504 shares of Series A-1 Convertible Preferred Stock to Summit Energy Ventures when Summit converted principal and interest of \$1,046,896 that was outstanding under a convertible note the Registrant issued to Summit in May 2003. The Series A-1 Convertible Preferred Stock provides the holders of the Series A-1 Convertible Preferred Stock with protection against dilution. In the event that the Registrant issues shares at a price less than \$1.281 per share, the conversion rights of the Series A-1 Convertible Preferred Stock will be 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. Currently, the conversion rights of the Series A-1 Convertible Preferred Stock entitle the holder of the Series A-1 Convertible Preferred Stock to receive 0.83 shares of common stock for each share of Series A-1 Convertible Preferred Stock. If all of the Registrant's outstanding shares of Series A-1 Convertible Preferred Stock were converted into common stock today, the holder of the Series A-1 Convertible Preferred Stock would receive 2,768,849 shares of common stock.

In the event of a Liquidation Event (as defined in the Certificate of Designation of the Series A-1 Convertible Preferred Stock which includes a winding up of the Registrant, a sale of substantially all of the Registrant's assets, and certain mergers and consolidations) 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 Registrant could obtain additional capital may be adversely affected by the Series A-1 Convertible Preferred Stock's anti-dilution provisions and superior liquidation preference.

***Authorization and Discretionary Issuance of Preferred Stock***

The Registrant'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, the Registrant's 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 the Registrant's common stock. In the event of issuance, the preferred stock could be used, under certain circumstances, as a method of discouraging, delaying or preventing a change in control of the Registrant, which could have the effect of discouraging bids for the Registrant and thereby prevent stockholders from receiving the maximum value for their shares. Although the Registrant has no present intention to issue any shares of its preferred stock, there can be no assurance that the Registrant will not do so in the future.

***Product Liability Risk***

The Registrant may be subject to potential product liability claims that could, in the absence of sufficient insurance coverage, have a material adverse impact on the Registrant. Presently, the Registrant has general liability coverage that includes product liability up to \$2,000,000. Any large product liability suits occurring early in the Registrant's growth may significantly and adversely affect the Registrant's ability to expand the market for its *Power Commander*® line of products.

***No Key Man Insurance***

The Registrant presently has no key man life insurance policies. As soon as practicable following the commencement of profitable operations and ongoing positive cash flow (of which there can be no assurance), the Registrant intends to purchase key man life insurance on the lives of its two principal executive officers, Steven Strasser and Nicholas Anderson. Upon purchase of such insurance, the Registrant intends to pay the premiums and be the sole beneficiary. The lack of such insurance may have a material adverse effect upon the Registrant's business.

***Line of Credit***

At the present time, the Registrant does not have a bank line of credit.

**Item 2. Description of Property**

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The Registrant's corporate office space is located at 3900 Paradise Road, Suite 283, Las Vegas, Nevada 89109 and shared with a major investor in the Registrant, Summit Energy Ventures, LLC. On October 5, 2004 the Company's board of directors formally approved moving the Company's headquarters from Livonia, Michigan to Las Vegas, Nevada. As of November 1, 2004, the Company's facility in Livonia was vacated entirely and all administrative functions have moved to Las Vegas, the location of the Company's Chief Executive Officer and Interim Chief Financial Officer. The Company's other functions, including research and development and managing manufacturing, were temporarily moved to Carlstadt, New Jersey, where the company as of December 31, 2004 sublet 3,000 square feet of work space for no cash payment. Instead, the Company on November 2, 2004 issued 100,000 warrants with an exercise price of \$0.65 per share as payment for subletting its space. The Company is currently in litigation with the owners of the Livonia, Michigan property that the Company vacated in 2004. The Company has accrued a reserve for the estimated loss in relation to the settlement of the litigation. 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 to the Financial Statements)

### **Item 3. Legal Proceedings**

The Registrant is currently in litigation with the owners of property in Livonia, Michigan that the Registrant vacated in 2004. See Item 2 Description of Property above.

**PART II****Item 5. Market for Common Equity and Related Stockholder Matters****Market for Common Stock**

The Registrant's common stock is thinly traded on the National Association of Securities Dealers Over the Counter Bulletin Board (OTCBB) 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, 2004 and December 31, 2003, as reported by Yahoo.com and Pink Sheets LLC, respectively. On March 1, 2004, the Company effected a one for seven reverse stock split. The numbers below and throughout this Form 10-KSB have been retroactively restated to reflect this reverse split.

<b>Twelve months Ended December 31, 2003</b>		<b>High</b>	<b>Low</b>
October 1, 2003	December 31, 2003	\$ 8.68	\$ 3.64
July 1, 2003	September 30, 2003	8.96	5.46
April 1, 2003	June 30, 2003	9.31	4.97
January 1, 2003	March 31, 2003	8.82	4.90

<b>Twelve months Ended December 31, 2004</b>		<b>High</b>	<b>Low</b>
October 1, 2004	December 31, 2004	\$ 1.00	\$ 0.21
July 1, 2004	September 30, 2004	0.67	0.28
April 1, 2004	June 30, 2004	1.50	0.61
January 1, 2004	March 31, 2004	5.04	0.90

As of March 11, 2005, there were 116 shareholders of record of the Registrant's common stock.

The Registrant has not paid dividends on its common stock since its incorporation on October 19, 1994. The Registrant does not expect to pay cash dividends on its common stock in the foreseeable future. The Registrant intends to invest funds otherwise available for dividends, if any, on improving the Registrant's capital assets.

## EQUITY COMPENSATION PLAN INFORMATION



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	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))(c)
Equity compensation plans approved by security holders	0	0	0
Equity compensation plans not approved by security holders	1,322,392	\$ 0.77	0
<b>Total</b>	<b>1,322,392</b>	<b>\$ 0.77</b>	<b>0</b>

1,322,392 warrants and options have been issued to non-employee consultants who have provided services to the Registrant. Of this amount, 750,699 warrants were for vendor settlements and 132,693 warrants were for commissions and services, and 439,000 options issued for vendor settlements.

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

## Recent Sales of Unregistered Securities

### Sales Made to Summit Energy Ventures

The following details several different sales of unregistered securities the Registrant made to Summit Energy Ventures, LLC, a private equity firm specializing in energy related technologies ( Summit ). All of the sales were exempt from registration under the Securities Act of 1933, as amended (the Securities Act ), pursuant to section 4(2) of the Securities Act.

In June 2002, the Company issued 2,346,233 shares of Series A-1 Convertible Preferred Stock to Summit Energy Ventures for a purchase price of \$2,380,000 (net of issuance costs of \$120,000). In October 2003, the Company issued an additional 982,504 shares of Series A-1 Convertible Preferred Stock to Summit Energy Ventures when Summit converted principal and interest of \$1,046,896 that was outstanding under a convertible note the Company issued to Summit in May 2003.

The Series A-1 Convertible Preferred Stock provides the holders of the Series A-1 Convertible Preferred Stock with protection against dilution. 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 will be 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 will also be 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. The Company has asked for and received on October 11, 2004, a waiver of these 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. Currently the conversion rights of the Series A-1 Convertible Preferred Stock entitle the holder to receive 0.83 shares of common stock for each share of Series A-1 Convertible Preferred Stock. If all of the Company's outstanding shares of Series A-1 Convertible Preferred Stock were converted into common stock today, the holder would receive 2,768,849 shares of common stock.

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.

### Sales Made to Purchasers Other than Summit Energy Ventures

On various dates from February 2004 to June 2004, The Company issued 13,580 shares of common stock to Richard Koch, the former President and Chief Executive Officer of the Company. These shares were issued in conjunction with the settlement of certain accounts payable and accrued expenses related to his employment agreement.

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On various dates from May 2003 to February 2004, the Company issued 682,156 shares of common stock to Starz Investments Limited, a Belize company. The Company received \$1,423,760 for these shares and paid \$88,276 in commissions to Burnham Securities. Additionally, the Company also issued Burnham Securities 48,303 common stock purchase warrants as compensation related to these transactions. The warrants had strike prices that varied from approximately \$1.40 to \$1.75. These warrants were exercised cashlessly resulting in 32,958 shares being issued at an effective strike price of zero. The sales of stock to Starz Investments Limited were exempt from registration under the Securities Act pursuant to Regulation S promulgated under the Securities Act. The issuance of the warrants to Burnham Securities was exempt from registration under the Securities Act pursuant to section 4(2) of the Securities Act. Burnham Securities cashlessly exercised the warrants on various dates and received 33,673 shares.

On February 26, 2004, the Company issued 174 shares of common stock to Leonard Bellezza. The shares were issued in exchange for the cancellation of debt owed to Mr. Bellezza in the amount of \$800. The issuance was exempt from registration under the Securities Act pursuant to Regulation D. Mr. Bellezza is a director of the Company.

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On January 8, 2004, the Company issued 15,397 shares of common stock to Raymond Skiptunis. The shares were issued in exchange for the cancellation of debt owed to Mr. Skiptunis in the amount of \$71,130. The issuance was exempt from registration under the Securities Act pursuant to Regulation D. Mr. Skiptunis is a director of the Company.

On various dates from December 2003 to February 27, 2004, the Company issued 15,103 shares of common stock to Richard Koch. The shares were issued in exchange for the cancellation of debt owed to Mr. Koch in the amount of \$60,866. The issuances were exempt from registration under the Securities Act pursuant to Regulation D. At the time, Mr. Koch was the Chief Executive Officer and a director of the Company.

On October 3, 2003, the Company issued 32,145 shares of common stock to its former Chief Executive Officer, Stephen Shulman. The shares were issued in connection with the settlement of a claim Mr. Shulman made against the Company pursuant to a change of control provision in his employment agreement. The issuance was exempt from registration under the Securities Act pursuant to Regulation D. Mr. Shulman is an accredited investor.

On September 30, 2003, the Company issued 76,663 shares of common stock to Nicholas Anderson. The shares were issued in exchange for the cancellation of debt owed to Mr. Anderson in the amount of \$466,875. The issuance was exempt from registration under the Securities Act pursuant to Regulation D. Mr. Anderson is the Chief Technology Officer and a director of the Company.

On September 30, 2003, the Company issued 32,143 shares of common stock to Nicholas Anderson. The shares were issued in connection with the settlement of a potential claim Mr. Anderson had against the Company pursuant to a change of control provision in his employment agreement. The issuance was exempt from registration under the Securities Act pursuant to Regulation D. Mr. Anderson is the Chief Technology Officer and a director of the Company.

On various dates during the first half of 2003, the Company issued 40,357 shares of common stock to various accredited investors in connection with a private placement pursuant to section 4(2) of the Securities Act. The shares were issued for an aggregate consideration of \$158,200. The issuance was exempt from registration under the Securities Act pursuant to Regulation D. The investors were all accredited investors.

In early 2003, the Company issued 13,889 shares of common stock to an investment banker for advisory and consulting services. The issuance was exempt from registration under the Securities Act pursuant to Regulation D.

**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 \$1,446,457 which primarily consisted of: a net loss of \$2,465,631; less allowances for inventory obsolescence of \$29,484, depreciation and amortization of \$64,337, loss on disposition of fixed assets of \$31,036, an increase in restricted cash related to a note payable of \$219,721, decreases in accounts receivable of \$7,194, inventory of \$143,396 and prepaid expenses and other of \$21,726. In addition, these amounts were partially offset by an increase in accounts payable and accrued expenses of \$162,742 and accrued salaries and payroll taxes of \$87,231.

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 \$15,551, compared to \$42,617 in fiscal year 2003. The amounts for both years consisted of the purchase of fixed assets.

Net cash provided by financing activities for fiscal year 2004 was \$1,568,972 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. 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

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Statements of Changes in Stockholders' Equity

Statements of Cash Flows

Notes to Financial Statements

**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>
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**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>

	\$	<b>2,918,203</b>
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**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
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<b>Total Liabilities</b>		<b>1,849,873</b>
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**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>
	\$	<b>2,918,203</b>

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



**POWER EFFICIENCY CORPORATION**

## STATEMENTS OF OPERATIONS

	<b>Year Ended December 31,</b>	
	<b>2004</b>	<b>2003</b>
REVENUES	\$ 284,373	\$ 397,673
<b>COMPONENTS OF COST OF SALES:</b>		
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
<b>COSTS AND EXPENSES:</b>		
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)
<b>OTHER INCOME (EXPENSE):</b>		
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)
<b>WEIGHTED AVERAGE COMMON SHARES OUTSTANDING</b>		
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 Receivable	Additional Paid-in Capital	Accumulated Deficit	Total Stockholders Equity
	Shares	Amount	Shares	Amount				
Balance, January 1, 2003	940,088	\$ 940	2,346,233	\$ 2,346	\$	11,749,702	\$ (9,844,283)	\$ 1,908,705
Issuance of common 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 debt to preferred stock			982,504	983		1,045,913		1,046,896
Common stock issued for settlement of compensation and other accrued expenses	172,582	173				1,034,800		1,034,973
Non-qualified stock options issued below market						77,158		77,158
Net loss 2003							(3,016,717)	(3,016,717)
Balance, 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 outstanding warrants	3,134,102	3,134						3,134
Fractional shares one-for-seven reverse split	25,260	24						24
Common stock issued for services rendered	13,580	13				35,796		35,809
Common stock issued in exchange for subscriptions receivable					181,045			181,045
Warrants issued in connection with issuance of Notes Payable - Pali Capital						580,000		580,000
Options and Warrants issued in connection with settlements and services from consultants and vendors, the forgiveness of indebtedness and the issuance of debt						550,969		550,969
Net loss 2004							(2,465,631)	(2,465,631)
Balance, 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	20,126	40,948
Depreciation and amortization	64,377	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		614,991
Accrued interest on converted debt		46,896
Changes in certain assets and liabilities:		
(Increase) decrease in:		
Accounts receivable	7,194	31,511
Inventory	143,369	43,353
Prepaid expenses and other	21,726	(18,832)
Restricted cash related to payment of indebtedness	(219,721)	
Deposits	18,147	(2,646)
Increase (decrease) in:		
Accounts payable and accrued expenses	162,742	(63,866)
Accrued salaries and payroll taxes	87,231	(19,294)
<b>Net Cash Used for Operating Activities</b>	<b>(1,446,457)</b>	<b>(2,028,798)</b>
<b>INVESTING ACTIVITIES:</b>		
Purchase of property, equipment and other assets	(15,551)	(42,617)
<b>FINANCING ACTIVITIES:</b>		
Deferred financing costs	(65,968)	(32,750)
Proceeds from issuance of equity securities, net of costs	184,800	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>1,568,972</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*®, which is used in industrial applications, and the Single Phase *Power Commander*®, 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:**

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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.

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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:**

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 as 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

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Property and Equipment, Net	\$	26,320
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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.

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.

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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 reconcilaition 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 Exercise 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 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

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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)
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 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.

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	\$	\$

## NON-CASH INVESTING AND FINANCING ACTIVITIES:

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 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.

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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.



**Item 8. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.**

**Not Applicable**

**Item 8A. Controls and Procedures.**

(a) Disclosure Controls and Procedures.

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

(b) Internal Control Over Financial Reporting.

There has been no change in the Company's internal control over financial reporting that occurred during the last fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

**PART III**

**Item 9. Directors and Executive Officers of the Registrant**

**INFORMATION ABOUT THE REGISTRANT'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 Registrant's current directors were appointed by written consent of the Registrant's majority shareholder in December of 2004.

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Name	Age	Positions with the Company	Director Since
Steven Strasser	56	Chief Executive Officer, Chairman of the Board	2002
John (BJ) Lackland	34	Interim Chief Financial Officer, Director	2002
Nicholas Anderson	70	Chief Technology Officer, Director	1994
Leonard Bellezza	56	Director	2001
Richard Pulford	58	Director	2003
Raymond J. Skiptunis	62	Director	2002

### Officers:

Steven Strasser Chief Executive Officer & Chairman of the Board. Mr. Strasser is presently the managing director of Summit Energy Ventures and the president of Northwest Power Management. Northwest Power Management is an investment management company that acts as the investment manager for Summit Energy Ventures LLC, a private equity fund focused on investments in energy technology companies. In the past five years Mr. Strasser was the CEO of Northwest

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Power Enterprises and president of Northwest Power Management. Northwest Power Enterprises and its predecessor companies were involved in multiple aspects of the energy development business. Mr. Strasser is a member of Washington State Bar Association, as well as the American Bar Association and the Canadian Bar Association.

John ( BJ ) Lackland - Interim Chief Financial Officer & Director. Mr. Lackland is a director and vice president at Summit Energy Ventures and a vice president of Northwest Power Management. Northwest Power Management is an investment management company that acts as the investment manager for Summit Energy Ventures LLC, a private equity fund focused on investments in energy technology companies. Prior to joining Summit, Mr. Lackland was the Director of Strategic Relations at Encompass Globalization, where he was in charge of strategic alliances and mergers and acquisitions. Prior to Encompass he was the Director of Strategic Planning and Corporate Development at WebStrategic, an Internet business development consulting company, where he was in charge of finance, strategic planning and investor relations. In 1999, BJ earned an MBA from the University of Washington Business School, and an MA in Asian Studies from the University of Washington's Jackson School of International Studies.

Nicholas Anderson - Chief Technology Officer and Director. Mr. Anderson is a founder of the Company. From 1992 to the present, Mr. Anderson has been a Director of Energy Services of Coyne Electrical Contracting, Inc., a major electrical service organization based in New York, New York. From 1988 to 1992, Mr. Anderson was the founder and CEO of Power Reducing Equipment, Inc., a Company formed to develop products to reduce energy consumption in AC motors. During this period, Mr. Anderson obtained a patent for the Company's technology, which patent was issued in April 1994 and transferred to the Company. Mr. Anderson attended the City College School of Engineering, and received a certification in Electronics Design from Manhattan Technical Institute in 1957.

Leonard S. Bellezza - Director. Mr. Bellezza has been employed as a retail consulting executive by Abacus Solutions, LLC, of New York City since 2003 and is currently assigned as the General Merchandise Manager for Franks Nursery of Troy, Michigan. He was a senior manager with the New York office of Deloitte & Touche, a national public accounting firm from 2001 to 2003. From November 1999 to December 2000, he was a contract consultant for smartcasual.com, an internet clothing manufacturer. From June 1997 to November 1999, Mr. Bellezza was employed as a vice president and a member of the operations committee of Frederick Atkins, a wholesale apparel company. From November 1993 to June 1997, Mr. Bellezza served as a consultant in various aspects of the retail management, logistics and information technology industries. Mr. Bellezza earned a Bachelor of Arts in Economics and a Masters of Business Administration from Rutgers University.

Richard D. Pulford - Director. Mr. Pulford has been President of Corporate Strategies, Inc. since 1981. The company provides investment banking services in the Great Lakes region.

Raymond J. Skiptunis - Director. Mr. Skiptunis has been a self employed business consultant since October of 2003. During the period, November of 2001 through October of 2003, Mr. Skiptunis worked with Power Efficiency Corporation in various capacities, including consultant, CFO and interim CEO. From January of 1997 through November of 2001, Mr. Skiptunis was a self employed business consultant. Mr. Skiptunis earned a Bachelor of Science in Accounting from Rutgers University.

### **Committees of the Board of Directors**

The Board of Directors had, as of December 31, 2004, an audit committee and a compensation committee to assist the full Board in administering its duties.

### **Audit Committee**

As of December 31, 2004, the Registrant had a separately-designated standing audit committee established in accordance with section 3(a)(58)(A) of the Exchange Act. Until recently, John (B.J.) Lackland (Chairman) was the sole member of the committee. In September 2004, Mr. Lackland became the Company's Interim Chief Financial Officer and therefore had to resign from the Audit Committee. At that time Mr. Rick Pulford, a director, became the sole member of the Audit Committee on a temporary basis. As of December 31, 2004, Mr. Pulford was the sole member of the Audit Committee. As Mr. Pulford agreed only to serve on the Audit Committee on a temporary basis, on February 10, 2005, the board of directors dissolved the Audit Committee because there were no independent directors willing to serve on it. The board desires to locate and form an Audit Committee as soon as willing and qualified directors can be located. Until that time, the board as a whole will take on the Audit Committee functions, such as, engaging the Company's auditors, approving audit services and fees, etc.

### **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.

Based solely on the review of copies of the forms provided to the Company and the representations by the executive officers, directors and ten percent shareholders during fiscal year 2004, the following failed to file on a timely basis, as disclosed in the above forms, reports required by Section 16(a) of the Exchange Act.

Steven Strasser inadvertently missed a filing deadline for reporting one transaction. Mr. Strasser has since filed a Form 4 to report the transaction.

John Lackland inadvertently missed a filing deadline for reporting one transaction. Mr. Strasser has since filed a Form 4 to report the transaction.

Raymond Skiptunis inadvertently missed a filing deadline for reporting one transaction. Mr. Skiptunis has since filed a Form 4 to report the transaction.

Nick Anderson inadvertently missed a filing deadline for reporting one transaction.

Len Bellezza inadvertently missed a filing deadline for reporting one transaction.

#### **CODE OF ETHICS**

The Registrant has not adopted a code of ethics. The Registrant has been focused on raising money and generating sales to support operations and consequently has not focused on adopting a code of ethics.

#### **Item 10. Executive Compensation**

##### **STOCK OPTION GRANTS DURING 2004**

The following table shows information as to options granted during the year ended December 31, 2004 for the executive officers still in their positions as of March 11, 2005..

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Name	Number of securities underlying Options Granted	Percentage of Total Options Granted to Employees in Fiscal Year	Individual Grants				Potential Realizable Value at Assumed Annual Rates of Stock Price Appreciation For Option Term (1)	
			Exercise Price in Dollars per Share	Market Price on Date of Grant	Expiration Date	5%	10%	
Steven Strasser	146,154	5.04%	\$ 0.65	\$ 0.28	10/10/14	\$ (28,341)	\$ 11,144	
Steven Strasser	453,846	15.65%	\$ 0.65	\$ 0.28	10/10/14	\$ (88,005)	\$ 34,605	
Nicholas Anderson	96,154	3.32%	\$ 0.65	\$ 0.28	10/10/14	\$ (186,959)	\$ 73,515	
Nicholas Anderson	403,846	13.92%	\$ 0.65	\$ 0.28	10/10/14	\$ (78,310)	\$ 30,792	
John (BJ) Lackland	46,154	1.59%	\$ 0.65	\$ 0.28	10/10/14	\$ (8,950)	\$ 3,519	
John (BJ) Lackland	328,846	13.92%	\$ 0.65	\$ 0.28	10/10/14	\$ (63,766)	\$ 25,074	

1. The potential realizable value of the options granted is calculated by multiplying the difference between the exercise price of the option and the market value per share of the underlying stock (assuming a 5% or 10%, as the case may be, compounded annual increase of the stock price from the date of grant to the final expiration of the option) by the number of shares underlying the options granted. The price appreciation assumptions are required disclosures under the rules of the Securities and Exchange Commission and are not to be viewed as any expectation or prediction by the Company of future value of the underlying common stock

As of March 11, 2005, the Company has only one employee with an employment contract. Nicholas Anderson, the Company's founder, Chief Technology Officer and director. (See Note 16 to the Financial Statements).

## Item 11. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

### STOCK OWNERSHIP

The following table sets forth information regarding the beneficial ownership of each director, each executive officer, all executive officers and directors as a group, and persons, according to information received by the Board of Directors, holding more than five percent of the outstanding Common Stock of the Company as of March 8, 2005.

Title of Class	Beneficial Owner	Shares Owned	Percent of Shares Owned (9)
Common Stock	Nicholas Anderson, CTO, Director	689,565(1)	5.6%
Common Stock	Steven Strasser, Chairman of the Board	3,103,901(2)	25.4%
Common Stock	Leonard Bellezza, Director	97,069(3)	Less than 1%
Common Stock	John (BJ) Lackland, Interim CFO, Director	200,000(4)	1.6%
Common Stock	Richard Pulford, Director	156,051(5)	1.3%
Common Stock	Raymond J. Skiptunis, Director	206,869(6)	1.7%
Common Stock	Summit Energy Ventures, LLC	2,803,901(7)	22.9%
Series A-1	Summit Energy Ventures, LLC	1,581,150	47.5%
Convertible Preferred Stock			
Common Stock	Commonwealth Energy Corporation	3,099,049(8)	25.3%
Series A-1			
Convertible Preferred Stock	Commonwealth Energy Corporation	1,747,587	52.5%
Common Stock	All Executive Officers and Directors as a Group (6 persons)	4,455,455	36.4%

(1) Includes 316,000 common shares subject to options and warrants exercisable within 60 days of March 8, 2005. Mr. Anderson was also granted an additional 400,000 common shares subject to options exercisable after 60 days of March 8, 2005.

(2) Includes 2,803,901 common shares held by Summit Energy Ventures, LLC (on a converted basis), in which Steven Strasser is one of two members, and 300,000 common shares subject to options exercisable within 60 days of March 8, 2005. Mr. Strasser was also granted an additional 300,000 common shares subject to options exercisable after 60 days of March 8, 2005.

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(3) Includes 67,000 common shares subject to options exercisable within 60 days of March 8, 2005. Mr. Bellazza was originally granted 500,000 options, but 433,000 options were subsequently cancelled in early 2005.

(4) Includes 200,000 common shares subject to options exercisable within 60 days of March 8, 2005. Mr. Lackland was also granted an additional 175,000 common shares subject to options exercisable after 60 days of March 8, 2005.

(5) Mr. Pulford owns no shares of the Registrant directly. Mr. Pulford has a 7% profit interest in Percon, LLC which owns 156,051 common shares. This total amount for Mr. Pulford includes 12,500 common shares subject to options exercisable within 60 days of March 8, 2005. Mr. Pulford was also granted an additional 12,500 common shares subject to options exercisable after 60 days of March 8, 2005.

(6) Includes 48,500 common shares subject to options and warrants exercisable within 60 days of March 8, 2005. Mr. Skiptunis was also granted an additional 12,500 common shares subject to options exercisable after 60 days of March 8, 2005.

(7) Includes 1,581,150 shares of Series A-1 Preferred Stock which is currently convertible into 1,315,203 shares of Common Stock.

(8) Includes 1,747,587 shares of Series A-1 Preferred Stock which is currently convertible into 1,453,645 shares of Common Stock.

(9) The percentages for Common Stock assume that the 3,328,737 shares of Series A-1 Preferred Stock were converted into 2,768,848 shares of Common Stock and include all common shares subject to options and warrants exercisable within 60 days of March 8, 2005.

**Item 12. Certain Relationships and Related Transactions**

As of December 31, 2004, the Registrant had no related transactions and certain relationships exceeding \$60,000. As of the filing date, the Registrant has paid management fees of \$60,000 to a management company, wholly owned by the Chief Executive Officer of the Registrant. See Note 14 in the Notes to Financial Statements in Part II.

**Item 13. Exhibits and Reports on Form 8-K**

(a) Exhibits

The following exhibits are filed as part of this report:

**Description of Document**

<b>Exhibit Number</b>	<b>Description</b>	<b>Location</b>
3.1	Certificate of Incorporation.	ii
3.2	Amendment to the Articles of Incorporation dated June 5, 2002.	i
3.3	Amended and Restated By-laws of the Company dated October 16, 2003.	vii
4.1	Certificate of Incorporation.	ii
4.2	Amended and Restated By-laws of the Company dated October 16, 2003.	vii
4.3	Stock Purchase Agreement dated June 14, 2002.	i
4.4	Registration Rights Agreement dated June 14, 2002.	i
4.5	Certificate of Designation dated June 13, 2002.	i

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10.1	Lease Agreement for Registrant's Ann Arbor, Michigan facility dated February 16, 1996.	ii
10.2	Stock Purchase Warrant dated June 14, 2002.	i
10.3	Amended and Restated Stockholders' Agreement dated June 14, 2002.	i
10.4	United States Patent #5,821,726.	ii
10.5	1994 Stock Option Plan.	ii
10.6	Patent License Agreement (DN-858) with NASA.	iii
10.7	Patent License Agreement (DE-256) with NASA.	iii
10.8	Settlement and Release Agreement with NASA.	iii
10.9	Modification No. 1 to Patent License Agreement (DE-256) with NASA.	iii
10.10	Product Warranty.	iii
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10.12	Test Report from Oak Ridge National Laboratory.	iii
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10.36	Business Property lease with Arens Investment Company dated November 1, 2003.	ix
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10.39	Subscription Agreement with Leonard Bellezza dated February 16, 2004.	ix
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10.42	Amended and Restated 1994 Stock Option Plan.	ix
10.43	\$300,000 Line of Credit Agreement with Summit Energy Ventures LLC	x
10.44	Single Phase Licensing Agreement with Commerce Energy Group	xi
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10.48	Business Property Lease involving Glenborough LLC and Northwest Power Management, Inc. dated February 7, 2005.	filed herewith
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10.51	Business Property Sublease with Famair, Inc. dated February 11, 2005	filed herewith
31.1	Certification of Steven Strasser pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.	filed herewith
31.2	Certification of John Lackland 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 John Lackland pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.	filed herewith

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i	Incorporated herein by reference from the Company s Form 8-K filed on June 18, 2002.
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xi	Incorporated herein by reference from the Company s Form 10-QSB filed on November 15, 2004

(b) Reports on Form 8-K filed during the fourth quarter:

On November 5, 2004 the Company filed a current report on Form 8-K announcing the creation of a direct financial obligation. That report is incorporated herein by reference.

On March 2, 2005 the Company filed a current report on Form 8-K announcing the creation of a direct financial obligation. That report is incorporated herein by reference.

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

(1) Audit Fees.

The aggregate fees billed in fiscal years 2004 and 2003 for professional services rendered by the principal accountant for the audit of the Registrant's annual financial statements and review of financial statements included in the Registrant's Form 10-QSB or services that are normally provided by the accountant in connection with statutory and regulatory filings or engagements for those fiscal years were \$51,900 and \$44,100, respectively.

(2) Audit-Related Fees.

The aggregate fees billed in fiscal years 2004 and 2003 for assurance and related services by the principal accountant that are reasonably related to the performance of the audit or review of the Registrant's financial statements and are not reported under Item 14(1) above were \$0 and \$0, respectively.

(3) Tax Fees.

The aggregate fees billed in fiscal years 2004 and 2003 for professional services rendered by the principal accountant for tax compliance, tax advice, and tax planning were \$2,150 and \$3,275, respectively.

(4) All Other Fees



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The aggregate fees billed in fiscal years 2004 and 2003 for products and services provided by the principal accountant, other than the services reported in Items 14(1) through 15(3) above were \$4,500 and \$0, respectively.

### (5) Audit Committee Approval

During fiscal year 2004 and 2003, the Audit Committee adopted the policy of pre-approving all engagements and fees for audit and tax related services.

**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: March 29, 2005

By: /s/ STEVEN STRASSER  
Steven Strasser, President and Chief Executive Officer and  
Chairman of the Board

Dated: March 29, 2005

By: /s/ JOHN LACKLAND  
John Lackland, Interim Chief Financial Officer and Director

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

Dated: March 29, 2005

By: /s/ NICHOLAS ANDERSON  
Nicholas Anderson, Director

Dated: March 29, 2005

By: /s/ LEONARD BELLEZZA  
Leonard Bellezza, Director

Dated: March 29, 2005

By: /s/ RICHARD PULFORD  
Richard Pulford, Director

Dated: March 29, 2005

By: /s/ RAYMOND J. SKIPTUNIS  
Raymond J. Skiptunis, Director

## EXHIBIT INDEX

## Description of Document

Exhibit Number	Description	Location
3.1	Certificate of Incorporation.	ii
3.2	Amendment to the Articles of Incorporation dated June 5, 2002.	i
3.3	Amended and Restated By-laws of the Company dated October 16, 2003.	vii
4.1	Certificate of Incorporation.	ii
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4.3	Stock Purchase Agreement dated June 14, 2002.	i
4.4	Registration Rights Agreement dated June 14, 2002.	i
4.5	Certificate of Designation dated June 13, 2002.	i
10.1	Lease Agreement for Registrant's Ann Arbor, Michigan facility dated February 16, 1996.	ii
10.2	Stock Purchase Warrant dated June 14, 2002.	i
10.3	Amended and Restated Stockholders' Agreement dated June 14, 2002.	i
10.4	United States Patent #5,821,726.	ii
10.5	1994 Stock Option Plan.	ii
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