ENERGY FOCUS, INC/DE
Form 10-K
March 30, 2012
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

x **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended December 31, 2011

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from to

Commission file number 0-24230

ENERGY FOCUS, INC.

(Exact name of registrant as specified in its charter)

DELAWARE	**94-3021850**
(State of incorporation)	**(I.R.S. Employer Identification No.)**

32000 Aurora Road

Solon, Ohio 44139

(Address of principal executive offices, including zip code)

Registrant s telephone number, including area code: 440.715.1300

Securities registered pursuant to Section 12(b) of the Act: None

Securities registered pursuant to Section 12(g) of the Exchange Act:

Title of Each Class

Common Stock, Par Value $0.0001

Series A Participating Preferred Stock Purchase Rights

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined by Rule 405 of the Securities Act of 1933. Yes ¨ No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Exchange Act. Yes ¨ No x

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Date File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not 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-K or any amendment to this Form 10-K. x

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

Large accelerated filer	¨	Accelerated filer	¨
Non-accelerated filer	¨ (Do not check if a smaller reporting company)	Smaller reporting company	x

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

Approximate aggregate market value (on basis of closing bid price) of voting stock held by non-affiliates as of June 30, 2011: $11,059,445

Number of the registrant s shares of common stock outstanding as of March 2, 2012: 44,513,135

Documents Incorporated by Reference

Portions of the Proxy Statement for the 2012 Annual Meeting of Shareholders to be filed with the Securities and Exchange Commission are incorporated by reference into Part III of this report.

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PART I

Forward-Looking Statements

All references to Energy Focus, we, us, our, or the Company means Energy Focus, Inc. and its subsidiaries, except where it is made clear th the term means only the parent company.

Statements and information included in this Annual Report on Form 10-K that are not purely historical are forward-looking statements intended to be covered by the safe harbor provisions of the Private Securities Litigation Reform Act of 1995.

Forward-looking statements in this Report on Form 10-K include statements regarding Energy Focus expectations, intentions, beliefs, and strategies regarding the future, including but not limited to; growth in the markets into which Energy Focus sells; conditions of the lighting industry and the economy in general; statements as to our competitive position; future operating results; net sales growth; expected operating expenses; gross product margin improvement; sources of net sales; anticipated revenue from government contracts; product development and enhancements; liquidity, ability to generate cash and cash reserves; our reliance upon a limited number of customers; our accounting policies; the effect of recent accounting announcements; the development and marketing of new products; relationships with customers and distributors; relationships with, dependence upon, and the ability to obtain components from suppliers; as well as our remarks concerning our ability to compete in certain markets; the evolution and future size of those markets; seasonal fluctuations; plans for and expected benefits of outsourcing and offshore manufacturing; trends in the price and performance of fiber optic lighting products; the benefits and performance of our lighting products; the adequacy of our current facilities; our strategy with regard to protecting our proprietary technology; and our ability to retain qualified employees.

When used in this report, the words believes, expects, anticipates, intends, assumes, estimates, evaluates, opinions, forecasts, n forward, , plans , potential, probable, and similar expressions are intended to identify forward-looking statements.

These forward-looking statements involve risks and uncertainties. We may make other forward-looking statements from time to time, including in press releases and public conference calls and webcasts. All forward-looking statements made by Energy Focus are based on information available to us at the time the statements are made, and we assume no obligation to update any forward-looking statements. It is important to note that the forward-looking statements are subject to a number of risks and uncertainties that could cause actual results to differ materially from those included in such forward-looking statements. Some of these risks and uncertainties are discussed below in Item 1A. Risk Factors of this Form 10-K.

Energy Focus ®, EFO®, Fiberstars®, BritePak®, and EFO-Ice® are our registered trademarks. We may also refer to trademarks of other corporations and organizations in this document.

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Item 1. Business

Energy Focus, Inc. and its subsidiaries (Energy Focus) design, develop, manufacture, and market energy-efficient lighting products, and is a leading provider of turnkey, energy-efficient, lighting solutions in the governmental and public sector market, general commercial market, and the pool market. Energy Focus lighting technology offers significant energy savings, heat dissipation and maintenance cost benefits over conventional lighting for multiple applications.

Overview

We engage in the design, development, manufacturing, marketing, and installation of energy-efficient lighting systems and solutions where we serve two segments:

- solutions-based sales providing turnkey, high-quality, energy-efficient lighting application alternatives primarily to the existing public-sector building market; and
- product-based sales providing military, general commercial and industrial lighting and pool lighting offerings, each of which markets and sells energy-efficient lighting systems.

We continue to evolve our business strategy to include providing our customers with turnkey, comprehensive energy-efficient lighting solutions, which use, but are not limited to, our patented and proprietary technology. Our product-based solutions include light-emitting diode (LED), fiber optic, high-intensity discharge (HID), fluorescent tube and other highly energy-efficient lighting technologies. Typical savings related to our current technology of the Company approximates 80% in electricity costs, while providing full-spectrum light closely simulating daylight colors. Our strategy also incorporates continued investment into the research of new and emerging energy sources including, but not limited to, LED and solar energy applications.

Our long-term strategy is to penetrate the $100 billion existing building and $300 million U.S. military lighting markets by providing turnkey, comprehensive energy-efficient lighting solutions, which utilize our proprietary energy-efficient lighting products. In March of 2012, we announced a cooperation agreement with Communal International Ltd. to develop the Asian Market for the Company s LED products. We will continue to focus on markets where the benefits of our lighting solutions offerings, combined with our technology, are most compelling. These markets include: schools, universities, hospitals, office buildings, parking garages, supermarkets, museums, cold storage facilities and manufacturing environments. The passage of the Energy Savings Performance Contracts legislation in nearly all the states and the Energy Independence and Security Act of 2007 by Congress created a natural market for our energy-efficient products. Under this Act, all incandescent light bulbs are mandated by federal law to utilize 25% to 30% less energy than today s products by the years 2012 through 2014. Since many of our products are approximately 80% more efficient than incandescent bulbs, our focus is to increase the public s awareness and knowledge of our technology and to establish comprehensive distribution channels so that demand can be fulfilled quickly.

During 2011, we made major progress in our plan to reposition the Company for growth and profitability. This plan involved three major areas of focus, which included:

- Dramatic reduction of operating expenses.
- Receipt of a $23.1 million order for the U.S. Navy to retrofit approximately 7% of the Naval fighting fleet with LED lighting products, including Intellitube lamps. We invoiced the U.S. Navy $1.9 million through December for products and services related to this contract.
- Added sales resources and broadened our customer base at Stones River Companies, LLC (SRC) during the year, which has positioned us for growth in 2012 for our lighting retrofit business.

We market our products and services through multiple sales channels and subsidiaries. The following is a brief summary of each business unit:

Business Unit: Stones River Companies, LLC

Offerings: Application design, engineering, project management, and turnkey lighting and solar retrofits.

Target Market: Energy Services Companies (ESCO s) selling into Fortune 100 corporate clients and public sector existing buildings such as: schools, universities, hospitals, and public office buildings at the federal, state and local level.

Business Unit: Energy Focus Government Contracts and Sales

Offerings: Solid state lighting technologies and products to the United States Military.

Target Market: United States Navy, United States Army and any other Federal Military units.

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Business Unit: Products which include:

Fiberstars Pool and Spa

Offerings: Decorative LED lighting and related products to the United States pool market.

Target Market: United States new pool construction market and existing market upgrades.

Fiberstars Commercial

Offerings: Premier energy-efficient LED lighting products; decorative architectural lighting products including LED and fiber optic technologies.

Target Market: Corporate accounts including, distribution centers, warehouses, manufacturing, food and clothing retail, and cold storage; decorative lighting for new commercial buildings.

Crescent Lighting Limited

Offerings: Decorative and specialty lighting products including LED and fiber optic technologies.

Target Market: New commercial building decorative lighting market in Europe, Asia, and the Middle East.

Products

In 2011, we produced, sourced, and/or marketed a wide variety of lighting technologies to serve two general markets: commercial buildings and pool lighting. Our offerings include the following products:

- LED docklights,
- LED parking garage lamps and fixtures,
- LED cold storage globe lamps and LED fiber optic lighting systems,
- LED landscape fixtures,
- LED retrofit kits for HID applications,
- LED replacements for linear fluorescent lamps,
- LED lamps and fixtures (e.g. pool PAL lights), and
- 25 Families of LED lamps and fixtures to serve the U.S. Navy.

In addition, we also sold customized components such as underwater lenses, color-changing LED lighting fixtures, and lighted water features, including waterfalls and laminar-flow water fountains. Furthermore, we continue to aggressively penetrate the government and military lighting markets. In this regard, we have many products being actively marketed to the United States federal government agencies through the General Services Administration website, https://www.GSAAdvantage.gov.

The key features of our products are as follows:

- Many of our products meet the lighting efficiency standards mandated for the year 2020.
- Our products qualify for federal and state tax incentives for commercial and residential consumers in certain states.
- Many of our products make use of proprietary optical and electronics delivery systems which enable high efficiencies with superior lighting qualities.

Long-Term Strategy

Our long-term strategy is to substantially penetrate the $100 billion existing building and $300 million U.S. military lighting markets by providing turnkey, comprehensive energy-efficient lighting solutions which utilize our proprietary energy-efficient lighting products. We will continue to focus on markets where the benefits of our lighting solutions offerings, combined with our technology, are most compelling.

Our strengths, which provide a strategic competitive advantage, include the following:

- fundamental intellectual property and trade secrets in non-imaging optics and coatings,
- a broad and intimate understanding of lighting technologies,
- proven ability to develop systems which efficiently create, transport, and display light,
- a superior understanding of the existing building market drivers and the evolution towards green lighting products and energy-efficient lighting systems that maximize customer ROI,
- core competencies in execution of all facets of solutions sales, and
- strong relationships with the federal government for research and development.

Our tactical approach to implement our long term strategy includes:

- intensifying our focus on the existing building market. During 2011, we added sales associates and expanded our customer base,
- developing mainstream lighting technologies that directly compete against linear fluorescent general illumination lamps, and
- continuing to increase our value added to our customers and increase gross margins.

We expect that these actions will result in the following outcomes:

- sales growth and improved financial performance,
- sales of military grade LED lighting products for the U.S. Armed Forces,
- the formation of a streamlined organization that is focused on creating economic value through energy-efficient products and solutions for existing building owners, and
- development of mainstream lighting products for the existing building market that are not currently available and are differentiated by their performance, energy consumption, longevity, and controllability.

Sales, Marketing, and Distribution of our Offerings Portfolio

Products

Our products are sold through a combination of direct sales employees, independent sales representatives, and various distributors in different geographic markets throughout the world. Our distributors obligation to us is not contingent upon the resale of our products and, as such, does not prohibit revenue recognition. We also distribute our products through our SRC subsidiary.

Within the commercial and pool lighting business units, we continue to focus on general contractors and specifiers especially in the retail, hospitality, museum, and health care markets. Our lighting retrofit subsidiary, SRC, is heavily targeting the existing public building market and will generate enormous benefits by utilizing our products for quick, energy-efficient upgrades.

Solutions

Our solutions-based sales are designed to enhance total value by providing turnkey, high-quality, energy-efficient lighting application alternatives that positively impact customers profitability, the environment, and the communities we serve. These solutions are sold through our SRC subsidiary and include not only our proprietary energy-efficient lighting solutions, but also sourced lighting systems, energy audits, and service agreements.

Through SRC, we target the existing public building market, particularly health care and hospitals, schools and universities, governments and municipalities, museums, hospitality and casinos, as well as industry and manufacturing. SRC s direct customers are large national ESCO s that provide energy-efficient upgrades around the country. Also within the solutions business unit, we serve multi-location food retailers, cold storage facilities, retailers, and industrial/commercial real estate companies.

As of December 31, 2011, we had approximately 101 sales and independent sales representatives throughout the United States and United Kingdom.

Our ten largest customers accounted for approximately 55.5% of our net sales from continuing operations for the twelve months ended December 31, 2011. One customer, Ameresco, Inc. (Ameresco), accounted for approximately 14.8% of our consolidated net sales from continuing operations and 39.7% of our solutions-based segment net sales in 2011. Ameresco is not related to the Company.

In 2010, our ten largest customers accounted for approximately 64.2% of our net sales from continuing operations. In 2010, two customers, Ameresco and Woodstone Energy, LLC (Woodstone), had 19.5% and 16.8%, respectively, of consolidated net sales from continuing operations. Ameresco contributed 34.7% and Woodstone contributed 29.9% of our solutions-based segment net sales in 2010. During 2011 and 2010, the former Vice President of SRC, who resigned on December 31, 2011, is a minority owner of Woodstone. See Note 16, Related Party Transactions, for further information.

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Manufacturing and Suppliers

In 2011, we produced our lighting systems through a combination of internal and outsourced manufacturing and assembly operations. Our internal lighting system manufacturing consisted primarily of fiber processing, final assembly, testing, and quality control. We used independent contractors to manufacture some components and sub-assemblies and have worked with a number of our vendors to design custom components to meet our specific needs. We manage inventories of domestically produced component parts on a just-in-time basis, when practicable. Our quality assurance program provides for testing of all sub-assemblies at key stages in the assembly process as well as testing of finished products.

Many of our products are manufactured by third-party suppliers resulting in significant cost savings. Under a Production Share Agreement initiated in 2003 and renewed in August 2007, we conduct contract manufacturing and assembly in Mexico through North American Production Sharing, Inc. and Industrias Unidas de BC, SA de CV (NAPS). Under this agreement, NAPS provides administrative and manufacturing services, including labor services and the use of manufacturing facilities in Mexico, for the manufacturing and assembly of certain fiber optic and LED lighting systems, equipment, and related components. We also perform final assembly of products acquired from Australia, India, Japan, and Taiwan. These suppliers generally supply products on a purchase order basis.

Research and Development

Research and development has remained a key focus of our Company; accordingly, we have committed substantial resources to this endeavor. Our research and development team is dedicated to continuous improvement and innovation of our current lighting technologies, including LED, fiber optics, and HID systems.

Research and development income, net of expenses, for the years ended December 31, 2011 and 2010 was $0.5 million and $0.2 million, respectively. Research and development expense, net of credits from the government, for the year ended December 31, 2009 was $0.3 million.

Our recent achievements include:

2011: We were awarded $26.1 million in government supply contracts and in research contracts and grants in 2011. In March 2011, we received a $1.0 million grant from the State of Ohio Third Frontier to develop a photovoltaic wall-pack unit for outdoor LED lighting. In April 2011, we received a Phase 2 Small Business Technology Transfer (STTR) grant for $0.6 million from the National Aeronautics and Space Administration (NASA) for Innovative Solid State Lighting Replacements for Industrial and Test Facility Locations. In May 2011, we received a $0.4 million increase in funding for the Very High Efficiency Solar Cell (VHESC) program. In July 2011, we received a $1.0 million grant from the State of Ohio Third Frontier to develop an ultra-low cost light sensor to compliment IntelliTube , the Company s LED based fluorescent replacement technology. Finally, in August, 2011 we received a $23.1 million supply contract to provide LED fixtures and our proprietary IntelliTube LED lamps for use on the U.S. Navy Fleet. The government has the right to change quantities throughout the life of this supply contract.

2010: We were awarded $3.0 million in research contracts and grants in 2010. These included three awards totaling $1.6 million announced in January 2010. Two of these awards, Explosion-Proof Solid State Lighting for Extreme Environments and A Spectrally Dynamic Berth Light for Active Circadian Cycle Management, are Phase 2 Small Business Innovation Research (SBIR) grants from Defense Advanced Research Projects Agency (DARPA). The third award, Innovative Solid State Lighting Replacements for Industrial and Test Facility Locations, is a Phase 1 STTR program grant received from the NASA. A Department of Energy (DoE) award for $1.0 million, to develop high performance Sol-Gel coatings for lighting and solar applications, was announced in August 2010. Finally, an additional $0.4 million in Department of Defense (DoD) funding to advance Energy Focus LED Intellitube technology and applications was announced in August 2010. In addition, we completed qualification of seven families of solid state lighting fixtures developed under Naval Sea Systems Command (NAVSEA) and DARPA contracts. The Company is currently shipping these products to the United States Navy.

2009:

We were awarded $5.2 million in research contracts and grants in 2009. In March 2009, the DoD selected Energy Focus to receive a Phase I SBIR grant to begin the development of a Solid State Infrared Replacement for the M-278 Flare for the United States Army s Hydra Rocket System. In July 2009, the Naval Research Warfare Center awarded us a $1.4 million contract to develop and produce solid state lighting fixtures for use on Virginia Class attack submarines. In August 2009, DARPA awarded us a $0.5 million SBIR extension grant to develop and produce solid state lighting fixtures for general use on United States Navy ships. In September 2009, we entered into a $3.1 million contract with the VHESC Consortium to deliver advanced optics research to enable development of high-efficiency, low-cost photovoltaic-based solar cells. Also, in September, we entered into a $0.1 million Agreement with the Department of Energy for a Phase I SBIR project to investigate methods of using coatings to improve color consistency for Metal Halide lamps. In October 2009, we entered into an additional $0.1 million, twelve-month contract with the VHESC Consortium to continue advanced solar research on low-cost energy-efficient spectrum splitting technologies.

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Intellectual Property

We have a policy of seeking to protect our intellectual property through patents, license agreements, trademark registrations, confidential disclosure agreements and trade secrets, as management deems appropriate. As of December 31, 2011, our intellectual property portfolio consisted of 75 issued United States and foreign patents, various pending United States patent applications, and various pending Patent Cooperation Treaty patent applications filed with the World Intellectual Property Organization that serves as the basis of national patent filings in countries of interest. Our issued patents expire at various times between September 2014 and May 2031. Generally, the term of patent protection is twenty years from the earliest effective filing date of the patent application. There can be no assurance, however, that our issued patents are valid or that any patents applied for will be issued. There can be no assurance that our competitors or customers will not copy aspects of our lighting systems or obtain information that we regard as proprietary. There can also be no assurance that others will not independently develop products similar to ours. The laws of some foreign countries in which we sell or may sell our products do not protect proprietary rights to products to the same extent as do the laws of the United States.

We are aware that a large number of patents and pending patent applications exist in the field of fiber optic technology and LED lighting. We are also aware that certain competitors hold and have applied for patents related to fiber optic lighting and LED lighting. Although, to date, we have not been involved in litigation challenging our intellectual property rights, we have, in the past, received communications from third parties asserting rights over our patents or that our technology infringes upon intellectual property held by such third parties. On January 29, 2010, a competitor and former supplier filed a complaint against the Company in the Court of Chancery of the State of Delaware, alleging that we had misused proprietary trade secrets, breached a contract, and engaged in deceptive trade practices relating to one of our lighting products. The complaint sought injunctive relief and damages. We answered the complaint and filed a counterclaim for breach of contract. The parties settled and dismissed the case in the second quarter of 2011. Neither the defense of the lawsuit nor the implementation of the settlement has had an adverse effect on our financial condition, cash flows, or results of operations.

We are not currently engaged in any other litigation, and do not anticipate becoming involved in any litigation in the foreseeable future. However, we may be required to engage in litigation to protect our patent rights or to defend against the claims of others. There can be no assurance that third parties will not assert additional claims that our products infringe upon third-party patents or other intellectual property rights or that, in case of a dispute, licenses to such technology will be available, if at all, on reasonable terms. In addition, we may need to take further legal action to enforce our intellectual property rights in the future. In the event of litigation to determine the validity of any third-party claims or claims by us against third parties, such litigation, whether or not determined in our favor could result in significant expense to us and divert the efforts of our technical and management personnel from productive tasks. Also, in the event of an adverse ruling in such litigation, we might be required to expend significant resources to develop non-infringing technology or to obtain licenses to the infringing technology, and the licenses may not be available on acceptable terms. In the event of a successful claim against us and our failure to develop or license a substitute technology, our operating results could be adversely affected.

Backlog

We typically ship standard products within a few days after receipt of order. Custom products are shipped within 30-60 days of receipt of order. Generally, there is not a significant backlog of orders except at year-end. Our products-based backlog at the end of 2011 was $1.9 million, compared to $1.5 million at the end of 2010. Our solutions-based backlog on awarded contracts totaled approximately $2.0 million compared to $3.5 million at the end of 2010. Revenues from our 2011 backlog are recognized over the course of 2012 and are recognized as the services are performed or the materials are delivered. Historically, materials have accounted for approximately 50% of the total recognized project revenues and auditing and engineering costs have accounted for approximately 10% of the total recognized project revenues. The remaining project revenues are recognized on a percentage of completion basis as installation services are performed.

Competition

Our commercial lighting products compete against a variety of lighting products, including conventional light sources such as: incandescent light bulbs, metal halide lamps, LEDs, compact fluorescent lamps, competitive fiber optic lighting systems, and decorative lighting technologies. Our ability to compete depends substantially upon the superior performance and lower lifecycle cost of our products and services. Principal competitors in our markets include: large lamp manufacturers, lighting fixture companies, distributors, lighting retrofit companies, and ESCO s whose financial resources may substantially exceed ours. These competitors may introduce new or improved products that may reduce or eliminate some of the competitive advantage of our products. We anticipate that the primary competition to our products will come from new technologies that offer increased energy efficiency, lower maintenance costs, and/or lower heat radiation. In certain applications, we compete with LED systems produced by large lighting companies such as Philips and General Electric. In traditional commercial lighting applications, we compete primarily with local and regional lighting manufacturers that, in many cases, are more established in their local markets than our Company. In traditional commercial lighting, fiber optic lighting products are offered by a number of smaller companies, some of which compete aggressively on price. Some of these competitors offer products with performance characteristics similar to those of our products. Additionally, some conventional lighting companies now manufacture or license fiber optic lighting systems that compete with our products.

Our pool lighting products compete with other sources of in-pool lighting, including colored and color-changing underwater lighting, and pool accent lighting. Principal competitive factors include: price, performance, ease of installation, and maintenance requirements. In the pool lighting market, we face competition from suppliers and distributors who bundle lighting and non-lighting products and sell these packages to pool builders and installers. In addition, we face competition directly from manufacturers who produce their own lighting systems and components. In this market, competitive products are offered by Pentair s American Products Division, a major manufacturer of pool equipment and supplies, as well as Next Steps LLC. In the spa lighting business, spa manufacturers install LED lighting systems during the manufacturing process. We intend to develop new lighting products that are complementary to traditional pool lights currently sold by pool equipment suppliers. To maximize the sales of these new products, we continue to leverage our well-established presence in the domestic pool lighting market.

The market for lighting energy solutions is fragmented and differs in the public and private sector markets. Serving the private sector markets, our National Accounts solutions business competes against in-house resources, electrical contractors, traditional lighting fixture manufacturers, and non-traditional ESCO s that are focused on commercial and industrial customers. In the public sector, our SRC solutions business competes against other lighting retrofit companies, as well as some traditional ESCO s that self-perform the lighting component of their projects. In both markets, we compete primarily on the basis of financial impact, technology, light quality and design, client relationships, lighting application knowledge, energy efficiency, customer service, and marketing support.

Insurance and Bonding

All of our properties and equipment are covered by insurance and we believe that such insurance is adequate. In addition, we maintain general liability and workers compensation insurance in amounts that we believe are consistent with our risk of loss and industry practice. In regards to our lighting solutions-based business, we are often required to provide various types of surety bonds as an additional level of security of our performance. We have a surety arrangement with one surety for which we provide cash collateral relating to our surety bonding program. We believe that this cash collateral is sufficient to support our current bonding requirements.

Employees

As of December 31, 2011, we had 67 associates, 17 of whom are located in the United Kingdom and 50 in the United States. None of our associates are subject to any collective bargaining agreement.

Business Segments

We have two reportable segments: product-based sales featuring pool lighting and general commercial lighting, each of which markets and sells lighting systems, and solutions-based sales providing turnkey, high-quality, energy-efficient lighting application alternatives. Our products are sold primarily in North America, Europe, and the Far East through a combination of direct sales employees, independent sales representatives, and various distributors. Our solutions-based sales are designed to enhance total value by positively impacting customers profitability, the environment, and the communities it serves. These solutions are sold in North America through our direct sales employees as well as our SRC subsidiary, and include not only our proprietary energy-efficient lighting solutions, but also sourced lighting systems, energy audits, and service agreements.

Available Information

Our Web site is located at http://www.efoi.com. We make available free of charge, on or through our Web site, our annual, quarterly, and current reports, as well as any amendments to those reports, as soon as reasonably practicable after electronically filing such reports with the Securities and Exchange Commission (SEC). Information contained on our Web site is not part of this report.

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Item 1A. Risk Factors

We have a history of operating losses and may incur losses in the future.

We have experienced net losses of $6.1 million and $8.5 million for the years ended December 31, 2011 and 2010, respectively. As of December 31, 2011, we had an accumulated deficit of $74.9 million. Although management continues to address many of the legacy issues that have historically burdened our financial performance, we still face challenges in order to reach profitability. In order for us to attain profitability and growth, we will need to successfully address these challenges, including the continuation of cost reductions throughout our organization, improvement in gross margins, execution of our marketing and sales plans for our turnkey energy-efficient lighting solutions business, the development of new technologies into sustainable product lines, and continued improvements in our supply chain performance.

Although we are optimistic about reaching profitability, there is a risk that our business may not be as successful as we envision. Our independent public accounting firm has issued an opinion in connection with our 2011 Annual Report on Form 10-K raising substantial doubt as to our ability to continue as a going concern. This opinion stems from our historically poor operating performance, and our historical inability to generate sufficient cash flow to meet obligations and sustain operations without obtaining additional external financing. Although we are optimistic about obtaining the funding necessary for us to continue as a going concern, there can be no assurances that this objective will be successful. As such, we will continue to review and pursue selected external funding sources, if necessary, to execute these objectives including, but not limited to, the following:

- obtain financing from traditional or non-traditional investment capital organizations or individuals,
- potential sale or divestiture of one or more operating units, and
- obtain funding from the sale of our common stock or other equity or debt instruments.

Obtaining financing through the above-mentioned mechanisms contains risks, including:

- loans or other debt instruments may have terms and/or conditions, such as interest rate, restrictive covenants, and control or revocation provisions, which are not acceptable to management or our Board of Directors,
- the current environment in capital markets combined with our capital constraints may prevent us from being able to obtain any debt financing,
- financing may not be available for parties interested in pursuing the acquisition of one or more of our operating units, and
- additional equity financing may not be available to us in the current capital environment and could lead to further dilution of shareholder value for current shareholders of record.

Downturns in general economic conditions and construction trends could continue to materially and adversely affect our business.

Downturns in general economic and market conditions, both nationally and internationally, could have a material adverse effect on our business. In our legacy businesses, sales of our lighting products depend significantly upon the level of new building construction, which are affected by housing market trends, interest rates and the weather. Sales of our pool and spa lighting products depend substantially upon the level of new pool construction, which is also affected by housing market and construction trends. In addition, due to the seasonality of construction, sales of swimming pool and lighting products, and thus our revenue and income, have tended to be significantly lower in the first quarter of each year. Our future results of operations may experience substantial fluctuations from period to period as a consequence of these factors, and such conditions and other factors affecting capital spending may affect the timing of orders. An economic downturn coupled with a decline in our net

sales could adversely affect our ability to meet our working capital requirements, support our capital requirements and growth objectives, or could otherwise adversely affect our business, financial condition, and results of operations. As a result, any general or market-specific economic downturns, particularly those affecting new building construction and renovation, or that cause end-users to reduce or delay their purchases of lighting products, services, or retrofit activities, would have a material adverse effect on our business, cash flows, financial condition, and results of operations.

An inability to obtain bonding could limit the number of solutions-based projects we are able to pursue.

As is customary in the construction business, we are often required to provide surety bonds to secure our performance under construction contracts. Our ability to obtain surety bonds primarily depends upon our capitalization, working capital, past performance, management expertise, and other external factors, including the overall capacity of the surety market. Surety companies consider such factors in relation to the amount of our backlog and their underwriting standards, which may change from time to time. The surety industry has undergone significant changes with several companies withdrawing completely from the industry or significantly reducing their bonding commitment. In addition, certain reinsurers of security risk have limited their participation in this market. Therefore, we could be unable to obtain surety bonds, when required, which could adversely affect our future results of operations and revenues.

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We may not fully recognize the anticipated revenue reported in our solutions-based backlog.

The contracts we enter into, related to our solutions-based business, can be relatively large and typically range in the amount of $0.1 million to as much as $4.0 million. As of December 31, 2011, our solutions-based backlog of uncompleted work was $2.0 million. We include a project in our backlog when a contract is awarded or a letter of intent is obtained. The revenue projected in our backlog may not be realized or, if realized, may not result in the revenue or profits expected. If a project included in our backlog is canceled, suspended or the scope of work is reduced, it would result in a reduction to our backlog which could materially affect the revenues and profits realized. If a customer should cancel a project, we may be reimbursed for costs expended to date but would have no contractual right to the total projected revenues included in our backlog. Cancellations or delays of significant projects could have a material adverse effect on future revenues, profits and cash flows.

If we are unable to accurately estimate the risks, revenues or costs associated with a project, we may achieve a lower than expected profit or incur a loss on that project.

For the solutions-based segment of our business, we generally enter into fixed price contracts. Fixed price contracts require us to perform a contract for a specified price regardless of our actual costs. As a result, the profit that we realize on a contract is dependent on the extent to which we successfully manage our costs and overruns. Cost overruns, whether due to inefficiency, inaccurate estimates or other factors, result in lower profit or a loss on a project. A majority of our contracts are based on cost estimates that are subject to a number of assumptions. If our estimates of the risks, revenues or costs prove inaccurate or circumstances change, we may incur a lower profit or a loss on that project.

The percentage-of-completion method of accounting for contract revenues may result in material adjustments, which could result in a charge against earnings.

We recognize certain contract revenues using the percentage-of-completion method. Under this method, percentage-of-completion is determined by relating the actual cost of the work performed to date to the current estimated total cost of the respective contracts. When the estimate on a contract indicates a loss, we record the entire loss during the accounting period in which it is estimable. In the ordinary course of business, at a minimum on a quarterly basis, we prepare updated estimates of the total forecasted revenue, cost and profit or loss for each contract. The cumulative effect of revisions in estimates of the total forecasted revenue and costs during the course of the work is reflected in the accounting period in which the facts that caused the revision become known. To the extent that these revisions result in an increase, a reduction or elimination of previously reported contract profit, we recognize a credit or a charge against current earnings, which could be material.

We have international sales and are subject to risks associated with operating in international markets.

For the years ending December 31, 2011 and 2010 net sales of our products outside of the United States represented approximately 15.6% and 10.9% respectively, of our total net sales from continuing operations. We generally provide technical expertise and limited marketing support, while our independent international distributors generally provide sales staff, local marketing, and product services. We believe our international distributors are better able to service international markets due to their understanding of local market conditions and best business practices. International business operations are subject to inherent risks, including, among others:

- unexpected changes in regulatory requirements, tariffs, and other trade barriers or restrictions,
- longer accounts receivable payment cycles and the difficulty of enforcing contracts and collecting receivables through certain foreign legal systems,
- difficulties in managing and staffing international operations,
- potentially adverse tax consequences,
- the burdens of compliance with a wide variety of foreign laws,

import and export license requirements and restrictions of the United States and each other country in which we operate,

exposure to different legal standards and reduced protection for intellectual property rights in some countries,

currency fluctuations and restrictions,

political, social, and economic instability, including war and the threat of war, acts of terrorism, pandemics, boycotts, curtailment of trade or other business restrictions,

periodic foreign economic downturns, and

sales variability as a result of fluctuations in foreign currency exchange rates.

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If we are unable to respond effectively as new lighting technologies and market trends emerge, our competitive position and our ability to generate revenue and profits may be harmed.

To be successful, we will need to keep pace with rapid changes in light-emitting diode (LED) technology, changing customer requirements, new product introductions by competitors and evolving industry standards, any of which could render our existing products obsolete if we fail to respond in a timely manner. Development of new products incorporating advanced technology is a complex process subject to numerous uncertainties. We have previously experienced, and could in the future, experience delays in the introduction of new products. If effective new sources of light other than LED are discovered, our current products and technologies could become less competitive or obsolete. If others develop innovative proprietary lighting technology that is superior to ours, or if we fail to accurately anticipate technology and market trends, respond on a timely basis with our own development of new products and enhancements to existing products, and achieve broad market acceptance of these products and enhancements, our competitive position may be harmed and we may not achieve sufficient growth in our net sales to attain or sustain profitability.

If we are not able to compete effectively against companies with greater resources, our prospects for future success will be jeopardized.

The lighting industry is highly competitive. In the high performance lighting markets in which we sell our advanced lighting systems, our products compete with lighting products utilizing traditional lighting technology provided by many vendors. Additionally, in the advanced lighting markets in which we have primarily competed to date, competition has largely been fragmented among a number of small manufacturers. However, some of our competitors, particularly those that offer traditional lighting products, are larger companies with greater resources to devote to research and development, manufacturing, and marketing.

Moreover, in the general lighting market, we expect to encounter competition from an even greater number of companies. Our competitors are expected to include the large, established companies in the general lighting industry, such as General Electric, Osram Sylvania and Royal Philips Electronics. Each of these competitors has undertaken initiatives to develop LED technology. These companies have global marketing capabilities and substantially greater resources to devote to research and development and other aspects of the development, manufacture and marketing of LED lighting products than we possess. We may also face competition from traditional lighting fixture companies, such as Acuity Brands Lighting, Cooper Lighting, Hubbell Lighting, Lithonia Lighting, and Royal Philips Electronics. The relatively low barriers to entry into the lighting industry and the limited proprietary nature of many lighting products also permit new competitors to enter the industry easily.

In each of our markets, we also anticipate the possibility that LED manufacturers, including those that currently supply us with LEDs, may seek to compete with us. Our competitors lighting technologies and products may be more readily accepted by customers than our products. Additionally, to the extent that competition in our markets intensifies, we may be required to reduce our prices in order to remain competitive. If we do not compete effectively, or if we reduce our prices without making commensurate reductions in our costs, our net sales and profitability, and our future prospects for success, may be harmed.

If we are unable to obtain and adequately protect our intellectual property rights, our ability to commercialize our products could be substantially limited.

We consider our technology and processes proprietary. If we are not able to adequately protect or enforce the proprietary aspects of our technology, competitors may utilize our proprietary technology and our business, financial condition, and results of operations could be adversely affected. We protect our technology through a combination of patent, copyright, trademark and trade secret laws, employee and third-party nondisclosure agreements, and similar means. Despite our efforts, other parties may attempt to disclose, obtain or use our technologies. Our competitors may also be able to independently develop products that are substantially equivalent or superior to our products or slightly modify our patents. In addition, the laws of some foreign countries do not protect our proprietary rights as fully as do the laws of the United States. As a result, we may not be able to protect our proprietary rights adequately in the United States or abroad.

As of December 31, 2011, our intellectual property portfolio consisted of 75 issued United States and foreign patents, various pending United States patent applications, and various pending Patent Cooperation Treaty patent applications filed with the World Intellectual Property Organization that serves as the basis of national patent filings in countries of interest. Because our patent position involves complex legal, scientific, and factual questions, the issuance, scope, validity, and enforceability of our patents cannot be predicted with certainty. Our issued patents may be invalidated or their enforceability challenged, and they may not provide us with competitive advantages against others with similar products and technology. Furthermore, others may independently develop similar products or technology or duplicate or design around any technologies that we have developed. We may receive notices that claim we have infringed upon the intellectual property of others. Even if these claims are not valid, they could subject us to significant costs. We have engaged in litigation in the past and litigation may be necessary in the future to enforce our intellectual property rights or to determine the validity and scope of the proprietary rights of others. Litigation may also be necessary to defend against claims of infringement or invalidity by others. An adverse outcome in litigation or any similar proceedings could subject us to significant liabilities to third parties, require us to license disputed rights from others or require us to cease marketing or using certain products or technologies. We may not be able to obtain any licenses on acceptable terms, if at all. We also may have to indemnify certain customers if it is determined that we have infringed upon or misappropriated another party s intellectual property.

Any of these results could adversely affect our business, financial condition, and results of operations. In addition, the cost of addressing any intellectual property litigation claim, both in legal fees and expenses, and the diversion of management resources, regardless of whether the claim is valid, could be significant and could materially harm our business, financial condition and results of operations.

If critical components that we currently purchase from a small number of third-party suppliers become unavailable for any reason or third-party manufacturers otherwise experience delays, we may incur delays in shipment, which would damage our business.

We depend on others to manufacture a significant portion of the component parts incorporated into our products. We purchase our component parts from third-party manufacturers that serve the advanced lighting systems market and believe that alternative sources of supply are readily available for most component parts. However, consolidation in the lighting industry could result in one or more current suppliers being acquired by a competitor, rendering us unable to continue purchasing necessary amounts of key components at competitive prices.

In an effort to reduce manufacturing costs, we have outsourced the production of certain parts and components, as well as finished goods in our product lines, to a number of overseas suppliers. We expect to outsource all of the production for selected products. While we believe alternative sources for the production of these products are available, we have selected these particular manufacturers based on their ability to consistently produce these products per our specifications, ensuring the best quality product at the most cost effective price. We depend on our suppliers to satisfy performance and quality specifications and to dedicate sufficient production capacity within scheduled delivery times. Although we maintain contracts with selected suppliers, we may be vulnerable to unanticipated price increases, payment term changes, and product shortages. Accordingly, the loss of all or one of these suppliers or delays in obtaining shipments could have a material adverse effect on our operations until such time as an alternative supplier could be found. We may be subject to various import duties applicable to materials manufactured in foreign countries and, in addition, may be affected by various other import and export restrictions, as well as other considerations or developments impacting upon international trade, including economic or political instability, shipping delays, and product quotas. These international trade factors will, under certain circumstances, have an impact on the cost of components, which will, in turn, have an impact on the cost to us of the manufactured product, and the wholesale and retail prices of our products.

If the companies to which we outsource the manufacture of our products fail to meet our requirements for quality, quantity, and timeliness, our revenue and reputation in the marketplace could be harmed.

We outsource a significant portion of the manufacture and assembly of our products and we expect to outsource all of the production of many of our products. We currently depend on a small number of contract manufacturers to manufacture our products at plants in various locations throughout the world, primarily in the United States, Mexico, China, Australia, and Taiwan. These manufacturers supply most of the necessary raw materials and provide all necessary facilities and labor to manufacture our products. We currently do not have long-term contracts with some of these manufacturers. If these companies were to terminate their arrangements with us without adequate notice, or fail to provide the required capacity and quality on a timely basis, we would be unable to manufacture and ship our lighting products until replacement manufacturing services could be obtained. To qualify a new contract manufacturer, familiarize it with our products, quality standards and other requirements, and commence volume production is a costly and time-consuming process. If it became necessary to do so, we may not be able to establish alternative manufacturing relationships on acceptable terms.

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Our reliance on contract manufacturers involves certain additional risks, including the following:

- lack of direct control over production capacity and delivery schedules,
- lack of direct control over quality assurance, manufacturing yields, and production costs,
- risk of loss of inventory while in transit from China, Mexico, Japan, Australia, and Taiwan, and
- risks associated with international commerce, particularly with China, Mexico, Japan, and Taiwan, including unexpected changes in legal and regulatory requirements, changes in tariffs and trade policies, risks associated with the protection of intellectual property and political and economic instability.

Any interruption in our ability to manufacture and distribute products could result in delays in shipment, lost sales, reductions in revenue and damage to our reputation in the market, all of which would adversely affect our business.

We depend on independent distributors and sales representatives for a substantial portion of our net sales, and the failure to manage, successfully, our relationships with these third parties, or the termination of these relationships, could cause our net sales to decline and harm our business.

We rely significantly on indirect sales channels to market and sell our products. Most of our products are sold through third-party independent distributors and sales representatives. In addition, these parties provide technical sales support to end-users. Our current agreements within these sales channels are non-exclusive with regard to lighting products in general, but exclusive with respect to LED lighting and fiber optic products. We anticipate that any such agreements we enter into in the future will be on similar terms. Furthermore, our agreements are generally short-term, and can be cancelled by these sales channels without significant financial consequence. We cannot control how these sales channels perform and cannot be certain that we or end-users will be satisfied by their performance. If these distributors and sales representatives significantly change their terms with us, or change their historical pattern of ordering products from us, there could be a significant impact on our net sales and profits.

Our products could contain defects or they may be installed or operated incorrectly, which could reduce sales of those products or result in claims against us.

Despite product testing, defects may be found in our existing or future products. This could result in, among other things, a delay in the recognition or loss of net sales, loss of market share or failure to achieve market acceptance. These defects could cause us to incur significant warranty, support and repair costs, divert the attention of our engineering personnel from our product development efforts, and harm our relationship with our customers. The occurrence of these problems could result in the delay or loss of market acceptance of our lighting products and would likely harm our business. Some of our products use line voltages (such as 120 or 240 AC), or are designed for installation in environments such as swimming pools and spas, which involve enhanced risk of electrical shock, injury or death in the event of a short circuit or other malfunction. Defects, integration issues or other performance problems in our lighting products could result in personal injury or financial or other damages to end-users or could damage market acceptance of our products. Our customers and end-users could also seek damages from us for their losses. A product liability claim brought against us, even if unsuccessful, would likely be time consuming and costly to defend.

If we are unable to attract or retain qualified personnel, our business and product development efforts could be harmed.

To a large extent, our future success will depend on the continued contributions of certain employees, such as our current Chief Executive Officer, Chief Financial Officer, Chief Operating Officer, and President. These and other key employees may be difficult to replace. Our future success will also depend on our ability to attract and retain qualified technical, sales, marketing, and management personnel, for whom competition is very intense. The loss of, or failure to attract, hire, and retain, any such persons could delay product development cycles, disrupt our operations, or otherwise harm our business or results of operations. We have been successful in hiring experienced energy solutions salespeople from leading firms in the industry but if these individuals are not successful in achieving our expectations, then planned sales may not occur and the anticipated net sales may not be realized.

A significant portion of our business is dependent upon the existence of government funding, which may not be available into the future and could result in a significant reduction in sales and could cause significant harm to our business.

A significant portion of our research and development efforts have been supported directly by government funding and were contracted for short periods, usually one to two years. Further, a significant portion of net sales generated by SRC are derived from state government funding and supported by federal government funding. If government funding is reduced or eliminated, there is no guarantee that we would be able to continue to fund our activities in these areas at their current levels, if at all. If we are unable to maintain our access to government funding in these areas, there could be a significant impact on our net sales and profits.

We believe that certification and compliance issues are critical to adoption of our lighting systems, and failure to obtain such certification or compliance would harm our business.

We are required to comply with certain legal requirements governing the materials in our products. Although we are not aware of any efforts to amend any existing legal requirements or implement new legal requirements in a manner with which we cannot comply, our net sales might be adversely affected if such an amendment or implementation were to occur.

Moreover, although not legally required to do so, we strive to obtain certification for substantially all our products. In the United States, we seek, and to date have obtained, certification on substantially all of our products from Underwriters Laboratories (UL® mark) or Intertek Testing Services (ETL® mark). Where appropriate in jurisdictions outside the United States and Europe, we seek to obtain other similar national or regional certifications for our products. Although we believe that our broad knowledge and experience with electrical codes and safety standards have facilitated certification approvals, we cannot ensure that we will be able to obtain any such certifications for our new products or that, if certification standards are amended, that we will be able to maintain such certifications for our existing products. Moreover, although we are not aware of any effort to amend any existing certification standard or implement a new certification standard in a manner that would render us unable to maintain certification for our existing products or obtain ratification for new products, our net sales might be adversely affected if such an amendment or implementation were to occur.

We must comply with regulatory requirements regarding internal control over financial reporting, corporate governance, and public disclosure, which will cause us to incur significant costs and our failure to comply with these requirements could cause our stock price to decline.

Section 404 of the Sarbanes-Oxley Act of 2002 requires that we annually evaluate and report on our systems of internal controls. These rules and regulations have increased our legal and compliance costs and made certain activities more time-consuming and costly. In the future, there may be material weaknesses in our internal controls that would be required to be reported in future Annual Reports on Form 10-K and/or Quarterly Reports on Form 10-Q. A negative reaction by the equity markets to the reporting of a material weakness could cause our stock price to decline.

We could issue additional common stock, which might dilute the book value of our common stock.

Our Board of Directors has the authority, without action or vote of our shareholders, to issue a sizeable part of our authorized but unissued shares. Such stock issuances could be made at a price that reflects a discount or a premium from the then-current trading price of our common stock. In addition, in order to raise capital or acquire businesses in the future, including future lighting retrofit businesses, we may need to issue securities or promissory notes that are convertible or exchangeable for shares of our common stock. These issuances would dilute shareholders percentage ownership interest, which would have the effect of reducing influence on matters on which our shareholders vote, and might dilute the book value of our common stock. Shareholders may incur additional dilution if holders of stock options, whether currently outstanding or subsequently granted, exercise those options, or if warrant holders exercise warrants purchasing shares of our common stock. If an insufficient amount of authorized, but unissued, shares of common stock exists to issue in the long term in connection with a subsequent equity financing or acquisition transactions, we may be required to ask our shareholders to authorize additional shares before undertaking, or as a condition to completing, a financing or acquisition transaction.

We may need to request our shareholders to authorize additional shares of common stock in connection with subsequent equity finance or acquisition transactions.

We are authorized to issue 60,000,000 shares of common stock, of which approximately 44,513,000 shares were issued and outstanding, as of March 2, 2012. An additional 15,364,000 shares have been reserved for issuance upon exercise of stock options and warrants outstanding. At our June 16, 2010 Annual Meeting, our shareholders increased the total number of authorized shares of common stock from 30,000,000 to 60,000,000. If an insufficient amount of authorized, but unissued, shares of common stock exists to issue in the long term in connection with a subsequent equity financing or acquisition transaction, we may be required to ask our shareholders to authorize additional shares before undertaking, or as a condition to completing, an offering or transaction. We cannot be assured that our shareholders would authorize an increase in the number of shares of our common stock.

Shares eligible for future sale may adversely affect the market for our common stock.

As of March 2, 2012, we had a significant number of convertible or derivative securities outstanding, including: (i) 2,307,000 shares of common stock issuable upon exercise of outstanding stock options at a weighted average exercise price of $2.27 per share, and (ii) 13,056,000 shares of common stock issuable upon exercise of our outstanding warrants at a weighted average exercise price of $0.94 per share. If or when these securities are exercised into shares of our common stock, the number of our shares of common stock outstanding will increase. Increases in our

outstanding shares, and any sales of shares, could have an adverse affect on the trading activity and market price of our common stock.

In addition, from time to time, certain of our shareholders may be eligible to sell all, or a portion of, their shares of common stock by means of ordinary brokerage transactions in the open market pursuant to Rule 144, promulgated under the Securities Act of 1933, or under effective resale prospectuses. Any substantial sale of our common stock pursuant to Rule 144 or any resale prospectus may have an adverse affect on the market price of our securities.

As a thinly-traded stock, large sales can and have placed negative pressure on our common stock price.

Our common stock, despite certain increases of trading volume from time to time, experiences periods when it could be considered thinly-traded. Financing or acquisition transactions resulting in a large number of newly issued shares that become immediately tradable, or other events that cause current shareholders to sell shares, could place negative pressure on the trading price of our stock. In addition, the lack of a robust secondary market may require a shareholder who desires to sell a large number of shares to sell those shares in increments over time in order to mitigate any adverse impact of the sales on the market price of our common stock.

We may be subject to legal claims against us or claims by us which could have a significant impact on our resulting financial performance.

At any given time, we may be subject to litigation, the disposition of which may have an adverse affect upon our business, financial condition, or results of operation. Information regarding our current legal proceedings is presented below in Part I, Item 3.

Item 1B. Unresolved Staff Comments

None.

Item 2. Properties

Our principal executive offices are located in approximately a 25,000 square foot facility in Solon, Ohio, under a lease agreement expiring on April 30, 2014. See Note 11, Commitments and Contingencies, to the Consolidated Financial Statements for additional information.

We also have leased facilities in Nashville, Tennessee, Pleasanton, California, and Berkshire, United Kingdom. In addition, we have a contract manufacturing facility near Tijuana, Mexico. We believe that our current facilities are adequate to support our current and anticipated operations.

Item 3. Legal Proceedings

On January 29, 2010, a competitor and former supplier filed a complaint against our Company in the Court of Chancery of the State of Delaware, alleging that the Company has misused proprietary trade secrets, breached a contract, and engaged in deceptive trade practices relating to one of our lighting products. The complaint sought injunctive relief and damages. The complaint was settled in June 2011. See Note 18, Legal Matters, to the Consolidated Financial Statements for additional information.

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

During the fourth quarter of the year ended December 31, 2011, there were no matters submitted to a vote of security holders.

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Executive Officers of the Registrant

The following is the name, age, and present position of each of our executive officers, as well as all prior positions held by each of them during the last five years and when each of them was first elected or appointed as an executive officer.

Name	Age	Current Position and Business Experience
Joseph G. Kaveski	51	**Chief Executive Officer and Director** May 2008 to present. Prior to joining Energy Focus, Mr. Kaveski led his own strategic consulting business, TGL Company. As a consultant he worked with equity investors and publicly traded companies on strategic initiatives and planning.
John M. Davenport	66	**President and Director** May 2008 to present. Chief Executive Officer July 2005 to May 2008. Chief Operating Officer July 2003 to July 2005. Vice President and Chief Technology Officer November 1999 to July 2003.
Eric W. Hilliard	44	**Chief Operating Officer and Vice President** November 2006 to present. Prior to joining Energy Focus, Mr. Hilliard served as a Business Manager at Saint Gobain s Aerospace Flight Structures Division from 2002 to 2006.
Mark J. Plush	62	**Chief Financial Officer and Vice President of Finance** July 2011 to present. Prior to joining Energy Focus, Mr. Plush served as Vice President and Chief Financial Officer with Keithley Instruments from 1998 to 2010.
Roger F. Buelow	39	**Chief Technology Officer and Vice President** July 2005 to present. Vice President of Engineering from February 2003 to July 2005.

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PART II

Item 5. Market for the Registrant s Common Equity, Related Stockholder Matters, and Issuer Purchases of Equity Securities

Our common stock is quoted on the Over The Counter Bulletin Board (OTCBB) under the symbol EFOI.OB. The following table sets forth the high, low, and close market prices per share for our common stock as reported by NASDAQ:

	High	Low	Close
First quarter 2011	$ 1.35	$ 0.91	$ 1.22
Second quarter 2011	1.16	0.38	0.48
Third quarter 2011	0.69	0.35	0.36
Fourth quarter 2011	0.47	0.17	0.20
First quarter 2010	$ 1.50	$ 0.65	$ 1.14
Second quarter 2010	1.50	0.97	1.21
Third quarter 2010	2.68	1.20	1.51
Fourth quarter 2010	1.55	0.90	0.95

There were approximately 122 holders of record of our common stock as of March 20, 2012, and we estimate that at that date there were approximately 3,257 additional beneficial owners.

We have not declared or paid any cash dividends, and do not anticipate paying cash dividends in the foreseeable future.

Stockholder Matters

On May 18, 2011, the NASDAQ Listing Qualifications Department had notified the Company that the bid price of its common shares had closed at less than $1.00 per share over the previous 30 consecutive business days and provided the Company with 180 days, or until November 14, 2011, to regain compliance with the NASDAQ Capital Market listing rule. On November 14, 2011, the Company s stock had not traded above $1.00 per share and, additionally, the Company was not in compliance with a second rule; shareholders equity was less than $5 million as set forth by NASDAQ Capital Market rules. Our stock began being listed on the OTCBB at the opening of markets on Tuesday, November 29, 2011. On December 15, 2011, The NASDAQ Stock Market announced that the Company s stock was delisted from The NASDAQ Capital Market.

At the 2011 Annual Meeting of Shareholders held on June 15, 2011, the shareholders approved an increase in the total number of shares of common stock that may be authorized for issuance under the 1994 Employee Stock Purchase Plan from 150,000 to 400,000.

On August 11, 2011 we issued five-year, detached warrants to Mark Plush, CFO of the Company, to purchase 125,000 shares of the Company s common stock at an exercise price of $.01 per share.

At the 2010 Annual Meeting of Shareholders held on June 16, 2010, the shareholders approved an increase in the total number of shares of common stock that may be awarded under the 2008 Incentive Stock Plan from 1,000,000 shares to 3,000,000 shares. In addition, our shareholders also approved an increase in the total number of authorized shares of common stock from 30,000,000 to 60,000,000.

In our subscription rights offering in the fall of 2009, an investor inadvertently purchased 1,000,000 shares of our common stock at $0.75 per share. We agreed to facilitate the sale of these shares to another shareholder or investor or to purchase them directly. A purchase of those shares by us would have severely depleted our cash-on-hand and working capital. After contacting selected shareholders and investors, we introduced the investor to The Quercus Trust (Quercus), our largest shareholder. We were informed on December 30, 2009, by the investor and Quercus, that Quercus had agreed to purchase those shares at $0.80 per share. At that time, the closing market price of a share of our common stock was approximately $0.65 per share. To facilitate the purchase of the 1,000,000 shares by Quercus, on December 30, 2009, our Board of Directors agreed with Quercus to reduce the exercise price of 1,560,062 warrants issued to Quercus, in the March 2008 private placement, to $0.01 per share upon the completion of the purchase of all 1,000,000 shares in 2010. The purchase of the 1,000,000 shares by Quercus was completed on February 20, 2010. We incurred a non-cash charge of $1.4 million for the quarter ended March 31, 2010 related to the valuation of the warrants to purchase shares of our common stock acquired by Quercus in our March 2008 equity financing. On April 28, 2010, Quercus exercised the 2008 warrants. Our shareholders approved the reduction in exercise price of the above mentioned warrants at the Annual Meeting of Shareholders on June 16, 2010.

On December 29, 2009, we issued five-year, detached warrants to John Davenport, President of the Company, and Quercus to purchase 125,000 and 150,000, respectively, of the Company s common stock at an exercise price of $.01 per share. Our shareholders approved the warrants at the Annual Meeting on June 16, 2010.

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On November 2, 2009, we closed our common stock rights offering to our shareholders that raised $3.3 million, net of expenses. Stockholder approval was not required. There were 7,500 stock options exercised during the calendar year 2011 and 15,000 stock option exercised during 2010.

Cumulative Total Return Comparison

The following graph compares the cumulative total shareholder return of the our common stock against the cumulative total return of the Russell 2000 Value Index, and a self-determined Old and New Peer Group for the period of the five fiscal years commencing December 31, 2006 and ending December 31, 2011. The graph and table assume that $100 was invested on December 31, 2006 in each of the Energy Focus, Inc. Common Stock, the Russell 2000 Value Index, and the self-determined Old and New Peer Group, and that all dividends were reinvested. The seven companies in the self-determined New Peer Group are: Lime Energy Co., Nexxus Lighting, Inc., LSI Industries, Inc., Orion Energy Systems, Inc., Lighting Science Group Corp., Cree, Inc., and Ameresco, Inc. The six companies in the self-determined Old Peer Group are: Cooper Industries, LTD., Pentair, Inc., Lime Energy Co., Nexxus Lighting, Inc., LSI Industries, Inc., and Orion Energy Systems, Inc. Cumulative total shareholder return for Energy Focus, Inc. Common Stock, the Russell 2000 Value Index, and the self-determined Old and New Peer Group are based upon the Energy Focus, Inc. fiscal year.

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Item 6. Selected Financial Data

The Selected Consolidated Financial Data set forth below have been derived from our Consolidated Financial Statements. It should be read in conjunction with the information appearing under the heading Management s Discussion and Analysis of Financial Condition and Results of Operations included in Item 7 of this report and the Consolidated Financial Statements and related notes found in Item 8 of this report.

SELECTED CONSOLIDATED FINANCIAL DATA

(IN THOUSANDS, EXCEPT PER SHARE DATA)

YEARS ENDED DECEMBER 31,	2011	2010	2009	2008	2007
OPERATING SUMMARY					
Net sales from continuing operations	$ 25,752	$ 35,129	$ 12,489	$ 20,032	$ 19,761
Gross profit from continuing operations	5,171	6,403	2,040	4,106	5,057
Net loss from continuing operations	(6,055)	(8,517)	(9,814)	(12,673)	(10,987)
Net loss from discontinued operations			(1,201)	(1,775)	(330)
Net loss	(6,055)	(8,517)	(11,015)	(14,448)	(11,317)
Net loss per share:					
Basic	$ (0.25)	$ (0.37)	$ (0.70)	$ (1.02)	$ (0.98)
Diluted	$ (0.25)	$ (0.37)	$ (0.70)	$ (1.02)	$ (0.98)
Shares used in per share calculation:					
Basic	24,669	22,791	15,763	14,182	11,500
Diluted	24,669	22,791	15,763	14,182	11,500
FINANCIAL POSITION SUMMARY					
Total assets	$ 13,778	$ 20,374	$ 17,378	$ 23,636	$ 29,104
Cash and cash equivalents	2,136	4,107	1,062	10,568	8,412
Credit line borrowings	701			1,904	1,159
Current portion of long-term borrowings	855	481		54	1,726
Long-term borrowings	955	1,344	715	245	314
Shareholders equity	1,468	6,658	11,505	16,789	21,618
Common shares outstanding	24,913	23,962	21,250	14,835	11,623

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

Overview

Energy Focus, Inc. and its subsidiaries (the Company) engage in the design, development, manufacturing, marketing, and installation of energy-efficient lighting systems and solutions where we serve two segments:

- solutions-based sales providing turnkey, high-quality, energy-efficient lighting application alternatives primarily to the existing public-sector building market; and
- product-based sales providing military, general commercial and industrial lighting, and pool lighting offerings, each of which markets and sells energy-efficient lighting systems.

We continue to evolve our business strategy to include providing our customers with turnkey, comprehensive energy-efficient lighting solutions, which use, but are not limited to, our patented and proprietary technology. Our product-based solutions include light-emitting diode (LED), fiber optic, high-intensity discharge (HID), fluorescent tube and other highly energy-efficient lighting technologies. Typical savings related to our current technology approximates 80% in electricity costs, while providing full-spectrum light closely simulating daylight colors. Our strategy also incorporates continued investment into the research of new and emerging energy sources including, but not limited to, LED and solar energy applications.

During 2011, we made major progress in our plan to reposition the Company for growth and profitability. This plan involved three major areas of focus which included:

- Dramatic reduction of operating expenses.
- Receipt of a $23.1 million order for the U.S. Navy to retrofit approximately 7% of the Naval fleet with LED lighting products, including Intellitube lamps. We invoiced the U.S. Navy $1.9 million through December for products and services related to this contract.
- Added sales resources and broadened our customer base at Stones River Companies, LLC (SRC) during the year, which has positioned us for growth in 2012 for our lighting retrofit business.

We were awarded $26.1 million in government supply contracts and in research contracts and grants in 2011. In March 2011, we received a $1.0 million grant from the State of Ohio Third Frontier to develop a photovoltaic wall-pack unit for outdoor LED lighting. In April 2011, we received a Phase 2 Small Business Technology Transfer (STTR) grant for $0.6 million from the National Aeronautics and Space Administration (NASA) for Innovative Solid State Lighting Replacements for Industrial and Test Facility Locations. In May 2011, we received a $0.4 million increase in funding for the Very High Efficiency Solar Cell (VHESC) program. In July 2011, we received a $1.0 million grant from the State of Ohio Third Frontier to develop an ultra-low cost light sensor to compliment IntelliTube , our LED based fluorescent replacement technology. Finally, in August 2011, we received a $23.1 million supply contract to provide LED fixtures and our proprietary IntelliTube LED lamps for use on the U.S. Navy Fleet. The government has the right to change quantities throughout the life of this supply contract.

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Results of Operations

The following table sets forth the percentage of net sales represented by certain items reflected on our Consolidated Statements of Operations for the years ended December 31:

	2011	2010	2009
Net sales	100.0%	100.0%	100.0%
Cost of sales	79.9	81.8	83.7
Gross profit	20.1	18.2	16.3
Operating expenses:			
Research and development	(2.0)	(0.6)	2.5
Sales and marketing	24.1	18.3	48.4
General and administrative	19.7	17.4	42.7
Loss on impairment		0.4	
Valuation of equity instruments	0.2	5.1	
Change in estimate of contingent liabilities	(1.6)		
Restructuring		0.1	1.0
Total operating expenses	40.4	40.7	94.6
Loss from operations	(20.3)	(22.5)	(78.3)
Other income (expense):			
Interest income	0.0	0.0	0.1
Interest expense	(3.3)	(1.6)	(0.7)
Other income (expense)	0.1	(0.1)	0.4
Loss from continuing operations before income taxes	(23.5)	(24.2)	(78.5)
Benefit from (provision for) income taxes	0.0	(0.0)	(0.1)
Net loss from continuing operations	(23.5)	(24.2)	(78.6)
Discontinued operations:			
Loss before income taxes of discontinued operations			(9.6)
Provision for income taxes			
Loss from discontinued operations			(9.6)
Net loss	(23.5)%	(24.2)%	(88.2)%

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Net Sales

Our sales breakdowns, by business segment, are as follows (in thousands):

	Year ending December 31,		
	2011	2010	2009
Solutions:			
Net sales - solutions	$ 9,563	$ 19,763	$
Products:			
Net sales - pool and commercial	11,911	12,265	11,561
Net sales - government products/R&D services	4,278	3,101	928
Total net sales - product segment	16,189	15,366	12,489
Total net sales from continuing operations	$ 25,752	$ 35,129	$ 12,489

Net sales from continuing operations were $25.8 million in 2011 compared with $35.1 million in 2010 and $12.5 million in 2009. The decrease in sales in 2011 is primarily related to $10.2 million of lower solution sales for SRC, due mainly to fewer contracts from two key Energy Services Companies (ESCO s). Net sales from this segment represented 37.1% of total net sales. Sales for pool and commercial products decreased slightly, $0.4 million, compared to 2010. Net sales from this segment represented 46.3% of total net sales. Slightly offsetting these decreases was an increase in government products/R&D services of $1.2 million. Net sales from this segment represented 16.6% of total net sales. The increase was due primarily to the U.S. Navy contract, $1.9 million of which was shipped through December 2011.

For the twelve months ended December 31, 2010, net sales from continuing operations were $35.1 million compared to $12.5 million in 2009, a $22.6 million increase. The increase is primarily related to $19.8 million of solution sales for SRC, which was acquired on December 31, 2009. Additionally, sales for government products/R&D services increased $2.2 million, which is related to revenue from E.I. DuPont de Nemours and Company as part of the VHESC Consortium being funded by DARPA. Net sales from the product segment increased $2.9 million over 2009 to $15.4 million, or 43.7% of total net sales. Of this amount, net sales for pool and commercial products increased $0.7 million, representing 34.9% of total net sales, and net sales from government products/R&D services increased $2.2 million over 2009, representing 8.8% of total net sales. The increase in the net sales of the product segment is primarily related to a slight improvement in customer confidence as it relates to the economy and a general softening within the markets in which we serve. Our solutions segment accounted for 56.3% of our total sales for 2010 and was derived primarily from the public sector markets such as state and municipal governments.

International Sales

We have a foreign manufacturing operation in the United Kingdom, and net sales and expenses from these operations are denominated in local currency, thereby creating exposures to changes in exchange rates. Fluctuations in this operation s respective currency may have an impact on our business, results of operations, and financial position. We currently do not use financial instruments to hedge our exposure to exchange rate fluctuations with respect to our international operations. As a result, we may experience foreign currency translation gains or losses due to the volatility of other currencies compared to the United States dollar, which may positively or negatively affect our results of operations attributed to these operations. For continuing operations, international net sales accounted for approximately 15.6% of net sales in 2011, as compared to 10.9% for 2010, and 36.5% for 2009. On a local currency basis, net sales increased 3.9% for our United Kingdom operation from 2010 levels. The breakdown of our global sales is as follows (in thousands):

	Year ending December 31,		
	2011	2010	2009
United States Domestic	$ 21,730	$ 31,314	$ 7,930
International	4,022	3,815	4,559
Total net sales from continuing operations	$ 25,752	$ 35,129	$ 12,489

Gross Profit

We had gross profit of $5.2 million in 2011 compared to $6.4 million in 2010. Total gross profit as a percentage of total net sales was 20.1% in 2011, compared to 18.2% in 2010. The $1.2 million decrease in gross profit was the result of lower sales, partially offset by approximately a $1.0 million reduction in manufacturing overhead costs as a result of our cost reduction efforts. Gross profit for the product segment was 22.5% while the gross profit for the solutions segment was 15.9% in 2011.

Gross profit in 2009 was $2.0 million, or 16.3% of net sales, compared to $6.4 million, or 18.2% of net sales in 2010. The increase in gross profit in 2010 compared to 2009 was the result of higher sales.

Operating Expenses

Research and Development

Gross research and development expenses were $4.5 million in 2011, a 50.5% increase from $3.0 million in 2010. This increase was due to higher salary expense, project and consultant costs as a result of developing Intellitube™ for the U.S. Navy contract. Patent expense also increased as a result of activities related to Intellitube™. In 2010, gross research and development expenses were $3.0 million, an 86.0% increase from $1.6 million incurred in 2009. This increase was due to higher salary expense and project costs as a result of an increase in the number of U.S. government contracts and grants.

Research and development expenses include salaries, contractor and consulting fees, supplies and materials, as well as costs related to other overhead items such as depreciation and facilities costs. Research and development costs are expensed as they are incurred.

Total government reimbursements are the combination of revenues and credits from government contracts.

The gross and net research and development spending along with credits from government contracts is shown in the following table (in thousands):

	Year ending December 31,		
	2011	2010	2009
Net Research & Development Spending			
Total gross research and development expenses	4,456	2,961	1,592
Cost recovery through cost of sales	(3,519)	(2,382)	(604)
Cost recovery and other Credits	(1,452)	(781)	(669)
Net research & development (income) / expense	$ (515)	$ (202)	$ 319

Sales and Marketing

Sales and marketing expenses were $6.2 million or 24.1% of net sales in 2011, compared to $6.4 million or 18.3% of net sales in 2010, a decrease of 3.4% year over year. This decrease is due primarily to lower commissions as a result of lower sales. In 2011, sales and marketing expenses for pool lighting amounted to $1.3 million, or 20.9% of total sales and marketing cost, whereas sales and marketing expense for commercial lighting was $1.4 million, or 22.7% of total marketing costs.

In 2010, sales and marketing expenses were $6.4 million, an increase of 6.1% compared to $6.0 million in 2009. In 2010, sales and marketing expenses for pool lighting amounted to $1.1 million, or 17.6% of total sales and marketing cost, whereas sales and marketing expense for commercial lighting was $1.4 million, or 22.3% of total marketing costs. In 2009, sales and marketing expenses for pool lighting amounted to $1.0 million, or 17.1% of total sales and marketing cost, whereas sales and marketing expense for commercial lighting was $5.0 million, or 82.9% of total marketing costs.

General and Administrative

General and administrative expenses were 19.7% of net sales in 2011, compared to 17.4% of net sales in 2010, and 42.7% of net sales in 2009. General and administrative expenses were $5.1 million in 2011, a 17.2% decrease, as compared to $6.1 million in 2010. This decrease was due to lower amortization of intangible assets from the acquisition of SRC, lower stock option expense and lower legal and accounting fees.

General and administrative expenses were $6.1 million in 2010, a 14.7% increase, as compared to $5.3 million in 2009. This increase was due primarily to the amortization of intangible assets related to the acquisition of SRC.

Loss on impairment

As of December 31, 2011, we have $0.7 million of goodwill on our books related to the acquisition of SRC in Nashville, Tennessee, which occurred on December 31, 2009. Management tests goodwill annually for impairment at the reporting unit level and determines fair value through the use of a discounted cash flow valuation model. Management determined there was no impairment as of 2011 or 2010.

Long-lived assets are reviewed for impairment whenever events or circumstances indicate the carrying amount may not be recoverable. In 2011, impairment tests were performed using undiscounted future cash flows to calculate the recoverable value of long-lived assets. All assets had undiscounted cash flows that were substantially in excess of their carrying value. As a result, management determined that there was not impairment. As a result of this review, the Company recorded an impairment charge of $156,000 in 2010, which represented the difference between the fair value of the assets and their carrying value and is included in the Consolidated Statements of Operations under the caption Loss on impairment .

Valuation of Equity Instruments

During the first quarter of 2010, we recognized a non-cash charge of $1.4 million related to the valuation of warrants to purchase shares of our common stock acquired by The Quercus Trust (Quercus) in our March 2008 equity financing. Furthermore, during the second quarter of 2010, we recognized non-cash charges of $0.3 million related to the valuation of 350,000 warrants issued to Lincoln Park Capital Partners, LLC. In addition during 2011, we recorded non-cash charges of an additional $0.1 million relating to the valuation of our common stock issued to Lincoln Park Capital Partners, LLC. Please refer to Note 12, Shareholders Equity, to the Consolidated Financial Statements for a discussion of these transactions.

Restructuring

We incurred no restructuring expense during 2011. For the twelve months ended December 31, 2010, we recognized restructuring expenses of $26 thousand. These expenses are associated with the relocation of our remaining manufacturing equipment and operations in Solon, Ohio to a third-party warehouse facility located in California. During the twelve months ended December 31, 2009, we incurred restructuring expenses of $0.1 million associated with relocating our manufacturing operations in the United States from Solon, Ohio to Mexico.

Other Income and Expenses

We had interest expense of $0.9 million, $0.6 million, and $88 thousand in 2011, 2010 and 2009, respectively. Interest expense is primarily related to our debt, which includes the amortization of debt discounts. Interest income was $4 thousand in 2011 compared to $6 thousand in 2010 and $15 thousand in 2009. Interest income consists of interest earned on deposits.

We have certain long-term leases. Payments due under these leases are disclosed below and in Note 11, Commitments and Contingencies, to the Consolidated Financial Statements and related notes included elsewhere in this report.

Discontinued Operations

As part of our strategy of evaluating the viability of our non-core businesses and our aggressive pursuit of capital funding, we determined that our German subsidiary, Lichtleit-Fasertechnik (LBM), was not directly aligned with our objective to become a leading provider of turnkey, comprehensive energy-efficient lighting solutions. Therefore, in the third quarter of 2009, we committed to a plan to sell our German subsidiary, LBM.

In December 2009, we completed the sale of our ownership in LBM for $0.2 million comprised of cash and a promissory note. Furthermore, we will receive an earn-out equal to ten percent (10%) of post-acquisition, pre-amortization, pre-tax profit for a period of 24 months commencing January, 2010. In March 2011, the Company received an earn-out payment in the amount of $27 thousand. Excluding this earn-out, we recorded a loss on disposal of subsidiary of $0.7 million. As part of this transaction, the purchaser assumed all rights to both tangible and intangible assets as well as all of the liabilities of LBM.

There were no net sales or losses from discontinued operations in 2011 or 2010. Net sales from discontinued operations for 2009 were $1.5 million. Losses from discontinued operations, net of taxes were $1.2 million in 2009. Included in the 2009 loss from discontinued operations, net of taxes was the loss on the sale of LBM of $0.7 million, and an impairment charge of $0.2 million that arose when the office building owned by LBM was sold during the restructuring of LBM into a sales office. We have reported the business described above as discontinued operations for all periods presented. For further information about discontinued operations, see Note 4, Discontinued Operations, to the Consolidated Financial Statements.

Income Taxes

We provided a full valuation allowance against our United States deferred tax assets in 2011, 2010 and 2009. The net deferred tax assets for 2011, 2010 and 2009 were $2 thousand, $14 thousand, and $11 thousand for our United Kingdom subsidiary, which has been profitable in prior years. We had no net deferred liabilities at December 31, 2011, 2010 or 2009. There were no Federal tax expenses for the United States operations in 2011, 2010 and 2009, as any expected benefits were offset by an increase in the valuation allowance.

Net Loss

The net loss was $6.1 million for 2011, a decrease of $2.5 million from our net loss of $8.5 million for 2010. Included in the net loss for 2010 are non-cash charges of $2.0 million related to a charge for the impairment of long-lived assets and the valuation of equity instruments. This compares to the net loss of $11.0 million in 2009.

Liquidity and Capital Resources

Cash and Cash Equivalents

At December 31, 2011, our cash and cash equivalents were $2.1 million, compared to $4.1 million at December 31, 2010. This 2011 balance includes restricted cash of $19 thousand, compared to $0.1 million in 2010, which relates to funds received from a grant from/for a branch of the United States government. We had $2.5 million in borrowings as of December 31, 2011 and $1.8 million as of December 31, 2010. The net decrease in cash and cash equivalents was $2.0 million for the twelve months ended December 31, 2011.

At December 31, 2010, our cash and cash equivalents were $4.1 million, compared to $1.1 million at December 31, 2009. We had $1.8 million in borrowings as of December 31, 2010 and $0.7 million in borrowings as of December 31, 2009. The net increase in cash and cash equivalents was $3.0 million for the twelve months ended December 31, 2010. Cash proceeds of $3.8 million were received in November 2009 from the issuance of rights to purchase common stock. On December 31, 2009, $3.7 million of cash was disbursed related to the acquisition of SRC and related bond securitization. Excluding bonding securitization, net cash disbursements related to the acquisition of SRC were $1.2 million.

In November, 2009, we received an additional $3.3 million in equity financing, net of expenses by selling 4,813,000 shares of common stock in a registered offering. The investment was made by numerous current Energy Focus shareholders. The investment was made under our Company s registration statement for a $3.5 million common stock subscription rights offering. Under the terms of the rights offering, we distributed, at no charge to our shareholders, transferable rights to purchase up to 3,500,000 of our common stock at the established subscription price per share of $0.75, which was set by our Board of Directors. At the time the offering began, we distributed to each shareholder one transferable right for each share of common stock owned by the shareholder. Each right entitled the holder to purchase one share of our common stock, par value $0.0001 per share, subject to a maximum of 4,600,000 shares to be issued in the offering. Shareholders were entitled to subscribe for shares not subscribed for by other shareholders.

Cash (Used in) Provided by Operating Activities

Net cash (used in) provided by operating activities primarily consists of net losses adjusted by non-cash items, including depreciation, amortization, stock-based compensation, loss on impairment, and the effect of changes in working capital. In 2011, net cash used in continuing operating activities was $2.6 million compared to net cash provided of $1.5 million in 2010 and net cash used of $10.1 million in 2009. Cash decreased during 2011 by a net loss of $6.1 million, which was partially offset by $2.4 million of non-cash charges to net income and a $1.0 million decrease in net assets and liabilities. Cash increased in 2010 primarily due to $6.3 million of non-cash charges to income, a decrease in net assets and liabilities of $3.7 million, partially offset by an $8.5 million net loss. Cash used in 2009 was $10.6 million and was the result of $11.0 million of net losses.

There was no cash used in discontinued operating activities in 2011 or 2010. Net cash used in discontinued operating activities was $0.4 million for 2009.

Cash Used in Investing Activities

Net cash used in continuing investing activities was $0.2 million in 2011 and $0.3 million in 2010, primarily for the purchase of property and equipment. Net cash used in 2009 was $1.7 million, primarily for the acquisition of SRC.

There was no cash provided by discontinued investing activities in 2011 or 2010. Net cash provided by discontinued investing activities was $0.8 million for 2009.

Cash Provided by Financing Activities

Net cash provided by continuing financing activities was $0.9 million in 2011, compared to $1.8 million in 2010 and $2.4 million in 2009. In 2011, cash proceeds from borrowings were $0.6 million and $0.7 million from a credit facility, which were reduced by $0.9 million for debt repayments. Cash proceeds from stock issuances, net of expenses, provided an additional $0.5 million. In 2010, proceeds from borrowings were $1.2 million and cash proceeds from stock issuances, net of expenses, provided an additional $0.7 million. In 2009, proceeds from stock issuances, net of expenses, provided $3.5 million of additional working capital. Also in 2009, additional long-term borrowings of $0.6 million were reduced by debt repayments of $1.8 million. In 2011, the cash provided by financing activities was the result of Lincoln Park Capital Fund LLC purchases from a shelf registration. In 2010, the cash provided by financing activities was primarily the result of us issuing a secured subordinated note payable to EF Energy Partners. The additional working capital provided by financing activities in 2009 was related to a subscription rights offering.

There was no cash used in discontinued financing activities in 2011 or 2010. Net cash used in discontinued financing activities was $0.4 million for 2009.

The net decrease in cash of $2.0 million over the prior year was primarily the result of cash used by operating activities, which resulted in an ending cash balance of $2.1 million as of December 31, 2011. This compares to a net increase in cash of $3.0 million in 2010 and a net decrease of $9.5 million in cash in 2009.

Debt

Credit Facilities

On December 22, 2011, we entered into a $4.5 million revolving line of credit with Rosenthal & Rosenthal. The total loan amount available to us under the line of credit is equal to 85% of our net amount of eligible receivables, plus available inventory (the lesser of 50% of the lower of cost or market value of eligible inventory, or $0.3 million). The credit facility is secured by a lien on our domestic assets. The interest rate for borrowing on accounts receivable is 8.5%, on inventories 10.0% and on overdrafts 13.0%. Additionally, there is an annual 1% facility fee on the entire amount of the credit facility, $4.5 million, payable at the beginning of the year. The Credit Facility is a three year agreement, expiring on December 31, 2014, unless terminated sooner. There are liquidated damages if the Credit Facility is terminated prior to December 31, 2014, which are based on the maximum credit facility amount then in effect. The damages are: 3% if terminated prior to the first anniversary of the closing date, 2% if terminated prior to the second anniversary of the closing date, and 1% if terminated prior to the third anniversary of the closing date. We are required to comply with certain financial covenants, measured quarterly, including, as defined in the agreement: a tangible net worth amount and a working capital amount. We were in compliance with the financial covenants at December 31, 2011.

On October 15, 2008, we entered into a one year credit agreement with Silicon Valley Bank (SVB) incorporating a $4.0 million revolving line of credit facility. Borrowings under this agreement were collateralized by our assets, including intellectual property, and bore interest at the SVB Prime Rate plus 1%. We were required to maintain 85% of our cash and cash equivalents in operating and investment accounts with SVB and were required to comply with certain covenant requirements, including a tangible net worth covenant. At December 31, 2008, we were not in compliance with the tangible net worth covenant requirement and such condition continued throughout 2009. As such, we entered into a series of loan modification and forbearance agreements with effective dates ranging from January 31, 2009 through November 17, 2009. In conjunction with these forbearance agreements, the terms of the credit facility were revised culminating in a reduction to our revolving line of credit to $1.3 million with a maturity date of October 15, 2009 and a change in the rates of interest charged throughout 2009 in the range of SVB Prime Rate plus 1.5% to 3.0%. During the third quarter of 2009, SVB informed us that it did not intend to renew our revolving line of credit when it was set to expire on October 15, 2009. Ultimately, we were able to extend the maturity date of this credit facility to December 31, 2009 at which time we liquidated the outstanding balance of $0.3 million on the line of credit.

Borrowings

On August 11, 2011, we entered into a Letter of Credit Agreement (LOC) with Mark Plush, Chief Financial Officer of the Company, in the amount of $0.3 million. The LOC has a term of 24 months and bears interest at a rate of 12.5% on the face amount. The LOC is collateralized by a cash deposit with an insurance company issuing the Company s contract performance bonds and by 32% of the unpledged stock of Crescent Lighting, Ltd., our subsidiary. As an incentive to enter into the LOC s, we issued five-year, detached warrants to purchase 125,000 shares of common stock at an exercise price of $0.01 per share. The LOC plan was approved by our shareholders at the Annual Meeting on June 16, 2010.

On August 1, 2011, we entered into a cognovit promissory note with Keystone Ruby, LLC, the Landlord of our Solon facility, in the amount of $0.3 million for past due rent. The balance is to be paid over 72 equal installments ending on April, 2017. However, the terms of the note call for

an immediate payment of the remaining principal balance if we do not renew our lease by December 31, 2013. The interest rate on the loan is 10.0% per annum.

On March 30, 2010, we entered into an agreement with EF Energy Partners LLC (EF Energy), an Ohio limited liability company, under which we sold to EF Energy a Secured Subordinated Promissory Note (Subordinated Note) for the principal amount of $1.2 million. We secured the full amount of this financing with a pledge of our United States gross accounts receivable and selected capital equipment. This Subordinated Note bears interest at a rate of 12.5%, which is payable quarterly, in arrears, commencing September 30, 2010. The entire outstanding principal balance of this Subordinated Note, together with all accrued interest thereon, is due and payable on March 30, 2013. Additionally, we issued to the eight investors in EF Energy five-year, detached penny warrants ($.01 per share) to purchase shares of its common stock at a rate of 0.2 warrants per dollar of financing, or 230,000 warrants, with an expiration date of March 30, 2015. On December 22, 2011 this agreement was amended by an Inter-creditor Agreement among EF Energy Partners, Rosenthal & Rosenthal and the Company. Per the terms of the Inter-creditor Agreement, we paid $0.9 million of the principal to EF Energy Partners, leaving a principal balance of approximately $0.3 million. Additionally, EF Energy Partners relinquished their security in our United States gross accounts receivable and selected capital equipment. The remaining balance of the loan is now secured by a secondary position in certain assets of our Stones River Companies, LLC subsidiary. We are not related to EF Energy Partners.

In conjunction with the acquisition of SRC on December 31, 2009, we entered into an agreement with TLC Investments, LLC (TLC), whereby a convertible promissory note (Convertible Note) was issued for the principal amount of $0.5 million. This Convertible Note bears interest at the Wall Street Journal Prime Rate plus two percent (2%), which along with the principal, is due and payable on June 30, 2013 (maturity date). Additionally, TLC has the right to convert the principal of the Convertible Note, in whole, into 500,000 shares of our common stock at any time during the period commencing on June 30, 2010 and through the maturity date. Additionally, as a provision to the Convertible Note, if the reported closing price of a share of our common stock shall not be equal to or greater than $2.00 for at least twenty (20) trading days between June 30, 2010 and June 30, 2013, we shall pay TLC an additional fee of $0.5 million on the maturity date.

On December 29, 2009, and in conjunction with the acquisition of SRC, we entered into Letter of Credit Agreements (LOC s) with John Davenport, President of our Company, and with Quercus, for $0.3 million and $0.3 million, respectively. These LOC s have terms of 24 months and bear interest at a rate of 12.5% on the face amount. The LOC s are collateralized by a percentage of the capital stock of Crescent Lighting Ltd. (CLL) which in turn is based on CLL s net worth as of November 30, 2009, and is subordinated to the senior indebtedness of the Company and CLL. As an incentive to enter into the LOC s, the Company issued five-year, detached warrants to purchase 125,000 and 150,000, respectively, of common stock at an exercise price of $0.01 per share. The Company s shareholders approved the warrants at the Annual Meeting on June 16, 2010. On December 21, 2011, the LOC with John Davenport was amended to extend the due date of the LOC from December 31, 2011 to a month by month basis as long as interest continued to be earned at 12.5%. The LOC was subsequently paid on March 5, 2012. As of December 31, 2011, we were in default with the LOC with Quercus. On March 2, 2012, the LOC due to Quercus was paid in full.

On May 27, 2009, we entered into an unsecured Promissory Note (Note) with Quercus in the amount of $70 thousand. Under the terms of this Note, we are obligated to pay Quercus the principal sum of the Note and interest accruing at a yearly rate of 1.00% in one lump sum payment on or before June 1, 2109. We received these funds on June 9, 2009.

Through our United Kingdom subsidiary, we maintain a British pounds sterling-denominated bank overdraft facility with Lloyds Bank Plc, in the amount of £100,000, which was approximately $0.2 million based on the exchange rate at December 31, 2011. There were no borrowings against this facility as of December 31, 2011 or December 31, 2010. This facility is renewed annually in May. The interest rate for this facility in 2011 was 3.60%, based on a variable interest rate equal to the Bank of England s Bank Rate, which was 0.50% at December 31, 2011, plus 3.10%. The interest rate on the facility at December 31, 2010 was 2.75%.

Equity

On March 17, 2010, we entered into a Purchase Agreement (the Purchase Agreement) with Lincoln Park Capital Fund, LLC (LPC) of Chicago, Illinois and issued to LPC 120,000 shares of our common stock. Under the Purchase Agreement, on May 31, 2010, we sold and issued to LPC, and LPC purchased from us, 360,500 shares of our common stock, together with warrants (Warrants) to purchase 350,000 shares at an exercise price of $1.20 per share, for a total consideration of $0.4 million. The Warrants have a term of five years, are not exercisable until December 1, 2010, and expire on December 1, 2015. Under the Purchase Agreement, LPC has also agreed to purchase up to an additional 3,650,000 shares of our common stock at our option over approximately 25 months. As often as every five (5) business days, we have the right to direct LPC to purchase a calculated number of shares as defined by the terms of the Purchase Agreement. We can suspend purchases or accelerate the number of shares to be purchased at any time. No sales of shares may occur below $1.00 per share. The purchase prices of the shares will be based on the market prices of our shares at the time of sale, as computed under the Agreement, without any fixed discount. We may at any time in our sole discretion terminate the Agreement without fee, penalty, or cost upon five (5) business dates notice. In connection with the transactions contemplated by the Purchase Agreement, we filed a Registration Statement (the Registration Statement) with the U.S. Securities & Exchange Commission (the SEC) to register under the Securities Act of 1933, as amended, the shares of common stock associated with this transaction. On July 14, 2010, we received a Notice of Effectiveness from the SEC relating to the Registration Statement. As of December 31, 2010, we sold and issued to LPC, and LPC purchased from us, a total of 705,550 shares of our common stock for a total consideration of $0.8 million which was offset by expenses of $0.1 million. In the first quarter of 2011, we sold and issued to LPC, and LPC purchased from us, a total of 412,000 shares of our common stock for a total consideration of $0.4 million.

Contractual Obligations

The following summarizes our contractual obligations as of December 31, 2011, consisting of current and future payments for borrowings in the United States, and minimum lease payments under operating leases, as well as the effect that these obligations are expected to have on our liquidity and cash flow in future periods (in thousands):

	United States Long-Term Borrowings	Non-Cancelable Operating Leases	Total
Year ending December 31,			
2012	$ 886	$ 583	$ 1,469
2013	804	506	1,310
2014	59	190	249
2015	65	81	146
2016 and thereafter	168	67	235
Total contractual obligations, gross	1,982	1,427	3,409
Less: discounts on long-term borrowings and sublease payments	(172)		(172)
Total contractual obligations, net	$ 1,810	$ 1,427	$ 3,237

For further information regarding our contractual obligations, refer to Notes 10 and 11 to the Consolidated Financial Statements.

Off-Balance Sheet Arrangements

We had no off-balance sheet arrangements as of December 31, 2011 or 2010.

Going Concern

We have experienced net losses of $6.1 million, $8.5 million and $11.0 million for the years ended December 31, 2011, 2010 and 2009, respectively. As of December 31, 2011, we had an accumulated deficit of $74.9 million. Although management continues to address many of the legacy issues that have historically burdened our financial performance, we still face challenges in order to reach profitability. In order for us to attain profitability and growth, we will need to successfully address these challenges, including the continuation of cost reductions throughout our organization, improvement in gross margins, execution of our marketing and sales plans for our turnkey energy-efficient lighting solutions business, execution of the $23.1 million U.S. Navy supply contract, the development of new technologies into sustainable product lines and

continued improvements in our supply chain performance.

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Our independent public accounting firm has issued an opinion in connection with our 2011 Annual Report on Form 10-K raising substantial doubt as to the Company s ability to continue as a going concern. This opinion stems from our historically poor operating performance and our historical inability to generate sufficient cash flow to meet obligations and sustain operations without obtaining additional external financing. We remain optimistic about obtaining the funding necessary to continue as a going concern, however, there can be no assurances that this objective will be successful. As such, the Company continues to review and pursue selected external funding sources, if necessary, to execute these objectives including, but not limited to, the following:

- obtain financing from traditional and non-traditional investment capital organizations or individuals,
- potential sale or divestiture of one or more operating units, and
- obtain funding from the sale of common stock or other equity or debt instruments.

Obtaining financing through the above-mentioned mechanisms contains risks, including:

- loans or other debt instruments may have terms and/or conditions, such as interest rate, restrictive covenants, and control or revocation provisions, which are not acceptable to management or the Board of Directors,
- the current environment in capital markets combined with our capital constraints may prevent us from being able to obtain any debt financing,
- financing may not be available for parties interested in pursuing the acquisition of one or more of our operating units, and
- additional equity financing may not be available to us in the current capital environment and could lead to further dilution of shareholder value for current shareholders of record.

Critical Accounting Policies and Estimates

The preparation of financial statements requires that we make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingencies, and the reported amounts of net sales and expenses in the financial statements. Material differences may result in the amount and timing of net sales and expenses if different judgments or different estimates were utilized. Critical accounting policies, judgments, and estimates that we believe have the most significant impact on our financial statements are set forth below:

- revenue recognition,
- allowances for doubtful accounts, returns and discounts,
- impairment of long-lived assets,
- valuation of inventories,

- accounting for income taxes, and
- share-based compensation.

Revenue Recognition

Revenue is recognized when it is realized or realizable, has been earned, and when all of the following has occurred:

- persuasive evidence or an arrangement exists (e.g., a sales order, a purchase order, or a sales agreement),
- shipment has occurred, with the standard shipping term being F.O.B. ship point, or services provided on a proportional performance basis or installation has been completed,
- price to the buyer is fixed or determinable, and
- collectability is reasonably assured.

Revenues from our products-based business are generally recognized upon shipping based upon the following:

- all sales made by the Company to its customer base are non-contingent, meaning that they are not tied to that customer s resale of products,
- standard terms of sale contain shipping terms of F.O.B. ship point, meaning that title is transferred when shipping occurs, and
- there are no automatic return provisions that allow the customer to return the product in the event that the product does not sell within a defined timeframe.

Revenues from our products-based business that incorporate specifically-defined installation services have historically been recognized as follows:

- product sale at completion of installation, and
- service at completion of installation.

Revenues and profits from our lighting solutions-based business are generally recognized by applying percentage-of-completion for the period to the estimated profits for the respective contracts. Percentage-of-completion is determined by relating the actual cost of the work performed to date to the current estimated total cost of the respective contracts. When the estimate on a contract indicates a loss, the Company s policy is to record the entire loss during the accounting period in which it is estimable. In the ordinary course of business, at a minimum on a quarterly basis, the Company prepares updated estimates of the total forecasted revenue, cost and profit or loss for each contract. The cumulative effect of revisions in estimates of the total forecasted revenue and costs during the course of the work is reflected in the accounting period in which the facts that caused the revision become known. The financial impact of these revisions to any one contract is a function of both the amount of the revision and the percentage-of-completion of the contract. Revenues from our lighting solutions-based business will generally be larger contracts and may range from three to eighteen months in duration.

In accordance with normal practices in the industry, we include in current assets and current liabilities amounts related to contracts realizable and payable. Billings in excess of costs represents the excess of contract billings to date over the amount of contract costs and profits (or contract revenue) recognized to date on a percentage-of-completion basis. Costs in excess of billings represents the excess of contract costs and profits (or contract revenue) recognized to date on the percentage-of-completion basis over the amount of contract billings to date on the remaining contracts. See Note 9, Contracts in Progress, for additional information.

Revenues from research & development contracts are recognized primarily on the Percentage-of-Completion Method of accounting.

We warrant our products against defects or workmanship issues. We set up allowances for estimated returns, discounts, and warranties upon recognition of revenue and these allowances are adjusted periodically to reflect actual and anticipated returns, discounts, and warranty expenses. These allowances are based on past history and historical trends, current economic conditions, and contractual terms. Our distributor s obligation to us is not contingent upon the resale of our products and as such does not prohibit revenue recognition.

Allowances for Doubtful Accounts, Returns, and Discounts

We establish allowances for doubtful accounts and returns for probable losses based on the customers loss history with us, the financial condition of the customer, the condition of the general economy and the industry as a whole, and the contractual terms established with the customer. The specific components are as follows:

- Allowance for doubtful accounts for accounts receivable, and
- Allowance for sales returns.

In 2011, the total allowance was $0.4 million, with $0.2 million related to accounts receivable and $0.2 million related to sales returns. In 2010, the total allowance was $0.4 million, with $0.3 million related to accounts receivable and $0.1 million related to sales returns. We review these allowance accounts periodically and adjust them accordingly for current conditions.

Long-lived Assets

Property and equipment is stated at cost and include expenditures for additions and major improvements. Expenditures for repairs and maintenance are charged to operations as incurred. We use the straight-line method of depreciation over their estimated useful lives of the related assets (generally two to fifteen years) for financial reporting purposes. Accelerated methods of depreciation are used for federal income tax purposes. When assets are sold or otherwise disposed of, the cost and accumulated depreciation are removed from the accounts and any gain or loss is reflected in the Consolidated Statement of Operations. Refer to Note 6, Property and Equipment, to the Consolidated Financial Statements for additional information.

We classify intangible assets into two categories: (1) intangible assets with definite lives subject to amortization, and (2) goodwill. We determine the useful lives of our identifiable intangible assets after considering the specific facts and circumstances related to each intangible asset. Factors we consider when determining useful lives include the contractual term of any agreement related to the asset, the historical performance of the asset, our long-term strategy for using the asset, any laws or other local regulations which could impact the useful life of the asset, and other economic factors, including competition and specific market conditions. Intangible assets that are deemed to have definite lives are amortized, on a straight-line basis or other method which best approximates cash flows, over their useful lives, ranging from 5 to 10 years. Goodwill represents the excess of the purchase price over the fair value of identifiable net assets acquired in a business acquisition. Refer to Note 7, Goodwill and Intangible Assets, to the Consolidated Financial Statements for additional information.

Long-lived assets, other than goodwill, are reviewed for impairment whenever events or circumstances indicate the carrying amount may not be recoverable. Events or circumstances that would result in an impairment review primarily include operations reporting losses, a significant change in the use of an asset, or the planned disposal or sale of the asset. The asset would be considered impaired when the future net undiscounted cash flows generated by the asset are less than its carrying value. An impairment loss would be recognized based on the amount by which the carrying value of the asset exceeds its fair value, as determined by quoted market prices (if available) or the present value of expected future cash flows.

We evaluate goodwill for impairment at least annually. Evaluating goodwill for impairment involves a two-step process. The first step is to estimate the fair value of the reporting unit. There are several valuation methods for estimating a reporting unit s fair value, including market quotations and discounted projected future net earnings or net cash flows and multiples of earnings. If the carrying amount of a reporting unit, including goodwill, exceeds the estimated fair value, a second step is performed. Under the second step, the identifiable assets, including identifiable intangible assets and liabilities of the reporting unit are estimated at fair value as of the current testing date. The excess of the estimated fair value of the reporting unit over the estimated fair value of net assets establishes the implied value of goodwill. The excess of the recorded goodwill over the implied value is charged to earnings as an impairment loss. A significant amount of judgment is required in estimating fair value of the reporting unit and performing these tests.

Valuation of Inventories

We state inventories at the lower of standard cost (which approximates actual cost determined using the first-in-first-out method) or market. We establish provisions for excess and obsolete inventories after evaluation of historical sales, current economic trends, forecasted sales, product lifecycles, and current inventory levels. During 2011, 2010 and 2009, we charged $0.2 million, $0.3 million, and $0.5 million, respectively, to cost of sales for excess and obsolete inventories. Adjustments to our estimates, such as forecasted sales and expected product lifecycles, could harm our operating results and financial position.

Accounting for Income Taxes

As part of the process of preparing our Consolidated Financial Statements, we are required to estimate our income tax liability in each of the jurisdictions in which we do business. This process involves estimating our actual current tax expense together with assessing temporary differences resulting from differing treatment of items, such as deferred revenues, for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included in our Consolidated Balance Sheet. We then assess the likelihood that these deferred tax assets will be recovered from future taxable income and, to the extent that we believe that recovery is more likely than not, or is unknown, we establish a valuation allowance.

Significant management judgment is required in determining our provision for income taxes, our deferred tax assets and liabilities, and any valuation allowance recorded against our deferred tax assets. At December 31, 2011, we have recorded a full valuation allowance against our deferred tax assets in the United States due to uncertainties related to our ability to utilize our deferred tax assets, primarily consisting of certain net operating losses carried forward. The valuation allowance is based upon our estimates of taxable income by jurisdiction and the period over which our deferred tax assets will be recoverable.

Share-Based Payments

In December 2004, the Financial Accounting Standards Board (FASB) issued Accounting Standards Codification (ASC) Topic Number 718, *Compensation Stock Compensation* (ASC 718). ASC 718 requires all entities to recognize compensation expense in an amount equal to the fair value of share-based payments, such as stock options granted to employees. We have applied ASC 718 using the modified prospective method. Under this method, we are required to record compensation expense (as previous awards continue to vest) for the unvested portion of previously granted awards that remain outstanding at the date of adoption. In March, 2005, the SEC released Staff Accounting Bulletin No. 107, Share-Based Payment (SAB 107), which provides interpretive guidance related to the interaction between ASC 718 and certain SEC rules and regulations. It also provides the SEC staff s views regarding valuation of share based payment arrangements. The application of ASC 718 with SAB 107 had the effect of increasing stock-based compensation expense and reducing earnings by $.02 million in 2011, and by $0.6 million in each of 2010 and 2009.

We measure all employee stock-based awards as an expense based on the grant-date fair value of these awards. The fair value of options is estimated on the date of grant using the Black-Scholes option pricing model. Weighted average assumptions used in the model include the expected life of the options, risk-free interest rate, and volatility. The estimated expected life of the option is calculated based on the contractual life of the option, the vesting life of the option, and historical exercise patterns of vested options. The volatility estimates are calculated using historical pricing experience.

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Recently Issued Accounting Pronouncements

In May 2011, the FASB amended fair value measurement and disclosure guidance to achieve convergence with International Financial Reporting Standards (IFRS). The amended guidance modifies the measurement of fair value, clarifies verbiage and changes disclosure or other requirements in U.S. GAAP and IFRS. The guidance is effective during the interim and annual periods beginning on or after December 15, 2011. The Company does not expect the guidance to have a material impact on our consolidated financial statements.

In June 2011, the FASB issued guidance related to the presentation of comprehensive income. The guidance aims to improve the comparability, consistency and transparency of financial reporting and to increase the prominence of items reported in other comprehensive income. The guidance is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. As this guidance impacts financial statement presentation requirements only, its adoption will not have a material impact on our consolidated financial statements.

In September 2011, the FASB amended guidance relating to the goodwill impairment test. The changes are intended to reduce the cost and complexity of the annual test by providing entities and option to perform a qualitative assessment to determine whether further impairment testing is necessary. The revised guidance includes examples of events and circumstances that might indicate that a reporting unit s fair value is less than its carrying amount. The changes are effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011, with early adoption permitted. We intend to adopt this guidance as stipulated.

Item 7A. Qualitative and Quantitative Disclosures About Market Risk

As of December 31, 2011, we had $0.3 million in cash held in foreign currencies based on the exchange rates at December 31, 2011. The balances for cash held overseas in foreign currencies are subject to exchange rate risk. We have a policy of maintaining cash balances in local currencies. Periodically, cash will be transferred in order to repay inter-company debts.

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Item 8. Financial Statements and Supplementary Data

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Shareholders

Energy Focus, Inc.

We have audited the accompanying consolidated balance sheets of Energy Focus, Inc. (a Delaware corporation) and Subsidiaries (collectively the Company) as of December 31, 2011 and 2010, and the related consolidated statements of operations, comprehensive income (loss), shareholders equity, and cash flows for the years ended December 31, 2011, 2010, and 2009. 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 audit.

We conducted our audit 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 disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Energy Focus, Inc. and Subsidiaries as of December 31, 2011 and 2010, and the results of their operations and their cash flows for the years ended December 31, 2011, 2010, and 2009, in conformity with accounting principles generally accepted in the United States of America.

The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 2, the Company incurred net losses of $6,055,000, $8,517,000, and $11,015,000 during the years ended December 31, 2011, 2010, and 2009. The continued losses, among other factors, as discussed in Note 2 to the financial statements, raise substantial doubt about the Company s ability to continue as a going concern. Management s plans in regard to these matters are also described in Note 2. The consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

/s/ Plante & Moran, PLLC

Cleveland, Ohio

March 30, 2012

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ENERGY FOCUS, INC.

CONSOLIDATED BALANCE SHEETS

As of December 31,

(amounts in thousands except share and per share amounts)

	2011	2010
ASSETS		
Current assets:		
Cash and cash equivalents	$ 2,136	$ 4,107
Trade accounts receivable less allowances of $447 and $446, respectively		