ENERGY FOCUS, INC/DE
Form 10-Q
November 12, 2010

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549
Form 10-Q

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES AND EXCHANGE ACT OF 1934**

For the quarterly period ended September 30, 2010

OR

o **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 or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

32000 Aurora Rd., Solon, OH
(Address of principal executive offices)
44139
(Zip Code)

(Registrant s telephone number, including area code): **(440) 715-1300**

(Former Name, Former Address and Former Fiscal Year, If Changed Since Last Report)

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 þ No o

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

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

Large accelerated filer o	Accelerated filer o	Non-accelerated filer þ (do not check if a smaller reporting company)	Smaller reporting company o

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

The number of outstanding shares of the registrant s Common Stock, $0.0001 par value, as of September 30, 2010 was 23,720,714.

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Item 1. Financial Statements

ENERGY FOCUS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(amounts in thousands except share and per share data)

	September 30, 2010 (unaudited)	December 31, 2009
ASSETS		
Current assets:		
Cash and cash equivalents	$ 2,748	$ 1,062
Accounts receivable, net	5,955	2,922
Inventories, net	2,775	3,770
Prepaid and other current assets	516	509
Total current assets	11,994	8,263
Property and equipment, net	2,627	3,091
Goodwill	672	672
Intangible assets, net	1,945	2,750
Collateralized assets	2,500	2,500
Other assets	70	102
Total assets	$ 19,808	$ 17,378
LIABILITIES		
Current liabilities:		
Accounts payable	$ 5,836	$ 1,677
Accrued liabilities	2,414	1,854
Deferred revenue	883	295
Total current liabilities	9,133	3,826
Other deferred liabilities	3	149
Acquisition-related contingent liabilities	886	1,183
Long-term borrowings	1,768	715
Total liabilities	11,790	5,873
SHAREHOLDERS EQUITY		
Preferred stock, par value $0.0001 per share:		
Authorized: 2,000,000 shares in 2010 and 2009 Issued and outstanding: no shares in 2010 and 2009		
Common stock, par value $0.0001 per share:		
Authorized: 60,000,000 shares at September 30, 2010 and 30,000,000 at December 31, 2009	1	1

Issued and outstanding: 23,721,000 at September 30, 2010 and 21,250,000 at December 31, 2009				
Additional paid-in capital		74,830		71,373
Accumulated other comprehensive income		475		474
Accumulated deficit		(67,288)		(60,343)
Total shareholders equity		8,018		11,505
Total liabilities and shareholders equity	$	19,808	$	17,378

The accompanying notes are an integral part of these financial statements.

ENERGY FOCUS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(amounts in thousands except per share amounts)
(unaudited)

	Three months ended September 30,		Nine months ended September 30,	
	2010	**2009**	**2010**	**2009**
Net sales	$ 9,049	$ 3,023	$ 26,364	$ 8,871
Cost of sales	7,187	2,700	21,539	7,508
Gross profit	1,862	323	4,825	1,363
Operating expenses:				
Research and development	(22)	(61)	(101)	270
Sales and marketing	1,721	1,429	4,858	4,549
General and administrative	1,528	1,408	4,723	3,845
Revaluation of equity instruments	53		1,803	
Restructuring expense		125	26	125
Total operating expenses	3,280	2,901	11,309	8,789
Loss from operations	(1,418)	(2,578)	(6,484)	(7,426)
Other income (expense):				
Other income (expense)	9	(88)	(57)	79
Interest expense	(153)	(21)	(400)	(61)
Loss from continuing operations before income taxes	(1,562)	(2,687)	(6,941)	(7,408)
Provision for income taxes	(1)		(4)	
Loss from continuing operations	$ (1,563)	$ (2,687)	$ (6,945)	$ (7,408)
Discontinued operations:				
Income (loss) from discontinued operations before income taxes		69		(600)
Provision for income taxes				
Income (loss) from discontinued operations		69		(600)
Net loss	$ (1,563)	$ (2,618)	$ (6,945)	$ (8,008)

Net loss per share basic and diluted	$ (0.07)	$ (0.17)	$ (0.31)	$ (0.54)
Shares used in computing net loss per share basic and diluted	23,420	15,079	22,431	14,946

The accompanying notes are an integral part of these financial statements.

ENERGY FOCUS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(amounts in thousands)
(unaudited)

	Three months ended September 30,		Nine months ended September 30,	
	2010	**2009**	**2010**	**2009**
Net loss	$ (1,563)	$ (2,618)	$ (6,945)	$ (8,008)
Other comprehensive income (loss):				
Foreign currency translation adjustments	99	(20)	1	(30)
Comprehensive loss	$ (1,464)	$ (2,638)	$ (6,944)	$ (8,038)

The accompanying notes are an integral part of these financial statements.

ENERGY FOCUS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(amounts in thousands)
(unaudited)

	Nine months ended September 30,	
	2010	**2009**
Cash flows from operating activities:		
Net loss	$ (6,945)	$ (8,008)
Less: loss from discontinued operations		(600)
Net loss from continuing operations	(6,945)	(7,408)
Adjustments to reconcile net loss from continuing operations to net cash used in operating activities:		
Depreciation	597	766
Stock-based compensation	754	514
Revaluation of equity instruments	1,803	
Provision for doubtful accounts receivable	66	(100)
Amortization of intangible assets	805	
Amortization of discounts on long-term borrowings	200	
Deferred revenue	587	(163)
(Gain) loss on disposal of fixed assets	(16)	44
Changes in assets and liabilities:		
Accounts receivable, inventories, and other assets	(1,956)	1,349
Accounts payable and accrued liabilities	4,260	(1,636)
Total adjustments	7,100	774
Net cash provided by (used in) continuing operations	155	(6,634)
Net cash provided by discontinued operations		186
Net cash provided by (used in) operating activities	155	(6,448)
Cash flows from investing activities:		
Acquisition of fixed assets	(138)	(159)
Proceeds from the sale of fixed assets	19	
Net cash used in continuing investing activities	(119)	(159)
Net cash provided by discontinued investing activities		313
Net cash (used in) provided by investing activities	(119)	154
Cash flows from financing activities:		
Cash proceeds from issuances of common stock, net	493	97
Cash proceeds from long-term borrowings	1,150	70
Net payments on credit line borrowings		(487)

Net cash provided by (used in) continuing financing activities	1,643	(320)
Net cash used in discontinued financing activities		(420)
Net cash provided by (used in) financing activities	1,643	(740)
Effect of exchange rate changes on cash	7	(222)
Net increase (decrease) in cash and cash equivalents	1,686	(7,256)
Cash and cash equivalents at beginning of period	1,062	10,568
Cash and cash equivalents at end of period	2,748	3,312
Less: cash and cash equivalents of discontinued operations at end of period		173
Cash and cash equivalents of continuing operations at end of period	$ 2,748	$ 3,139
Classification of cash and cash equivalents:		
Cash and cash equivalents	$ 2,748	$ 1,839
Restricted cash held in certificates of deposit		1,300
Cash and cash equivalents of continuing operations at end of period	$ 2,748	$ 3,139

ENERGY FOCUS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2010
(Unaudited)

NOTE 1. NATURE OF OPERATIONS

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 the Company serves 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 general commercial and industrial lighting and pool lighting offerings, each of which markets and sells energy-efficient lighting systems.

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

The Company s development of solar technology continues through its role in the United States Government s Very High Efficiency Solar Cell (VHESC) Consortium sponsored by the Defense Advanced Research Projects Agency (DARPA). The goal of the VHESC project is to develop a 40% or greater efficient solar cell for United States military applications, which would also ultimately become available to the public for commercial application.

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The significant accounting policies of the Company, which are summarized below, are consistent with generally accepted accounting principles and reflect practices appropriate to the business in which it operates.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Estimates include, but are not limited to, the establishment of reserves for accounts receivable, sales returns, inventory obsolescence, and warranty claims; the useful lives for property, equipment, and intangible assets; revenues recognized on a percentage-of-completion basis; and stock-based compensation. In addition, estimates and assumptions associated with the determination of fair value of financial instruments and evaluation of goodwill and long-lived assets for impairment requires considerable judgment. Actual results could differ from those estimates.

Reclassifications

Certain prior year amounts have been reclassified within the Consolidated Financial Statements (financial statements), and related notes thereto, to be consistent with the current year presentation.

Basis of Presentation

The financial statements include the accounts of the Company and its subsidiaries, Stones River Companies, LLC (SRC) in Nashville, Tennessee, and Crescent Lighting Limited (CLL) located in the United Kingdom. LBM Lichtleit-Fasertechnik (LBM) located in Berching, Germany, was sold in December 2009 and is included in these financial statements as discontinued operations. All significant inter-company balances and transactions have been eliminated.

ENERGY FOCUS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2010
(Unaudited)

Interim Financial Statements (unaudited)

Although unaudited, the interim financial statements in this report reflect all adjustments, consisting only of all normal recurring adjustments, which are, in the opinion of management, necessary for a fair statement of financial position, results of operations, and cash flows for the interim periods covered and of the financial condition of the Company at the interim balance sheet date. The results of operations for the interim periods presented are not necessarily indicative of the results expected for the entire year.

Year-end Balance Sheet

The year-end balance sheet information was derived from audited financial statements but does not include all disclosures required by generally accepted accounting principles. These financial statements should be read in conjunction with the Company s audited financial statements and notes thereto for the year ended December 31, 2009, which are contained in the Company s 2009 Annual Report on Form 10-K.

Foreign Currency Translation

The Company s UK subsidiary uses its local currency as its functional currency. The Company s financial statements are translated at exchange rates in effect at the balance sheet date. Resulting translation adjustments are recorded directly to Accumulated other comprehensive income within shareholders equity. Foreign currency transaction gains and losses are included as a component of Other income (expense) . Gains and losses from foreign currency translation are included as a separate component of Other comprehensive loss within the Condensed Consolidated Statement of Comprehensive Income (Loss).

Liquidity

Historically, the Company has incurred losses attributable to operational performance which have negatively impacted cash flows. Although management continues to address many of the legacy issues that have historically burdened the Company s financial performance, the Company still faces challenges in order to reach profitability. In order for the Company to attain profitability and growth, the Company will need to continue to successfully address these challenges, including the continuation of cost reductions throughout the organization, execution of the marketing and sales plans for the Company s new turnkey energy-efficient lighting solutions business, continued exploration of accretive acquisition targets, continued evaluation and potential divestiture of select business product lines, and continued improvements in supply chain performance.

The Company is optimistic about obtaining the funding necessary to meet on-going tactical and strategic capital requirements. However, there can be no assurances that this objective will be successful. As such, the Company will continue to review and pursue selected external funding sources, if necessary, to execute these objectives including the following:

- obtain financing from non-traditional investment capital organizations,

- potential sale or divestiture of one or more operating units, and

- obtain funding from the sale of common stock or other equity, debt, or convertible 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 economic environment combined with the Company s capital constraints may prevent the Company from being able to obtain any debt financing,

- financing may not be available for parties interested in pursuing the acquisition of one or more operating units of the Company, and additional equity financing may not be available in the current economic environment and could lead to further dilution of shareholder value for current shareholders of record.

Collateralized Assets

The Company maintains $2,500,000 of cash securitization related to the Company s $10,000,000 surety bonding program associated with the acquisition of SRC on December 31, 2009. This cash is pledged to the surety carrier through December, 2011, unless the Company is able to provide sufficient alternative means of securitization satisfactory to the carrier.

ENERGY FOCUS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2010
(Unaudited)

Earnings (Loss) per Share

Basic loss per share is computed by dividing net loss available to common shareholders by the weighted average number of common shares outstanding for the period. Diluted loss per share is computed giving effect to all dilutive potential common shares that were outstanding during the period. Dilutive potential common shares consist of incremental shares upon exercise of stock options and warrants, unless the effect would be anti-dilutive.

A reconciliation of basic and diluted loss per share is provided as follows (in thousands, except per share amounts):

	Three months ended September 30,		Nine months ended September 30,	
	2010	**2009**	**2010**	**2009**
Basic and diluted loss per share:				
Net loss	$ (1,563)	$ (2,618)	$ (6,945)	$ (8,008)
Basic and diluted loss per share:				
Weighted average shares outstanding	23,420	15,079	22,431	14,946
Basic and diluted net loss per share	$ (0.07)	$ (0.17)	$ (0.31)	$ (0.54)

At September 30, 2010 and 2009, options and warrants to purchase 6,525,000 and 5,734,000 shares of common stock, respectively, were outstanding, but were not included in the calculation of diluted net loss per share because their inclusion would have been anti-dilutive.

Stock-Based Compensation

The Company s stock-based compensation plan is described in detail in its Annual Report on Form 10-K for the year ended December 31, 2009.

For the three and nine months ended September 30, 2010, the Company recorded compensation expense of $214,000 and $535,000 related to its outstanding stock options, respectively, compared to $150,000 and $514,000 for the three and nine months ended September 30, 2009, respectively. Total unearned compensation of $1,453,000 remains at September 30, 2010 compared to $1,002,000 at September 30, 2009. These costs will be charged to expense, amortized on a straight line basis, in future periods through the first quarter of 2014. The remaining weighted average life of the outstanding options is approximately 1.8 years.

The fair value of each stock option is estimated on the date of grant using the Black-Scholes option pricing model. Estimates utilized in the calculation include the expected life of option, risk-free interest rate, and expected volatility, and are further comparatively detailed as follows:

	Nine months ended September 30,	
	2010	**2009**
Fair value of options issued	$ 0.73	$ 0.48
Exercise price	$ 1.07	$ 0.79
Expected life of option	4.0 years	4.0 years
Risk-free interest rate	1.77%	1.70%
Expected volatility	97.70%	84.05%
Dividend yield	0%	0%

ENERGY FOCUS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2010
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At the 2010 Annual Meeting of Shareholders (Annual Meeting) 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. The Company granted 1,010,000 performance-based stock options through the nine months ended September 30, 2010, and 465,000 during the nine months ended September 30, 2009. Of the 1,010,000 performance-based stock options awarded in 2010, all were issued in February. These performance-based stock options are exercisable by the grantees if, and only if, the Company achieves required revenue and cash-flow generation targets as reported in the Company s 2010 Form 10-K. In addition to theses performance-based stock options, the Company also granted 383,000 shares of restricted stock and stock options in the three and nine months ended September 30, 2010.

On May 29, 2009, the Company s five senior executive officers agreed to accept voluntary salary reductions for the remainder of the 2009 calendar year in exchange for the issuance of restricted shares of common stock as authorized under the Company s 2008 Incentive Stock Plan. Two other key executives of the Company also accepted salary reductions for the balance of the year in exchange for restricted shares. Each officer and key executive voluntarily accepted a ten percent (10%) salary reduction for the remainder of 2009, except for one officer who voluntarily accepted a forty percent (40%) decrease for the remainder of 2009. The number of restricted shares of common stock issued to each officer and executive was equal to the dollar value of the individual s salary reduction divided by the closing price per share of the Company s common stock on May 29, 2009. The total number of restricted shares of common stock issued to these officers and executives was 209,000. The Company reserved the right to extend these salary reductions into the 2010 calendar year and beyond. Additionally, on May 29, 2009, two members of the Company s Board of Directors voluntarily relinquished their directors fee for the balance of 2009 in exchange for restricted shares of common stock on the same terms as the shares granted to the officers. The number of restricted shares of common stock issued to each director was equal to the dollar value of the individual s relinquished director s fee divided by the closing price per share of the Company s common stock on May 29, 2009. The total number of restricted shares of common stock issued to these directors was 19,000.

On December 31, 2009, the Company extended these salary reductions through June 30, 2010 issuing an additional 170,000 of restricted shares. The number of restricted shares of common stock issued to each officer and executive was equal to the dollar value of the individual s salary reduction divided by the closing price per share of the Company s common stock on December 30, 2009. On July 9, 2010, the Company s Chief Executive Officer, with the approval of the Board of Directors, decided to continue the cash salary reductions through December 31, 2010. Each officer and key executive voluntarily accepted a ten percent (10%) salary reduction for this six month period, except for one officer who voluntarily accepted a forty percent (40%) decrease for this six month period. The number of restricted shares of common stock issued to each officer and executive was equal to the dollar value of the individual s salary reduction divided by the closing price per share of the Company s common stock on July 9, 2010. The total number of restricted shares of common stock to be issued to these officers and executives is 88,000, but these shares have not yet been issued to the affected executives. The Company recorded compensation expense of $55,000 and $165,000 for the three and nine months ended September 30, 2010, respectively, related to these restricted shares.

In the third quarter of 2010, the Board of Directors approved a program offering the independent Directors of the Company the option of accepting restricted shares of the Company s common stock in lieu of quarterly cash compensation. Directors who choose to participate and accept restricted shares in lieu of cash compensation received the equivalent of two dollars ($2.00) of Company common stock for every one dollar ($1.00) of their normal cash compensation. Directors that chose to accept this program agreed to receive restricted shares compensation for four consecutive quarters, covering the period of July 2010 until June 2011 with the aforementioned common stock vesting over an equivalent 12 month period. The price of the common stock shares was based on the closing price of the Company s common stock on September 20, 2010. On September 1, 2010, four of the five Directors agreed to participate in this program. Director stock compensation expense under this program amounted to $54,000 for both the three and nine months ended September 30, 2010, respectively, related to these restricted shares.

ENERGY FOCUS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
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(Unaudited)

Product Warranties

The Company warrants finished goods against defects in material and workmanship under normal use and service for periods of one to three years for products and labor. Settlement costs consist of actual amounts expensed for warranty services which are largely a result of third-party service calls, and the costs of replacement products. A liability for the estimated future costs under product warranties is maintained for products outstanding under warranty and is included in Accrued liabilities in the Condensed Consolidated Balance Sheet. The warranty activity, from continuing operations, for the respective years is as follows (in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2010	**2009**	**2010**	**2009**
Balance at the beginning of the period	$ 145	$ 131	$ 211	$ 292
Accruals for warranties issued	22	119	(10)	157
Settlements made during the period (in cash or in kind)	(21)	(39)	(55)	(238)
Balance at the end of the period	$ 146	$ 211	$ 146	$ 211

NOTE 3. ACQUISITION

On December 31, 2009, the Company acquired 100% of the members interest of SRC, a Tennessee limited liability company, from TLC Investments, LLC (TLC), a Tennessee limited liability company, for a combination of cash, convertible debt, a contingent based earn-out, and shares of the Company s common stock. SRC is a lighting retro fit company and an energy systems and solutions provider located in Nashville, Tennessee. SRC provides the Company with the reputation and strong brand recognition within the existing public sector buildings market based upon its 20 years of experience serving these markets. Given the significant existing contract backlog, pipeline of potential future contracts, proven delivery performance and strong existing relationships with its customer base that SRC brings to the Company; it will be able to readily penetrate these markets with its unique and proven technology while simultaneously benefiting from the other natural synergies that exist between our two businesses. This acquisition is the foundation by which the Company will emerge into a national turn-key energy solutions provider.

The Company acquired approximately $4,700,000 in assets, including accounts receivable, fixed assets, and other intangible assets. $672,000 of the purchase price was recorded on the Company s Condensed Consolidated Balance Sheet under the caption Goodwill . Purchase price consideration was paid in the form of $1,500,000 of cash, 1,000,000 shares of Energy Focus common stock, and a $500,000 promissory note convertible into 500,000 shares of the Company s common stock. The transaction also includes performance-related contingent consideration including a 2.5% payout on the annual revenues of SRC over 42 months, and a $500,000 fee if the market price of the Company s common stock is not equal to or greater than $2.00 per share for at least twenty trading days between June 30, 2010 and June 30, 2013. For the three and nine months ended September 30, 2010, the Company has paid $123,000 and $380,000, respectively, for this performance-related contingent consideration.

The acquisition was accounted for as a stock purchase and, accordingly, was included in the financial statements of the Company as of December 31, 2009. Due to the absence of activity between the purchase date, December 31, 2009, and the date of our financial statements, there were no results of operations reported in 2009. In addition, comparative pro-forma information has not been presented as SRC was not a comparable stand-alone entity prior to the acquisition.

ENERGY FOCUS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2010
(Unaudited)

The purchase price was allocated based on the fair value of the assets acquired leading to the purchase price allocation as follows (in thousands):

Assets acquired:	Amortization Life (in years)	Amount
Accounts receivable		$ 1,258
Property and equipment, net		20
Goodwill	n/a	672
Intangible assets:		
Tradename	10	500
Client relationships	5	2,250
Total purchase price		$ 4,700

The purchase price in excess of the fair value of the tangible assets acquired was allocated to intangible assets and goodwill. The Company engaged an independent third-party expert to assist in the allocation of the purchase price to the various specific separately identifiable intangible assets. The methods utilized by this third-party are based upon generally accepted accounting conventions used in acquisition-related valuations and include peer volatility analysis, discounted cash flow analysis, annuity stream valuation and earnings-based valuation techniques. These conventions were reviewed and approved by management as well as the Company s current independent public accounting firm. These intangible assets have estimated useful lives as set forth in the table above and amortization expense for the following fiscal years for the acquired intangible assets is estimated to be as follows (in thousands):

Year ending December 31,	Amount
2011	$ 649
2012	420
2013	253
2014	105
2015 and thereafter	250
Total amortization expense	$ 1,677

Amortization expense for these intangible assets for the three and nine months ended September 30, 2010 amounted to $268,000 and $805,000, respectively.

Of the intangible assets acquired, $672,000 was assigned to goodwill. None of the goodwill is expected to be deductible for tax purposes.

NOTE 4. DISCONTINUED OPERATIONS

As part of the Company s strategy of directing its core business activities towards providing turnkey lighting energy solutions to the existing public-sector building market, the Company determined that its German subsidiary was not directly aligned with this strategic initiative. Therefore, in the third quarter of 2009, the Company committed to a plan to divest its German subsidiary, LBM.

In December 2009, the Company completed the sale of its ownership rights in LBM for $225,000 comprised of cash and a promissory note. Furthermore, the Company 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. Excluding this earn out, the Company recorded a loss on disposal of subsidiary of $664,000. 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. Through September 30, 2010, LBM has not made any earn out payments to the Company nor has the Company accrued any earnings related to these payments.

ENERGY FOCUS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2010
(Unaudited)

The following table summarizes the components included in Loss from discontinued operations within the Company s Condensed Consolidated Statement of Operations for the periods indicated (amounts in thousands):

	Three Months Ended September 30, 2009	Nine Months Ended September 30, 2009
Net sales	$ 513	$ 1,217
Total expenses	444	1,817
Gain (loss) from operations of discontinued operations	69	(600)
Provision for income tax		
Net gain (loss) from discontinued operations	$ 69	$ (600)

NOTE 5. INVENTORIES

Inventories are stated at the lower of standard cost (which approximates actual cost determined using the first-in, first-out cost method) or market and consist of the following (in thousands):

	September 30, 2010	December 31, 2009
Raw materials	$ 2,113	$ 2,755
Inventory reserve	(861)	(1,010)
Finished goods	1,523	2,025
Inventories	$ 2,775	$ 3,770

On September 24, 2010, the Company disposed of $291,000 of remaining excess and slow-moving inventory located at the former Solon, Ohio manufacturing facility. Of this amount, $277,000 was recorded against the Company inventory reserve.

NOTE 6. PROPERTY AND EQUIPMENT

Property and equipment is stated at cost and are depreciated using the straight-line method over the estimated useful lives of the related assets and consist of the following (in thousands):

	September 30, 2010	December 31, 2009
Equipment (useful life 3 - 15 years)	$ 7,663	$ 7,856
Tooling (useful life 2 - 5 years)	2,308	2,305
Furniture and fixtures (useful life 5 years)	168	168
Computer software (useful life 3 years)	375	476
Leasehold improvements (the shorter of useful life or lease life)	889	911

Construction in progress		70		
Property and equipment at cost		11,473		11,716
Less: accumulated depreciation		(8,846)		(8,625)
Property and equipment, net	$	2,627	$	3,091

ENERGY FOCUS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
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NOTE 7. LONG-TERM BORROWINGS

Effective October 15, 2008, the Company entered into a one year credit agreement with Silicon Valley Bank (SVB) incorporating a $4,000,000 revolving line of credit which replaced all existing facilities including the United States term loans. This new line of credit included a $1,500,000 sub-limit for cash management products, letters of credit and foreign currency exchange. Borrowings under this agreement were collateralized by the Company s assets, including intellectual property, and bore interest at the SVB Prime Rate plus 1%. The Company was required to maintain 85% of its cash and cash equivalents in operating and investment accounts with SVB and was also required to comply with certain covenant requirements, including a tangible net worth covenant. The amount of borrowings available to the Company was the lesser of $4,000,000 or the sum of up to 75% of eligible accounts receivable, as defined by the agreement, and 50% of its cash balance in deposit at SVB, capped at $1,500,000.

At December 31, 2008, the Company was not in compliance with the tangible net worth covenant requirement and such condition continued throughout 2009. As such, the Company entered into a series of loan modification and forbearance agreements (agreements) with effective dates ranging from January 31, 2009 through November 17, 2009. In conjunction with these agreements, the terms of the Company s credit facility were revised culminating in a reduction to its revolving line of credit to $1,300,000 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 3.00%. Under this revised credit facility, the Company was required to maintain all of its cash and cash equivalents in operating and investment accounts with SVB and its affiliates and was also required to continue compliance with certain covenant requirements, including the tangible net worth covenant. During the third quarter of 2009, SVB informed the Company that it did not intend to renew its revolving line of credit when it was set to expire on October 15, 2009. Ultimately, the Company was able to extend the maturity date of this credit facility to December 31, 2009 at which time it liquidated the outstanding balance of $253,000 on the line of credit.

On May 27, 2009, the Company entered into an Unsecured Promissory Note (Note) with The Quercus Trust (The Trust) in the amount of $70,000. Under the terms of this Note, the Company is obligated to pay The Trust 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. The Company received these funds on June 9, 2009.

On December 29, 2009 and in conjunction with the acquisition of SRC, the Company entered into Letter of Credit Agreements (LOC s) with John Davenport, President of the Company, and with The Trust, for $250,000 and $300,000, 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 15% and 18%, respectively, of the capital stock of Crescent Lighting Ltd., which in turn is based on CLL s net worth as of November 30, 2009 and are 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 shares, 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.

In conjunction with the acquisition of SRC on December 31, 2009, the Company entered into an agreement with TLC, whereby a Convertible Promissory Note (Convertible Note) was issued for the principal amount of $500,000. 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, but not in part, 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 common stock of the Company is not 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 $500,000 on the maturity date. The Company accrued for this potential fee at the time of the agreement.

On March 30, 2010, the Company entered into an agreement with EF Energy Partners LLC (EF Energy), an Ohio limited liability company, under which it sold to EF Energy a Secured Subordinated Promissory Note (Subordinated

Note) for the principal amount of $1,150,000. The Company secured the full amount of this financing with a pledge of its United States gross accounts receivable and selected capital equipment. This Subordinated Note bears interest at a rate of 12.5%, which is payable quarterly, in arrears, commencing September 30, 2010. The entire outstanding principal balance of this Subordinated Note, together with all accrued interest thereon, is due and payable on March 30, 2013. Additionally, the Company issued to the eight investors in EF Energy five-year, detached penny warrants ($.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. The Company and EF Energy Partners are not related.

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Through its United Kingdom subsidiary, the Company maintains a British pounds sterling-denominated bank overdraft facility with Lloyds Bank Plc, in the amount of $397,000, based on the exchange rate at September 30, 2010. There were no borrowings against this facility as of September 30, 2010 or December 31, 2009. This facility is renewed annually on January 1. The interest rate on the facility was 2.75% at September 30, 2010, and December 31, 2009.

Future maturities of remaining borrowings are (in thousands):

Year ending December 31,	Long-Term Borrowings
2011	$ 550
2012	
2013	1,650
2014	
2015 and thereafter	70
Gross long-term borrowings	2,270
Less: discounts on long-term borrowings	(502)
Total commitment, net	$ 1,768

NOTE 8. COMPREHENSIVE INCOME (LOSS)

Comprehensive income (loss) is defined as net income (loss) plus sales, expenses, gains, and losses that, under generally accepted accounting principles, are included in comprehensive income (loss) but excluded from net income (loss). A separate statement of comprehensive loss has been presented with this report.

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NOTE 9. SEGMENTS AND GEOGRAPHIC INFORMATION

The Company has 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. The Company s products are sold through a combination of direct sales employees, independent sales representatives, and various distributors in different geographic markets throughout the world. The Company s 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 through our direct sales employees as well as our SRC subsidiary, and include not only the Company s proprietary energy-efficient lighting solutions, but also sourced lighting systems, energy audits, and service agreements.

The following summarizes the Company s reportable segment data for periods indicated (in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2010	**2009**	**2010**	**2009**
Solutions:				
Net sales	$ 4,416	$	$ 14,631	$
Cost of goods sold	3,657		11,995	
Gross profit	759		2,636	
Operating expenses:				
Sales and marketing	425		1,048	
General and administrative	397		1,080	
Total operating expenses	822		2,128	
Segment income (loss)	$ (63)	$	$ 508	$
Products:				
Net sales	$ 4,633	$ 3,023	$ 11,733	$ 8,871
Cost of goods sold	3,530	2,700	9,544	7,508
Gross profit	1,103	323	2,189	1,363
Operating expenses:				
Research and development	(22)	(61)	(101)	270
Sales and marketing	1,252	1,375	3,662	4,387
General and administrative	101	106	179	181
Restructuring expense		125	26	125
Total operating expenses	1,331	1,545	3,766	4,963
Segment loss	$ (228)	$ (1,222)	$ (1,577)	$ (3,600)

Reconciliation of segment income (loss) to net loss:

Segment income (loss):				
Solutions	$ (63)	$	$ 508	$
Products	(228)	(1,222)	(1,577)	(3,600)
Total segment loss	(291)	(1,222)	(1,069)	(3,600)
Operating expenses:				
Sales and marketing	44	54	148	162
General and administrative	1,030	1,302	3,464	3,664
Revaluation of equity instruments	53		1,803	
Total operating expenses	1,127	1,356	5,415	3,826
Other (expense) income	(144)	(109)	(457)	18
Net loss from continuing operations before income taxes	(1,562)	(2,687)	(6,941)	(7,408)
Provision for income taxes	(1)		(4)	
Net loss from continuing operations	(1,563)	(2,687)	(6,945)	(7,408)
Income (loss) from discontinued operations		69		(600)
Net loss	$ (1,563)	$ (2,618)	$ (6,945)	$ (8,008)

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The following table provides additional business unit gross profitability detail for the Company s Products-based business segment for the periods indicated (in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2010	**2009**	**2010**	**2009**
Products segment net sales:				
Pool and commercial products	$ 3,694	$ 3,007	$ 9,428	$ 8,780
Government products/R&D services	939	16	2,305	91
Total products segment net sales	4,633	3,023	11,733	8,871
Products segment cost of sales:				
Pool and commercial products	2,328	2,114	6,025	5,670
Government products/R&D services	925	9	2,286	81
Unallocated manufacturing overhead	277	577	1,233	1,757
Total products segment cost of sales	3,530	2,700	9,544	7,508
Products segment gross profit:				
Pool and commercial products	1,366	893	3,403	3,110
Government products/R&D services	14	7	19	10
Unallocated manufacturing overhead	(277)	(577)	(1,233)	(1,757)
Total products segment gross profit	$ 1,103	$ 323	$ 2,189	$ 1,363

Unallocated manufacturing overhead is defined as follows:

1) costs associated with the operation and shut down of the Solon manufacturing facility which has been relocated to the Mexico facility and

2) specific expenses which are not attributable to a specific business unit but rather are calculated on the total products business segment. Expenses include Solon manufacturing facility rent, Solon manufacturing depreciation, inventory reserves and accruals and Solon manufacturing support payroll and severance.

A geographic summary of net sales from continuing operations is as follows (in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2010	**2009**	**2010**	**2009**
United States Domestic	$ 8,048	$ 1,600	$ 23,595	$ 5,681
Other Countries	1,001	1,423	2,769	3,190
Net sales from continuing operations	$ 9,049	$ 3,023	$ 26,364	$ 8,871

A geographic summary of long-lived assets, which consists of fixed assets, goodwill, and intangible assets, is as follows (in thousands):

	September 30, 2010	December 31, 2009
United States Domestic	$ 5,111	$ 6,306
Other Countries	133	207
Long-lived assets, net	$ 5,244	$ 6,513

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NOTE 10. INCOME TAXES

At September 30, 2010, the Company has recorded a full valuation allowance against its deferred tax asset in the United States, due to uncertainties related to the Company s ability to utilize its deferred tax assets, primarily consisting of certain net operating losses carried forward. The valuation allowance is based upon the Company s estimates of taxable income by jurisdiction and the period over which its deferred tax assets will be recoverable.

NOTE 11. COMMITMENTS AND CONTINGENCIES

In connection with the acquisition of SRC, the Company maintains a performance-related contingent obligation related to the 2.5% payout based upon the annual revenues of the acquired business over the 42 months commencing January 1, 2010, and a $500,000 fee if the market price of the Company s common stock is not equal to or greater than $2.00 per share for at least twenty trading days between June 30, 2010 and June 30, 2013. The Company accrued for this potential fee at the time of the agreement. For the three and nine months ended September 30, 2010, the Company has paid $123,000 and $380,000, respectively, relating to this 2.5% payout.

NOTE 12. RELATED PARTY TRANSACTIONS

On February 3, 2006, the Company had entered into a consulting agreement with David Ruckert, a member of its Board of Directors. This agreement was terminated on June 30, 2007. No payments were made during the three and nine months ended September 30, 2010 or September 30, 2009. Additionally, Mr. Ruckert was granted options to purchase 32,000 shares of the Company s common stock. Stock compensation expense incurred under Auditing Standards Codification Topic Number 718, *Compensation Stock Compensation* related to these options was $15,000 for the nine months ended September 30, 2010. No expense was incurred during the third quarter 2010 since the options became fully vested on June 30, 2010. Compensation expense for the three and nine months ended September 30, 2009 was $7,000 and $22,000, respectively.

On May 27, 2009, the Company entered into a Promissory Note (Note) with The Trust in the amount of $70,000. Please refer to Note 7, Long-Term Borrowings, for discussion of the terms of the Note.

In November 2009, the Company received an additional $3,344,000 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, including two then current members of the Company s Board of Directors. The investment was made under the Company s registration statement for a $3,500,000 common stock subscription rights offering. Under the terms of the rights offering, the Company distributed, at no charge to its shareholders, transferable rights to purchase up to $3.5 million of the Company s common stock at the established subscription price per share of $0.75, which was set by the Company s Board of Directors. At the time the offering began, the Company 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 the Company s 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. Among the investors were Philip E. Wolfson, a member of the Company s Board of Directors at the time of the transaction, and who invested approximately $8,000 in the aggregate. Also among the investors was The Trust, whose trustees include David Gelbaum, who was a director at the time of the offering.

In the Company s subscription rights offering discussed above, an investor inadvertently purchased 1,000,000 shares of our common stock at $0.75 per share. The Company agreed to facilitate the sale of these shares to another shareholder or investor or to purchase them directly. A purchase of those shares by the Company would have severely depleted its cash-on-hand and working capital. After contacting selected shareholders and investors, the Company introduced the investor to The Trust, the Company s largest shareholder. The Company was informed on December 30, 2009, by the investor and The Trust that The Trust had agreed to purchase those shares at $0.80 per share. At that time, the closing market price of a share of the Company s common stock was approximately $0.65 per share. To facilitate the purchase of the 1,000,000 shares by The Trust, on December 30, 2009, the Company agreed with The Trust to reduce the exercise price of the 1,560,062 warrants issued to The Trust in March 2008 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 The Trust was completed on February 20, 2010. The Company incurred a non-cash charge of $1,421,000 for the quarter ended March 31, 2010 related to the revaluation of the warrants to purchase shares of the Company s common stock acquired by The Trust in the Company s March 2008 equity financing. On April 28, 2010, The Trust exercised the 2008 warrants. The Company s shareholders overwhelmingly approved the reduction in exercise price of the above mentioned warrants at its Annual Meeting on June 16, 2010.

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On December 29, 2009, and in conjunction with the acquisition of SRC, the Company entered into LOC s with John Davenport, President of the Company, and with The Trust, for $250,000 and $300,000, respectively. Please refer to Note 7, Long-Term Borrowings, for discussion of the terms of these LOC s.

Robert Wilson, the Company s Vice President of its SRC subsidiary, is a minority owner in TLC as well as in Woodstone Energy, LLC (Woodstone), a Tennessee limited liability company, both of which are located in Nashville, Tennessee and are key strategic partners of the Company.

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

On December 31, 2009, the Company issued to Woodstone warrants to purchase up to 600,000 shares of the Company s common stock at an exercise price of $0.65 per share, and with a term ending on December 31, 2014. The warrants become exercisable only if SRC receives from Woodstone firm contracts or purchase orders for at least $10,000,000 by June 30, 2013. The warrants vest in two tranches: 400,000 shares when contracts or purchase orders between SRC and Woodstone reach $10,000,000 and an additional 200,000 shares when contracts or purchase orders between SRC and Woodstone reach an additional $5,000,000.

The Company, in the agreement for the acquisition of SRC, provided for payment of a management fee to TLC for overhead expenses in support of up to $20,000,000 in project revenues in 2010 for those projects on which TLC provides installation support services. The management fee will total $1,232,000, payable in equal monthly installments, and began January 31, 2010 and will end on December 31, 2010. Further, an additional 8% management fee is payable for project revenues above $20,000,000 in fiscal year 2010 for those projects on which TLC provides installation support. TLC has provided predominantly all of the Company s installation support services for SRC in the first nine months of 2010. The Company has paid $308,000 and $924,000 in TLC management fees for the three and nine months ended September 30, 2010, respectively.

NOTE 13. LEGAL MATTERS

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 the Company has misused proprietary trade secrets, breached a contract, and engaged in deceptive trade practices relating to one of the Company s lighting products. The complaint seeks injunctive relief and damages. The Company has answered the complaint and filed a counterclaim for breach of contract. The Company strongly denies any impropriety, believes that the complaint is without merit, and intends to vigorously defend the Company against this complaint. The parties are currently in the discovery phase. In the opinion of management, this lawsuit should not have an adverse effect on the financial condition, cash flows, or results of operations.

The Company is involved in other litigation which, in the Company s opinion, will not have a material adverse effect on our financial position, results of operations or cash flows.

NOTE 14. SUBSEQUENT EVENTS

On October 6, 2010 and November 1, 2010, the Company sold and issued to LPC, and LPC purchased from the Company, a total of 82,400 shares of its common stock for a total consideration of $87,000. Although the Company retains the right, in its sole discretion, to terminate the agreement without fee, penalty, or cost, the Company plans to continue to utilize this financing activity for general corporate and working capital purposes and pursuit of its business strategy.

On June 29, 2010, the Company registered with the SEC the resale of the shares issued and that we may issue in the future under the terms of the SRC, EF Energy, and LPC transactions.

ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with the Condensed Consolidated Financial Statements (financial statements) and related notes included elsewhere in this report and the section entitled Management s Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the year ended December 31, 2009.

When used in this discussion, the words expects, anticipates, estimates, plan, and similar expressions are intended to identify forward-looking statements. These statements, which include statements as to our expected sales and gross profit margins, expected operating expenses and capital expenditure levels, our sales and marketing expenses, our general and administrative expenses, expected expenses related to compliance with the Sarbanes-Oxley Act of 2002, the adequacy of capital resources and necessity to raise additional funds, our critical accounting policies, expected restructuring costs related to our consolidation in Solon, Ohio, expected benefits from our consolidation and statements regarding pending litigation are subject to risks and uncertainties that could cause actual results to differ materially from those projected. These risks and uncertainties include, but are not limited to, those risks discussed below, as well as our ability to manage expenses, our ability to reduce manufacturing overhead and general and administrative expenses as a percentage of sales, our ability to collect on doubtful accounts receivable, our ability to increase cash balances in future quarters, the cost of enforcing or defending intellectual property, unforeseen adverse competitive, economic or other factors that may impact our cash position, risks associated with raising additional funds, and risks associated with our pending litigation. These forward-looking statements speak only as of the date hereof. We expressly disclaim any obligation or undertaking to release publicly any updates or revisions to any forward-looking statements contained herein to reflect any change in our expectations with regard thereto or any change in events, conditions or circumstances on which any such statement is based.

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 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 solutions include light-emitting diode (LED), ceramic metal halide (CMH), 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.

Our development of solar technology continues through our role in the United States Government s Very High Efficiency Solar Cell (VHESC) Consortium sponsored by the Defense Advanced Research Projects Agency (DARPA). The goal of the VHESC project is to develop a 40% or greater efficient solar cell for United States military applications, which would also ultimately become available to the public for commercial application.

Results of Operations

Cash Accumulation

Net increase in cash and cash equivalents was $649,000 and $1,686,000 for the three and nine months ended September 30, 2010, respectively, which included $1,150,000 of cash received from the selling of a Secured Subordinated Promissory Note and $493,000 of net proceeds from the issuance of shares of Energy Focus, Inc. Common Stock. Net decrease in cash and cash equivalents for the three and nine months ended September 30, 2009 was $2,301,000 and $7,256,000, respectively.

Net Sales and Gross Profit

Solutions-based net sales from continuing operations were $4,416,000 and $14,631,000 for the three and nine months ended September 30, 2010, respectively, resulting from our Stones River Companies, LLC (SRC) subsidiary, which was acquired on December 31, 2009.

Product-based net sales from continuing operations were $4,633,000 and $11,733,000 for the three and nine months ended September 30, 2010, respectively; an increase of $1,610,000 and $2,862,000 compared to the three and nine months ended September 30, 2009, respectively. The increase in net sales for the quarter ended September 30, 2010 from the quarter ended September 30, 2009 was primarily the result of a $923,000 increase in government-related contractual research and product sales, as well as a $1,162,000 increase in product-based net sales by our US products division. These gains were partially offset by a decrease in the net sales of our UK subsidiary of $539,000 as compared to the quarter ended September 30, 2009.

Revenues from our products-based business include, but are not limited to, revenues recognized upon shipping, product sale at completion of installation and installation service at completion of installation. Revenues from our lighting solutions-based business include, but are not limited to, revenues recognized from long-term contracts on a percentage-of-completion basis or the fair value of certain contract deliverables. For a detailed discussion on our revenue recognition policy, see our Annual Report on Form 10-K for the year ended December 31, 2009.

Gross profit was $1,862,000 and $4,825,000 for the three and nine months ended September 30, 2010, respectively; an increase of $1,539,000 and $3,462,000 compared to the three and nine months ended September 30, 2009, respectively. The gross profit margin, as a percentage of sales, increased to 20.6% and 18.3% for the three and nine months ended September 30, 2010, respectively, as compared to 10.7% and 15.4% for the three and nine months ended September 30, 2009, respectively, and is primarily the result of higher profit margins relating to our solution-based net sales and product-based business in the third quarter of 2010 coupled with a reduction in indirect costs of our US product-based business.

During 2009, global economic conditions within all of our product-based legacy markets, and particularly within the housing and new construction markets, deteriorated at a pace faster than our cost reduction initiatives could offset. We maintained two manufacturing and assembly facilities for our North American operations which resulted in overall lower gross profitability on a net sales per dollar basis. In a continuing effort to reduce the fixed overhead of the Company, and in conjunction with the strategic transition into a turnkey energy-efficient lighting services solutions company, we relocated 100% of the North American manufacturing and assembly operation into our lower cost Mexican contract manufacturing facility. Relative to our solutions business segment, we continue to aggressively pursue material cost reductions from our current vendor base and are also exploring alternative vendors to supply this explosive growth segment. Furthermore, we continue to reduce our fixed overhead within our corporate infrastructure including the continued negotiation with our Solon facility landlord to develop a lower-cost and mutually beneficial cost structure for that facility. As of September 30, 2010, we have reached a verbal agreement with the landlord that will provide for a significantly lower monthly lease structure in return for an extension of lease term upon the termination of the current lease at the end of April, 2011.

Research and Development

Research and development expense that has not been reclassified to cost of goods sold was $164,000 for the three months ended September 30, 2010, as compared to $236,000 for the three months ended September 30, 2009. Revenues recognized by research and development for the same three month period ended September 30, 2010 and 2009 were $977,000 and $16,000, respectively. Year-to-date 2010 research and development expense that has not been reclassified to cost of goods sold was $566,000 as compared to $878,000 for 2009, while revenues recognized by research and development for the same nine month period ended September 30, 2010 and 2009 were $2,305,000 and $91,000, respectively.

Our research and development expenses are further reduced on a proportional performance basis under DARPA Small Business Innovation Research (SBIR) development contracts. During 2009 and 2010, additional SBIR contracts were signed totaling $2,548,000. Of this total contract amount, $1,078,000 was billed through September 30, 2010 with the remaining $1,470,000 categorized as unrecognized reductions of gross research and development expenses. The research and development spending that has not been reclassified to cost of goods sold along with credits from government contracts is shown in the following table (in thousands):

	Three months ended September 30,	Nine months ended September 30,

	2010	2009	2010	2009
Gross research and development expense	$ 164	$ 236	$ 566	$ 878
Deduct: incurred and accrued credits from government contracts	(186)	(297)	(667)	(608)
Net research and development (income) expense	$ (22)	$ (61)	$ (101)	$ 270

Sales and Marketing

Sales and marketing expenses increased 20.4% to $1,721,000 for the three months ended September 30, 2010, as compared to $1,429,000 for the three months ended September 30, 2009. Included in the 2010 sales and marketing expenses are expenses related to SRC of $426,000. Excluding the SRC related expenses, sales and marketing expenses decreased 9.4% to $1,295,000, primarily due to decreased salaries and benefits, as well as management s continuing efforts to reduce costs.

Sales and marketing expenses increased 6.8% to $4,858,000 for the nine months ended September 30, 2010, as compared to $4,549,000 for the nine months ended September 30, 2009. The increase is primarily due to sales and marketing expenses related to SRC of $1,048,000. Excluding the SRC related expenses, sales and marketing expenses decreased 16.2% to $3,810,000, primarily due to decreased salaries and benefits, as well as management s continuing efforts to reduce costs.

General and Administrative

General and administrative expenses increased $120,000 to $1,528,000 for the three months ended September 30, 2010, as compared to $1,408,000 for the three months ended September 30, 2009. The increase is primarily due to general and administrative expenses related to SRC of $397,000. Included in the general and administrative expenses related to SRC is a non-cash charge of $268,000 for the amortization of SRC s intangible assets. Excluding the SRC related expenses, general and administrative expenses decreased by $277,000 or 19.7%, which is primarily attributable to expenses incurred in 2009 relating to our rights offering partially offset by increases in 2010 for non-cash charges for stock compensation and valuation of equity securities.

General and administrative expenses increased $878,000 to $4,723,000 for the nine months ended September 30, 2010 as compared to $3,845,000 for the nine months ended September 30, 2009. The increase is primarily due to general and administrative expenses related to SRC of $1,080,000. Included in the general and administrative expenses related to SRC is a non-cash charge of $805,000 for the amortization of SRC s intangible assets. Excluding the SRC related expenses, general and administrative expenses decreased 5.3% to $3,643,000, primarily due to a decrease in employee wages and other employee costs.

Revaluation of Equity Instruments

During the first quarter of 2010, we recognized a non-cash charge of $1,421,000 related to the revaluation of warrants to purchase shares of our common stock acquired by The Trust in our March 2008 equity financing. Furthermore, during the second quarter of 2010, we recognized non-cash charges of $281,000 related to the valuation of 350,000 warrants issued to Lincoln Park Capital Partners, LLC in May, 2010 and $101,000 relating to the valuation of our common stock issued to Lincoln Park Capital Partners, LLC. Please refer to Note 12 of our financial statements for discussion of the transaction with The Trust.

Restructuring Expenses

For the nine months ended September 30, 2010, we recognized restructuring expenses of $26,000. 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 nine months ended September 30, 2009, we incurred restructuring expenses of $125,000 associated with relocating our manufacturing operations in the United States from Solon, Ohio to Mexico.

Other Income and Expenses

We had interest income of $1,000 and interest expense of $154,000 for the three months ended September 30, 2010. We had interest income of $4,000 and interest expense of $404,000 for the nine months ended September 30, 2010. Interest income consists of interest earned on deposits. Interest expense includes interest on our long-term borrowings and contingent consideration, including any amortization of debt discounts related to these commitments. Please refer to Note 3 of our financial statements for discussion of this contingent consideration. We had interest income of $4,000 and interest expense of $25,000 for the three months ended September 30, 2009. We had interest income of $13,000 and interest expense of $74,000 for the nine months ended September 30, 2009.

Discontinued Operations

As part of our strategy of directing our core business activities towards providing turnkey lighting energy solutions to the existing public-sector building market, we determined that our German subsidiary was not directly aligned with this strategic initiative. Therefore, in the third quarter of 2009, we committed to a plan to sell our German subsidiary, LBM Lichtleit-Fasertechnik (LBM).

In December 2009, we completed the sale of our ownership in LBM for $225,000 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. 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.

Through September 30, 2010, LBM has not made any earn out payments to the Company nor has the Company accrued any earnings related to these payments.

Net sales from discontinued operations were $513,000 and $1,217,000 for the three and nine months ended September 30, 2009, respectively. Net income from discontinued operations was $69,000 for the three months ended September 30, 2009. Net loss from discontinued operations was $600,000 for the nine months ended September 30, 2009.

We have reported the business described above as discontinued operations for all periods presented. Please refer to Note 4 of our financial statements for a discussion concerning discontinued operations.

Net loss

We recorded a net loss of $1,563,000 for the three months ended September 30, 2010; a 40.3% decrease from the net loss of $2,618,000 for the three months ended September 30, 2009 including the impact of discontinued operations. Of this loss, $268,000 is a non-cash charge for the amortization of SRC s intangible assets and $54,000 is a non-cash charge related to the valuation of certain financial securities. We recorded a net loss of $6,945,000 for the nine months ended September 30, 2010 compared to a net loss of $8,008,000 for the nine months ended September 30, 2009. Of this loss, $805,000 is a non-cash charge for the amortization of SRC s intangible assets and $1,803,000 is a non-cash charge related to the valuation of certain financial securities.

Liquidity and Capital Resources

Cash and Cash Equivalents

At September 30, 2010, our cash and cash equivalents were $2,748,000 as compared to $1,062,000 at December 31, 2009, a net cash increase of $1,686,000 for the nine months September 30, 2010. This compares to a net cash decrease of $7,429,000 for nine months ended September 30, 2009.

Net Cash (Used in) Provided by Operating Activities

Net cash used in operating activities of continuing operations primarily consists of net loss adjusted by non-cash items, including depreciation, amortization, and stock-based compensation, as well as the effect of changes in working capital. Cash decreased during the nine months ended September 30, 2010, by a net loss of $6,945,000, compared to a net loss of $7,408,000 for the nine months ended September 30, 2009. After adjustments, net cash provided by operating activities of continuing operations was $155,000 for the nine months ended September 30, 2010 compared to a net cash usage of $6,634,000 for the nine months ended September 30, 2009.

Net cash provided by operating activities of discontinued operations primarily consisted of net loss adjusted by non-cash items, including depreciation, as well as the effect of changes in working capital. Cash decreased during the nine months ended September 30, 2009, by a net loss of $600,000 for the nine months ended September 30, 2009. After adjustments, net cash provided by operating activities of discontinued operations was $186,000 for the nine months ended September 30, 2009.

Net Cash Used in Investing Activities

Net cash used in investing activities of continuing operations was $119,000 for the nine months ended September 30, 2010, a decrease of 25.2% compared to a net cash usage of $159,000 for the nine months ended September 30, 2009. During both periods, cash was used for the acquisition of fixed assets.

Net cash provided by investing activities of discontinued operations was $313,000 for the nine months ended September 30, 2009.

Net Cash Provided by (Used in) Financing Activities

Net cash provided by financing activities of continuing operations was $1,643,000 for the nine months ended September 30, 2010. Cash provided was due to the selling of a Secured Subordinated Promissory Note for the principal amount of $1,150,000 and $493,000 of net proceeds from the issuance of shares of Energy Focus, Inc. common stock. Please refer to the discussion below for details of these transactions.

Net cash used in financing activities of continuing operations for the nine months ended September 30, 2009 was $320,000 while net cash used in financing activities of discontinued operations was $420,000 for this same period. This cash usage was due to payment on our line of credit and long-term borrowings.

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 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 $375,000. 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. We have the right to direct LPC to purchase up to 20,000 shares as often as every five (5) business days. 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 business dates notice. In connection with the transactions contemplated by the Purchase Agreement, the Company 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 September 30, 2010, we sold and issued to LPC, and LPC purchased from us, a total of 540,750 shares of our common stock for a total consideration of $646,000. On October 6, 2010 and November 1, 2010, we sold and issued to LPC, and LPC purchased from us, a total of 82,400 shares of our common stock for a total consideration of $87,000. Although we retain the right, in our sole discretion, to terminate the agreement without fee, penalty, or cost, we reserve the right to continue to utilize this financing activity for general corporate and working capital purposes and pursuit of our business strategy.

On May 18, 2010, we received a notification from the NASDAQ Listing Qualifications Department indicating that our shareholders equity as shown in its Condensed Consolidated Balance Sheet as of March 31, 2010 was $9,727,000, which was less than the minimum $10,000,000 required by NASDAQ Listing Rule 5450(b)(1)(A). In response to the notification, on July 14, 2010 we transferred the listing of the Company s common stock from the NASDAQ Global Market to the NASDAQ Capital Market. Like the Global Market, the Capital Market has certain continued listing requirements. Among them, the Capital Market requires a listed company to have a minimum of $2,500,000 in stockholders equity and a minimum bid price of a company s shares of $1.00. We are in compliance with all current listing requirements.

Long-Term Borrowings

Effective October 15, 2008, we entered into a one year credit agreement with Silicon Valley Bank (SVB) incorporating a $4,000,000 revolving line of credit which replaced all existing facilities including the United States term loans. This new line of credit included a $1,500,000 sub-limit for cash management products, letters of credit and foreign currency exchange. 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 also required to comply with certain covenant requirements, including a tangible net worth covenant. The amount of borrowings available to the Company was the lesser of $4,000,000 or the sum of up to 75% of eligible accounts receivable, as defined by the agreement, and 50% of our cash balance in deposit at SVB, capped at $1,500,000.

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 (agreements) with effective dates ranging from January 31, 2009 through November 17, 2009. In conjunction with these agreements, the terms of our credit facility were revised culminating in a reduction to our revolving line of credit to $1,300,000 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 3.00%. Under this revised credit facility, we were required to maintain all of our cash and cash equivalents in operating and investment accounts with SVB and its affiliates and were also required to continue compliance with certain covenant requirements, including the tangible net worth covenant. During the third quarter of 2009, SVB informed the Company 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 $253,000 on the line of credit.

On May 27, 2009, we entered into an Unsecured Promissory Note (Note) with The Quercus Trust (The Trust) in the amount of $70,000. Under the terms of this Note, we are obligated to pay The Trust 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.

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 the Company, and with The Trust, for $250,000 and $300,000, 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 15% and 18%, respectively, 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 are subordinated to the senior indebtedness of the Company and CLL. As an incentive to enter into the LOC s, we issued five-year, detached warrants to purchase 125,000 and 150,000 shares, respectively, of common stock at an exercise price of $0.01 per share.

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 $500,000. 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 common stock of the Company is not 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 $500,000 on the maturity date. The Company accrued for this potential fee at the time of the agreement.

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 $1,150,000. We secured the full amount of this financing with a pledge of our United States gross accounts receivable and selected capital equipment. This Subordinated Note bears interest at a rate of 12.5%, which is payable quarterly, in arrears, commencing September 30, 2010. The entire outstanding principal balance of this Subordinated Note, together with all accrued interest thereon, is due and payable on March 30, 2013. Additionally, we issued to the eight investors in EF Energy five-year, detached penny warrants ($.01 per share) to purchase shares of our 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. The Company and EF Energy Partners are not related.

Through our United Kingdom subsidiary, we maintain a British pounds sterling-denominated bank overdraft facility with Lloyds Bank Plc, in the amount of $397,000, based on the exchange rate at September 30, 2010. There were no borrowings against this facility as of September 30, 2010 or December 31, 2009. This facility is renewed annually on January 1. The interest rate on the facility was 2.75% at September 30, 2010, and December 31, 2009.

Liquidity

Historically, we have incurred losses attributable to operational performance which have negatively impacted cash flows. Although we continue 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 the Company to attain profitability and growth, we will need to continue to successfully address these challenges, including the continuation of cost reductions throughout our organization, execution of our marketing and sales plans for our new turnkey energy-efficient lighting solutions business, continued exploration of accretive acquisition targets, continued evaluation and potential divestiture of select business product lines, and continued improvements in our supply chain performance.

We are optimistic about obtaining the funding necessary for the Company to meet on-going tactical and strategic capital requirements. However, 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 the following:

- obtain financing from non-traditional investment capital organizations,
- potential sale or divestiture of one or more operating units, and
- obtain funding from the sale of our common stock or other equity, debt, or convertible 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 economic environment combined with our capital constraints 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 economic environment and could lead to further dilution of shareholder value for current shareholders of record.

Critical Accounting Policies

The preparation of our 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 which we believe have the most significant impact on our financial statements include allowances for doubtful accounts, returns, warranties, valuation of inventories, revenues recognized on a percentage-of-completion basis and stock-based compensation. For the detailed discussion of the application of policies critical to our business operations, see our Annual Report on Form 10-K for the year ended December 31, 2009.

Recent Accounting Pronouncements

In January, 2010, the FASB issued Accounting Standards Update (ASU) 2010-02, *Consolidation (Topic 810) Accounting and Reporting for Decreases in Ownership of a Subsidiary A Scope Clarification*. ASU 2010-02 clarifies the scope of the decrease in ownership provisions of Subtopic 810 and expands disclosure requirements about deconsolidation of a subsidiary or de-recognition of a group of assets. ASU 2010-02 is effective beginning in the first interim of annual reporting period ending on or after December 15, 2009. The adoption of ASU 2010-02-02 did not have an impact on our consolidated financial statements.

In October, 2009, the FASB issued ASU 2009-013, *Revenue Recognition (Topic 605) Multiple-Deliverable Revenue Arrangements*. ASU 2009-13 revises certain accounting for revenue arrangements with multiple deliverables. In particular, when vendor specific objective evidence or third-party evidence for deliverables in an arrangement cannot be determined, ASU 2009-13 allows use of a best estimate of the selling price to allocate the arrangement consideration among them. ASU 2009-13 is effective for the first quarter of 2011, with early adoption permitted. The Company has adopted ASU 2009-13, which did not have a material impact on our consolidated financial statements.

In August, 2009, the FASB issued ASU 2009-05, an amendment to Accounting Standards Codification 820-10, *Fair Value Measurements and Disclosures Overall* for measuring liabilities at fair value. ASU 2009-05 provides clarification that in certain circumstances in which a quoted price in an active market for the identical liability is not available, a reporting entity is required to measure fair value using certain other valuation techniques. The guidance provided in this ASU is effective for the first reporting period beginning after issuance. This ASU had no impact on our consolidated financial statements.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

As of September 30, 2010, we had British pounds sterling-denominated cash valued at $508,000 held in the United Kingdom, based on the exchange rate at September 30, 2010. The balances for cash held in the United Kingdom are subject to exchange rate risk. We have a policy of maintaining cash balances in local currency unless an amount of cash is occasionally transferred in order to repay inter-company debts.

ITEM 4. CONTROLS AND PROCEDURES

(a) Evaluation of disclosure controls and procedures

We maintain disclosure controls and procedures, as such term is defined in Rule 13a-15(e) under the Securities Exchange Act of 1934 (the Exchange Act), that are designed to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in Securities and Exchange Commission rules and forms and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating our disclosure controls and procedures, management recognized that disclosure controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the disclosure controls and procedures are met. Our disclosure controls and procedures have been designed to meet, and management believes that they meet, reasonable assurance standards. Additionally, in designing disclosure controls and procedures, our management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible disclosure controls and procedures. Any design of disclosure controls and procedures also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions.

Based on their evaluation as of the end of the period covered by this Quarterly Report on Form 10-Q, our Chief Executive Officer and Chief Financial Officer have concluded that, subject to the limitations noted above, our disclosure controls and procedures were effective to ensure that material information relating to us, including our consolidated subsidiaries, is made known to them by others within those entities, particularly during the period in which this Quarterly Report on Form 10-Q was being prepared.

(b) Changes in internal control over financial reporting

During the quarter, we replaced our Manager of Financial Reporting. Our new manager has over eight years of financial reporting, analysis, and budgeting experience with nationally-recognized, multi-billion dollar, publicly-traded companies and approximately two years of experience working with internationally-recognized independent public accounting firms. There were no other changes in our internal controls over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) during the quarter. Further, there were no other items identified in connection with our internal evaluations that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

There have been no material changes in the legal proceedings discussed in our Annual Report on Form 10-K for the year ended December 31, 2009 and our Quarterly Report on Form 10-Q for the quarter ended June 30, 2010. However, we are involved in other litigation which, in our opinion, will not have a material adverse effect on our financial position, results of operations or cash flows.

ITEM 1A. RISK FACTORS

Other than the below risk factor, there are no significant changes in risk factors from our Annual Report on Form 10-K for the year ended December 31, 2009.

Compliance with the continued listing requirements of the NASDAQ Stock Market.

Prior to the opening of trading on July 14, 2010, the listing of our shares of common stock for trading transferred from the NASDAQ Global Market to the NASDAQ Capital Market.

From time to time during the fourth quarter of 2009 and early in the first quarter of 2010, we did not meet the Global Market s continued listing requirements that called for the maintenance of a minimum bid price of our common stock of $1.00 per share and minimum shareholders equity of $10,000,000. We received formal notices of non-compliance from the Global Market. Although we regained compliance with the continued listing requirements on those occasions, there was a continuing risk that we could again become non-compliant with the requirements.

In this regard, our shareholders equity as of the end of the first quarter fell below the minimum shareholders equity requirement of the Global Market. On May 18, 2010, we received a notification from the Global Market that we had fallen out of compliance and that we had until July 2, 2010 to submit a plan to regain compliance or to submit an application to transfer the listing of our shares of common stock from the NASDAQ Global Market to the NASDAQ Capital Market where the minimum shareholders equity listing requirement is $2,500,000. On July 2, 2010 we submitted an application to transfer to the Capital Market. On July 9, 2010 the NASDAQ Stock Market informed us that it had approved our transfer application. Our common stock began trading on the Capital Market on July 14, 2010.

The Capital Market, like the Global Market, has a continued listing requirement that calls for the maintenance of a minimum bid price of our common stock of $1.00 per share. If the minimum bid price of our common stock should fall below $1.00 for an extended period of time in the future, we will be required to take remedial action on it. The Company is currently in compliance with all listing requirements.

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

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 to purchase 350,000 shares at an exercise price of $1.20 per share, for a total consideration of $375,000. During the month of July 2010, we sold and issued to LPC, and LPC purchased from us, 30,900 shares of the Company s common stock for a total consideration of $37,000. We have used the proceeds from the sale of shares to LPC for general corporate and working capital purposes and to pursue our business strategy. In connection with the transactions contemplated by the Purchase Agreement, we filed a Registration Statement with 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.

ITEM 5. OTHER INFORMATION

As mentioned in Item 1A above, our shareholders equity as of the end of the first quarter fell below the minimum shareholders equity requirement of the Global Market. On May 18, 2010, we received a notification from the Global Market that we had fallen out of compliance and that we had until July 2, 2010 to submit a plan to regain compliance or to submit an application to transfer the listing of our shares of common stock from the NASDAQ Global Market to the NASDAQ Capital Market where the minimum shareholders equity listing requirement is $2,500,000. On July 2, 2010 we submitted an application to transfer to the Capital Market. On July 9, 2010 the NASDAQ Stock Market informed us that it had approved our transfer application. Our common stock began trading on the Capital Market on July 14, 2010 and we are currently in compliance with all listing requirements.

ITEM 6. EXHIBITS

Exhibit Number	Description
31.1	Rule 13a-14(a) Certification of Chief Executive Officer.
31.2	Rule 13a-14(a) Certification of Chief Financial Officer.
32.1	Statement of Chief Executive Officer under Section 906 of the Sarbanes-Oxley Act of 2003 (18 U.S.C. §1350).
32.2	Statement of Chief Financial Officer under Section 906 of the Sarbanes-Oxley Act of 2003 (18 U.S.C. §1350).

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

ENERGY FOCUS, INC.

Date: November 11, 2010

By: /s/ Joseph G. Kaveski
Joseph G. Kaveski
Chief Executive Officer

By: /s/ Nicholas G. Berchtold
Nicholas G. Berchtold
Chief Financial Officer
(Principal Financial and Accounting Officer)

EXHIBIT INDEX

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