

ENERGY FOCUS, INC/DE
Form 10-Q
November 14, 2012

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

Form 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2012

OR

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
(State or other jurisdiction of incorporation
or organization)

94-3021850
(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

None
(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 No

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 No

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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 the definitions of “large accelerated filer”, “accelerated filer”, and “smaller reporting company” in rule 12b-2 of the Exchange Act.

| | |
|--|---|
| Large accelerated filer <input type="checkbox"/> | Accelerated filer <input type="checkbox"/> |
| Non-accelerated filer <input type="checkbox"/> (do not check if a smaller reporting company) | Smaller reporting company <input checked="" type="checkbox"/> |

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

The number of outstanding shares of the registrant’s Common Stock, \$0.0001 par value, as of October 31, 2012 was 44,541,696.

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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, 2012 | December 31, 2011 |
|---|-----------------------|----------------------|
| (unaudited) | | |
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 380 | \$ 2,136 |
| Trade accounts receivable less allowances of \$321 and \$447, respectively | 4,193 | 2,738 |
| Retainage receivable | 91 | 474 |
| Inventories, net | 2,364 | 2,429 |
| Costs in excess of billings | 45 | 171 |
| Prepaid and other current assets | 1,226 | 881 |
| Total current assets | 8,299 | 8,829 |
| Property and equipment, net | 1,787 | 2,105 |
| Goodwill | 672 | 672 |
| Intangible assets, net | 713 | 1,027 |
| Collateralized assets | 1,000 | 1,000 |
| Other assets | 86 | 145 |
| Total assets | \$ 12,557 | \$ 13,778 |
| LIABILITIES | | |
| Current liabilities: | | |
| Accounts payable | \$ 3,591 | \$ 5,653 |
| Accrued liabilities | 3,045 | 1,995 |
| Deferred revenue | 539 | 1,373 |
| Billings in excess of costs | 221 | 154 |
| Credit line borrowings | 1,330 | 701 |
| Current maturities of long-term debt | 731 | 855 |
| Total current liabilities | 9,457 | 10,731 |
| Other liabilities | 31 | 71 |
| Acquisition-related contingent liabilities | - | 553 |
| Long-term debt | 307 | 955 |
| Total liabilities | 9,795 | 12,310 |
| SHAREHOLDERS' EQUITY | | |
| Preferred stock, par value \$0.0001 per share: | | |
| Authorized: 2,000,000 shares in 2012 and 2011 Issued and outstanding: no shares in 2012 and 2011 | - | - |
| Common stock, par value \$0.0001 per share: | | |
| Authorized: 100,000,000 shares in 2012 and 60,000,000 shares in 2011 Issued and outstanding: 44,542,000 at September 30, 2012 and 24,913,000 at December 31, 2011 | 4 | 1 |

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| | | |
|--|-----------|-----------|
| Additional paid-in capital | 80,911 | 75,962 |
| Accumulated other comprehensive income | 457 | 420 |
| Accumulated deficit | (78,610) | (74,915) |
| Total shareholders' equity | 2,762 | 1,468 |
| Total liabilities and shareholders' equity | \$ 12,557 | \$ 13,778 |

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, | |
|--|-------------------------------------|------------|------------------------------------|------------|
| | 2012 | 2011 | 2012 | 2011 |
| Net sales | \$7,904 | \$6,046 | \$20,878 | \$19,699 |
| Cost of sales | 5,945 | 4,831 | 16,430 | 15,777 |
| Gross profit | 1,959 | 1,215 | 4,448 | 3,922 |
| Operating expenses: | | | | |
| Research and development | 102 | (278) | 87 | (144) |
| Sales and marketing | 1,423 | 1,524 | 4,084 | 5,095 |
| General and administrative | 1,211 | 1,212 | 3,479 | 3,834 |
| Valuation of equity instruments | - | - | - | 56 |
| Total operating expenses | 2,736 | 2,458 | 7,650 | 8,841 |
| Loss from operations | (777) | (1,243) | (3,202) | (4,919) |
| Other income (expense): | | | | |
| Other (expense) income | (26) | (6) | (98) | 65 |
| Interest income | - | - | 1 | 3 |
| Interest expense | (123) | (206) | (388) | (581) |
| Loss before income taxes | (926) | (1,455) | (3,687) | (5,432) |
| Provision for income taxes | (2) | (4) | (8) | (13) |
| Net loss | \$(928) | \$(1,459) | \$(3,695) | \$(5,445) |
| Net loss per share - basic and diluted | \$(0.02) | \$(0.06) | \$(0.09) | \$(0.22) |
| Shares used in computing net loss per share - basic and diluted | 44,542 | 24,845 | 40,241 | 24,610 |

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, | |
|--|-------------------------------------|-------------|------------------------------------|-------------|
| | 2012 | 2011 | 2012 | 2011 |
| Net loss | \$ (928) | \$ (1,459) | \$ (3,695) | \$ (5,445) |
| Other comprehensive income: | | | | |
| Foreign currency translation adjustments | 26 | (27) | 37 | 2 |
| Comprehensive loss | \$ (902) | \$ (1,486) | \$ (3,658) | \$ (5,443) |

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, | |
|---|------------------------------------|------------|
| | 2012 | 2011 |
| Cash flows from operating activities: | | |
| Net loss | \$(3,695 |) \$(5,445 |
| Adjustments to reconcile net loss to net cash used in operating activities: | | |
| Depreciation | 478 | 463 |
| Stock-based compensation | 146 | 384 |
| Valuation of equity instruments | - | 56 |
| Provision for doubtful accounts receivable | 104 | 45 |
| Amortization of intangible assets | 314 | 487 |
| Amortization of discounts on long-term borrowings and acquisition related liabilities | 180 | 375 |
| Deferred revenue | (766 |) 70 |
| Gain on disposal of fixed assets | - | (10 |
| Changes in assets and liabilities: | | |
| Accounts receivable, inventories, and other assets | (1,274 |) 2,512 |
| Accounts payable and accrued liabilities | (1,655 |) (1,625 |
| Total adjustments | (2,473 |) 2,757 |
| Net cash used in operating activities | (6,168 |) (2,688 |
| Cash flows from investing activities: | | |
| Acquisition of property and equipment | (159 |) (222 |
| Proceeds from the sale of property and equipment | - | 9 |
| Net cash used in investing activities | (159 |) (213 |
| Cash flows from financing activities: | | |
| Proceeds from issuances of common stock, net | 4,805 | 450 |
| Proceeds from other borrowings | - | 250 |
| Payments on other borrowings | (873 |) (18 |
| Net proceeds on credit line borrowings | 629 | - |
| Net cash provided by financing activities | 4,561 | 682 |
| Effect of exchange rate changes on cash | 10 | 2 |
| Net decrease in cash and cash equivalents | (1,756 |) (2,217 |
| Cash and cash equivalents at beginning of period | 2,136 | 4,107 |
| Cash and cash equivalents at end of period | \$380 | \$1,890 |
| Classification of cash and cash equivalents: | | |
| Cash and cash equivalents | \$353 | \$1,803 |
| Restricted cash held | 27 | 87 |
| Cash and cash equivalents at end of period | \$380 | \$1,890 |

Supplemental Information - Non-cash financing activities

| | |
|--|-------|
| Cognovit promissory note for past due rent | \$355 |
|--|-------|

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

ENERGY FOCUS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2012
(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 military, 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”), fiber optic, high-intensity discharge (“HID”), fluorescent tube and other highly energy-efficient lighting technologies. 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.

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 the 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 and such differences could be material.

Reclassifications

Certain prior year amounts have been reclassified within the Condensed 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. All significant inter-company balances and transactions have been eliminated.

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.

ENERGY FOCUS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2012
(Unaudited)

The Company's independent public accounting firm has issued an opinion in connection with its 2011 Annual Report on Form 10-K raising substantial doubt as to its ability to continue as a going concern. The interim financial statements have been prepared assuming the Company will continue to operate as a going concern, which contemplates the realization of assets and the settlement of liabilities in the normal course of business. The interim financial statements do not include any adjustments to reflect the possible future effects on the recoverability and classification of assets or the amounts and classification of liabilities that may result from uncertainty related to our ability to continue as a going concern.

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, 2011, which are contained in the Company's 2011 Annual Report on Form 10-K and amendments thereof ("Form 10-K").

Recent Accounting Pronouncements

In May 2011, the Financial Accounting Standards Board ("FASB") issued ASU 2011-04, Fair Value Measurement, amending ASC Topic 820, which eliminates terminology differences between U.S. generally accepted accounting principles ("GAAP") and International Financial Reporting Standards ("IFRS") on the measurement of fair value and related fair value disclosures. While largely consistent with existing fair value measurement principles and disclosures, the changes were made as part of the continuing efforts to converge GAAP and IFRS. The adoption of this guidance was effective for interim and annual periods beginning after December 15, 2011, and its adoption did not have a material impact on the financial statements of the Company.

In June 2011, the FASB issued ASU 2011-05, Comprehensive Income, amending ASC Topic 220. Under ASU 2011-05, an entity has the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The guidance was issued to improve the comparability, consistency and transparency of financial reporting and to increase the prominence of items reported in other comprehensive income. The guidance is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. Its adoption did not have a material impact on the Company's financial statements.

In July 2012, the FASB issued ASU 2012-02, Intangibles — Goodwill and Other, amending ASC Topic 350. Under the revised guidance, entities testing indefinite-lived intangible assets for impairment have the option of performing a qualitative assessment before calculating fair value. If entities determine, on the basis of qualitative factors, that it is more likely than not that the fair value of the indefinite-lived intangible is less than the carrying amount, the fair value calculation would be required. The ASU also requires that the same qualitative factors be considered when determining whether an interim impairment evaluation is necessary. The guidance is effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012, with early adoption permitted. The adoption of this guidance is not expected to have a material effect on our financial statements.

Retainage Receivable

The Company's solutions-based sales are normally subject to a holdback of a percentage of the sale as retainage. This holdback is recorded on the Company's Condensed Consolidated Balance Sheets as "Retainage receivable". Retainage is a portion of the total bid price of a project that is held back by the customer until the project is complete and functioning satisfactorily according to the contract terms. Retainage percentages typically range from 5% to 10% and are collected anywhere from three to eighteen months from the inception of the project. At September 30, 2012 and December 31, 2011, the Company had a Retainage receivable from its customers totaling \$91 thousand and \$474 thousand, respectively.

Collateralized Assets

The Company maintains \$1.0 million of cash collateral related to its surety bonding program associated with SRC. This cash is pledged to the surety carrier until such time as the Company is able to provide sufficient alternative means of collateralization satisfactory to the surety carrier.

ENERGY FOCUS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2012
(Unaudited)

Earnings (Loss) per Share

Basic loss per share is computed by dividing the 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, | |
|---|-------------------------------------|------------------|------------------------------------|------------------|
| | 2012 | 2011 | 2012 | 2011 |
| Basic and diluted loss per share: | | | | |
| Net loss | \$(928) | \$(1,459) | \$(3,695) | \$(5,445) |
| Basic and diluted loss per share: | | | | |
| Weighted average shares outstanding | 44,542 | 24,845 | 40,241 | 24,610 |
| Basic and diluted net loss per share | \$(0.02) | \$(0.06) | \$(0.09) | \$(0.22) |

Options and warrants to purchase approximately 15,283,000 and 5,804,000 shares of common stock, were outstanding at September 30, 2012 and 2011, respectively, 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 2011 Form 10-K for the year ended December 31, 2011. The following table summarizes the Company's stock-based compensation (in thousands):

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|-------------------------------------|------|------------------------------------|-------|
| | 2012 | 2011 | 2012 | 2011 |
| Stock option expense | \$42 | \$75 | \$146 | \$171 |
| Executive & Director stock-based compensation | - | - | - | 107 |
| Employee incentive stock-based compensation | - | - | - | 106 |
| Total stock-based compensation | \$42 | \$75 | \$146 | \$384 |

Total unearned compensation of \$241 thousand related to stock options remains at September 30, 2012 compared to \$452 thousand at September 30, 2011. These costs will be charged to expense and amortized on a straight line basis in future periods through the third quarter of 2016. The weighted average period over which this unearned compensation is expected to be recognized is approximately 1.1 years.

ENERGY FOCUS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2012
(Unaudited)

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 the option, risk-free interest rate, and expected volatility, and are further comparatively detailed as follows:

| | Nine months ended September 30, | | | |
|---------------------------------|------------------------------------|-------|------|-------|
| | 2012 | | 2011 | |
| Fair value of options issued | \$ | 0.15 | \$ | 0.45 |
| Exercise price | \$ | 0.27 | \$ | 0.83 |
| Expected life of option (years) | | 5.6 | | 6.1 |
| Risk-free interest rate | | 0.82 | % | 2.14 |
| Expected volatility | | 59.00 | % | 56.39 |
| Dividend yield | | 0 | % | 0 |

Option activity under the Company's stock plans during the nine months ended September 30, 2012 was as follows:

| | Options | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term (in Years) |
|--------------------------------------|------------|---------------------------------------|---|
| Outstanding as of December 31, 2011 | 2,318,498 | \$ 2.28 | |
| Granted | 120,000 | \$ 0.27 | |
| Exercised | - | \$ - | |
| Cancelled/forfeited | (212,248) | \$ 2.52 | |
| Outstanding as of September 30, 2012 | 2,226,250 | \$ 2.17 | 7.0 |
| Exercisable as of September 30, 2012 | 1,394,611 | \$ 3.02 | 6.1 |

At the 2012 Annual Meeting of Shareholders held on July 25, 2012, 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 3,000,000 shares to 5,000,000 shares. Additionally, the shareholders approved an increase in the total number of shares of common stock that may be issued under the 1994 Employee Stock Purchase Plan from 400,000 to 600,000.

Product Warranties

The Company warrants finished goods against defects in material and workmanship under normal use and service for periods generally between one and five 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 Sheets. The warranty activity for the respective periods is as follows (in thousands):

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| | Three months ended September 30, | | Nine months ended September 30, | |
|--|-------------------------------------|--------|------------------------------------|--------|
| | 2012 | 2011 | 2012 | 2011 |
| Balance at the beginning of the period | \$ 125 | \$ 100 | \$ 100 | \$ 126 |
| Accruals for warranties issued | 52 | 23 | 110 | 45 |
| Settlements made during the period (in cash or in kind) | (18) | (23) | (51) | (71) |
| Balance at the end of the period | \$ 159 | \$ 100 | \$ 159 | \$ 100 |

ENERGY FOCUS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2012
(Unaudited)

NOTE 3. 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, net of reserves (in thousands):

| | September 30, 2012 | December 31, 2011 |
|------------------|-----------------------|----------------------|
| Raw materials | \$ 1,446 | \$ 1,517 |
| Finished goods | 918 | 912 |
| Inventories, net | \$ 2,364 | \$ 2,429 |

NOTE 4. PROPERTY AND EQUIPMENT

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

| | September 30, 2012 | December 31, 2011 |
|---|--------------------------|-------------------------|
| Equipment (useful life 3 - 15 years) | \$5,847 | \$5,831 |
| Tooling (useful life 2 - 5 years) | 2,481 | 2,440 |
| Furniture and fixtures (useful life 5 years) | 132 | 129 |
| Computer software (useful life 3 years) | 462 | 431 |
| Leasehold improvements (the shorter of useful life or lease life) | 632 | 630 |
| Construction in progress | 110 | 27 |
| Property and equipment at cost | 9,664 | 9,488 |
| Less: accumulated depreciation | (7,877) | (7,383) |
| Property and equipment, net | \$1,787 | \$2,105 |

NOTE 5. GOODWILL AND INTANGIBLE ASSETS

The following table summarizes information related to net carrying value of intangible assets (in thousands):

| | Amortization Life (in years) | September 30, 2012 | December 31, 2011 |
|-----------------------------------|------------------------------------|--------------------------|-------------------------|
| Goodwill | n/a | \$672 | \$672 |
| Definite-lived intangible assets: | | | |
| Tradenames | 10 | 363 | 400 |

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| | | | |
|--|---|---------|---------|
| Customer relationships | 5 | 350 | 627 |
| Total definite-lived intangible assets | | 713 | 1,027 |
| Total intangible assets, net | | \$1,385 | \$1,699 |

ENERGY FOCUS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2012
(Unaudited)

Amortization expense for intangible assets subject to amortization was \$104 thousand and \$162 thousand for the three months ended September 30, 2012 and 2011, respectively. Amortization expense for the nine months ended September 30, 2012 and 2011 was \$314 thousand and \$487 thousand, respectively. The Company amortizes Tradenames on a straight-line basis over the estimated useful lives of the intangible assets. Customer relationships are amortized over their expected useful lives on an accelerated method that approximates the cash flows associated with those relationships. Based on the carrying value of amortized intangible assets, the Company estimates amortization expense for future years to be as follows (in thousands):

| Year ending December 31, | Amount |
|-------------------------------|--------|
| 2012 October through December | \$ 105 |
| 2013 | 253 |
| 2014 | 105 |
| 2015 | 50 |
| 2016 | 50 |
| 2017 and thereafter | 150 |
| Total amortization expense | \$ 713 |

As of September 30, 2012, the Company had \$672 thousand of goodwill on its financial statements related to the acquisition of SRC.

NOTE 6. CONTRACTS IN PROGRESS

Costs and estimated earnings on contracts in progress as of the periods indicated are summarized in the following table (in thousands):

| | September 30, 2012 | December 31, 2011 |
|--|--------------------------|-------------------------|
| Costs incurred on uncompleted contracts | \$3,922 | \$3,193 |
| Estimated earnings | 1,064 | 855 |
| Total revenues | 4,986 | 4,048 |
| Less: billings to date | 5,162 | 4,031 |
| Total | \$(176) |) \$17 |
| Balance sheet classification: | | |
| Costs in excess of billings on uncompleted contracts | \$45 | \$171 |
| Billings in excess of costs on uncompleted contracts | (221) |) (154) |
| Total | \$(176) |) \$17 |

NOTE 7. DEBT

Credit Facilities

On December 22, 2011, the Company entered into a \$4.5 million revolving line of credit (“credit facility”) with Rosenthal & Rosenthal. The total loan amount available to the Company under the line of credit is equal to 85% of its net amount of eligible receivables, plus available inventory (the lesser of 50% of the lower of cost or market value of eligible inventory, or \$250 thousand). The credit facility is secured by a lien on the domestic assets of the Company. The interest rate for borrowing on accounts receivable is 8.5%, on inventories 10.0% and on overdrafts 13.0%. Additionally, there is an annual 1% facility fee on the entire amount of the credit facility, \$4.5 million, payable at the beginning of the year. The credit facility is a three year agreement, expiring on December 31, 2014, unless terminated sooner. There are liquidated damages if the credit facility is terminated prior to December 31, 2014, which are based on the maximum credit facility amount then in effect. The damages are: 3% if terminated prior to the first anniversary of the closing date, 2% if terminated prior to the second anniversary of the closing date, and 1% if terminated prior to the third anniversary of the closing date. The Company is required to comply with certain financial covenants, measured quarterly, including, as defined in the agreement: a tangible net worth amount and a working capital amount. The Company was in compliance with the financial covenants at September 30, 2012. Borrowings under the revolving line of credit were \$1.3 million at September 30, 2012, and \$701 thousand at December 31, 2011, and are recorded in the Company’s Condensed Consolidated Balance Sheets as a current liability under the caption “Credit line borrowings.”

ENERGY FOCUS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2012
(Unaudited)

The Company maintained a British pounds sterling-denominated bank overdraft facility with Lloyds Bank Plc through its United Kingdom subsidiary in the amount of £100,000, which had been renewed on an annual basis in May. However, in May of 2012, this facility was not renewed. The interest rate on the facility at December 31, 2011 was 3.60%, and there were no borrowing against it at that time.

Borrowings

The components of the Company's debt at September 30, 2012 and December 31, 2011 were as follows (in thousands):

| | September 30, 2012 | December 31, 2011 |
|---|--------------------------|-------------------------|
| Letter of Credit Agreement - Mark Plush | \$250 | \$250 |
| Cognovit Note - Keystone Ruby, LLC | 289 | 325 |
| Secured Subordinated Promissory Note - EF Energy Partners LLC | - | 287 |
| Convertible Promissory Note - TLC Investments LLC | 500 | 500 |
| Letter of Credit Agreement - John Davenport | - | 250 |
| Letter of Credit Agreement - Quercus Trust | - | 300 |
| Unsecured Promissory Note - Quercus Trust | 70 | 70 |
| Discounts on long-term borrowings | (71) | (172) |
| Subtotal | 1,038 | 1,810 |
| Less: Current maturities of long-term debt | (731) | (855) |
| Long-term debt | \$307 | \$955 |

For a full description of the Company's debt financing, reference is made to Note 10, Debt, of the Company's 2011 Form 10-K.

Future maturities of remaining borrowings are (in thousands):

| Year ending December 31, | Long-Term Debt |
|---|-------------------|
| 2012 October through December | \$ 13 |
| 2013 | 804 |
| 2014 | 59 |
| 2015 | 65 |
| 2016 | 72 |
| 2017 and thereafter | 96 |
| Gross long-term borrowings | 1,109 |
| Less: discounts on long-term borrowings | (71) |
| Total commitment, net | 1,038 |

| | |
|-------------------------------------|--------|
| Less: portion classified as current | (731) |
| Long-term borrowings, net | \$ 307 |

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

NOTE 8. SEGMENTS AND GEOGRAPHIC INFORMATION

The Company has two reportable segments: product-based sales, featuring military, general commercial and industrial lighting, and pool 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 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 the Company's direct sales employees as well as our SRC subsidiary, and include not only its 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, | |
|---|-------------------------------------|---------|------------------------------------|-----------|
| | 2012 | 2011 | 2012 | 2011 |
| Solutions: | | | | |
| Net sales | \$2,066 | \$2,014 | \$5,811 | \$7,960 |
| Cost of sales | 1,672 | 1,686 | 4,912 | 6,686 |
| Gross profit | 394 | 328 | 899 | 1,274 |
| Operating expenses: | | | | |
| Sales and marketing | 320 | 311 | 1,004 | 1,032 |
| General and administrative | 244 | 231 | 558 | 706 |
| Total operating expenses | 564 | 542 | 1,562 | 1,738 |
| Segment loss | \$(170) | \$(214) | \$(663) | \$(464) |
| Products: | | | | |
| Net sales | \$5,838 | \$4,032 | \$15,067 | \$11,739 |
| Cost of sales | 4,273 | 3,145 | 11,518 | 9,091 |
| Gross profit | 1,565 | 887 | 3,549 | 2,648 |
| Operating expenses (income): | | | | |
| Research and development | 102 | (278) | 87 | (144) |
| Sales and marketing | 957 | 1,140 | 2,708 | 3,872 |
| General and administrative | 119 | 85 | 261 | 257 |
| Total operating expenses | 1,178 | 947 | 3,056 | 3,985 |
| Segment income (loss) | \$387 | \$(60) | \$493 | \$(1,337) |
| Reconciliation of segment income (loss) to net loss: | | | | |
| Segment income (loss): | | | | |
| Solutions | \$(170) | \$(214) | \$(663) | \$(464) |
| Products | 387 | (60) | 493 | (1,337) |
| Total segment income (loss) | 217 | (274) | (170) | (1,801) |
| Operating expenses: | | | | |

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| | | | | |
|---------------------------------|----------|------------|------------|------------|
| Sales and marketing | 146 | 73 | 372 | 191 |
| General and administrative | 848 | 896 | 2,660 | 2,871 |
| Valuation of equity instruments | - | - | - | 56 |
| Total operating expenses | 994 | 969 | 3,032 | 3,118 |
| Other expense | (149) | (212) | (485) | (513) |
| Loss before income taxes | (926) | (1,455) | (3,687) | (5,432) |
| Provision for income taxes | (2) | (4) | (8) | (13) |
| Net loss | \$(928) | \$(1,459) | \$(3,695) | \$(5,445) |

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

| | Three months ended September 30, | | Nine months ended September 30, | |
|--|-------------------------------------|--------------|------------------------------------|----------------|
| | 2012 | 2011 | 2012 | 2011 |
| Products segment net sales: | | | | |
| Pool and commercial products | \$4,159 | \$3,127 | \$11,354 | \$9,149 |
| Government products/R&D services | 1,679 | 905 | 3,713 | 2,590 |
| Total products segment net sales | 5,838 | 4,032 | 15,067 | 11,739 |
| Products segment cost of sales: | | | | |
| Pool and commercial products | 2,892 | 2,229 | 8,077 | 6,593 |
| Government products/R&D services | 1,381 | 916 | 3,441 | 2,498 |
| Total products segment cost of sales | 4,273 | 3,145 | 11,518 | 9,091 |
| Products segment gross profit (loss): | | | | |
| Pool and commercial products | 1,267 | 898 | 3,277 | 2,556 |
| Government products/R&D services | 298 | (11) | 272 | 92 |
| Total products segment gross profit | \$1,565 | \$887 | \$3,549 | \$2,648 |

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

| | Three months ended September 30, | | Nine months ended September 30, | |
|----------------------|-------------------------------------|-----------------|------------------------------------|------------------|
| | 2012 | 2011 | 2012 | 2011 |
| United States | \$ 6,976 | \$ 4,966 | \$ 18,700 | \$ 16,479 |
| International | 928 | 1,080 | 2,178 | 3,220 |
| Net sales | \$ 7,904 | \$ 6,046 | \$ 20,878 | \$ 19,699 |

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

| | September 30, 2012 | December 31, 2011 |
|-------------------------------|-----------------------|----------------------|
| United States | \$ 3,123 | \$ 3,747 |
| International | 49 | 57 |
| Long-lived assets, net | \$ 3,172 | \$ 3,804 |

NOTE 9. INCOME TAXES

At September 30, 2012, 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.

ENERGY FOCUS, INC.
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NOTE 10. COMMITMENTS AND CONTINGENCIES

In connection with the acquisition of SRC, in December 2010, the Company recorded a performance-related contingent obligation related to a 2.5% payout payable over 42 months commencing January 1, 2010 and based upon the fair value of projected annual billings of the acquired business, and a \$500 thousand 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 each of these contingent liabilities at their respective fair values at the time of the acquisition. For the three and nine months ended September 30, 2012, the Company paid \$51 thousand and \$140 thousand, respectively, relating to the 2.5% payout. For the three and nine months ended September 30, 2011, the Company paid \$86 thousand and \$255 thousand, respectively, relating to the payout.

In the fourth quarter of 2011, the Company reassessed the carrying value of the contingent liability related to the 2.5% payout and, based upon revised projected future billings, subsequently recorded a reduction to the contingent liability of \$404 thousand. At September 30, 2012, the Company has recorded a current liability related to these contingent obligations of \$842 thousand, which is recorded under the caption "Accrued liabilities" in its Condensed Consolidated Balance Sheets.

NOTE 11. RELATED PARTY TRANSACTIONS

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 Quercus, for \$0.3 million each. In March 2012, both of these LOC's were paid in full. Additionally, on August 11, 2011, the Company entered into a LOC agreement with Mark Plush, Chief Financial Officer of the Company, for \$0.3 million. For a full description of the terms of these LOC's, reference is made to Note 10, Debt, of the Company's 2011 Form 10-K.

The former Vice President of SRC, who resigned on December 31, 2011, is a minority owner in TLC Investments, LLC ("TLC"), a Tennessee limited liability company, as well as in Woodstone Energy, LLC ("Woodstone"), a Tennessee limited liability company, both of which are located in Nashville, Tennessee.

SRC renders lighting design and lighting solution services to these parties within the scope of their ordinary business activities. Conversely, these parties, operating as electrical subcontractors, provide installation support services to SRC as part of their normal business. During the three and nine months ended September 30, 2011, the Company recorded revenue of \$424 thousand and \$1.4 million, respectively. The receivable from these parties, including retainage, was \$0.4 million at December 31, 2011. Subcontractor installation support services provided by these parties totaled \$1.2 million in the third quarter of 2011, and \$5.0 million for the first nine months of 2011. The payable to these parties was \$1.2 million at December 31, 2011.

With the acquisition of SRC, the Company entered into an agreement with the seller, TLC, whereby, SRC would be guaranteed a profit percentage of 25% on certain projects which were begun prior to the acquisition or were out for bid at the time the acquisition occurred on December 31, 2009. During 2012, a small number of SRC projects continue to be subject to this guarantee, as the majority of these projects have been completed.

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

thousand. 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 on 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 thousand on the maturity date.

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 original exercise price of \$0.65 per share, later re-priced to \$0.49 during the first quarter of 2012, 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 \$10.0 million by June 30, 2013. The warrants vest in two tranches: 400,000 shares when contracts or purchase orders between

ENERGY FOCUS, INC.
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SRC and Woodstone reach \$10.0 million and an additional 200,000 shares when contracts or purchase orders between SRC and Woodstone reach an additional \$5.0 million. As of September 30, 2012, warrants to purchase 400,000 shares of the Company's common stock have vested but have not been exercised.

The Company, in the agreement for the acquisition of SRC, provided for payment of a management fee of 8% in support of billings, on projects that were pending at the date of acquisition, for which TLC provided installation support services. For the first three and nine months ended September 30, 2011, SRC incurred \$75 thousand and \$343 thousand of management fees, respectively.

NOTE 12. SHAREHOLDERS EQUITY

Between February 29, 2012 and March 2, 2012, the Company entered into Securities Purchase Agreements with ten investors, under which it sold 19,600,000 units, each of which consists of one share of the Company's common stock, par value \$0.0001 per share, and one-half warrant to purchase one share of common stock, and raised \$4.9 million. The purchase price of each unit was \$0.25, based on a formula involving the stock's 30 day average price prior to February 24, 2012. Each warrant entitles the holder to purchase one share of common stock at an exercise price of \$0.54. Each warrant is immediately separable from the unit and immediately exercisable, and expires three years from the date of issuance. The Company used the proceeds of the offering to retire debt and for working capital purposes. Eight of the ten investors are new investors and the largest single investment was \$1.0 million.

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 in Item 1 of 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, 2011.

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

When used in this discussion, the words "believes," "expects," "anticipates," "intends," "assumes," "estimates," "evaluates," "opinions," "forecasts," "may," "could," "future," "forward," "plans," "potential," "probable," 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 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 engage in the design, development, manufacturing, marketing, and installation of energy-efficient lighting systems and solutions where we serve two segments:

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

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

Results of Operations

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

| | Three months ended | | Nine months ended | |
|-------------------------------------|--------------------|-----------|-------------------|-----------|
| | September 30, | | September 30, | |
| | 2012 | 2011 | 2012 | 2011 |
| Net sales | 100.0 | % 100.0 | % 100.0 | % 100.0 |
| Cost of sales | 75.2 | 79.9 | 78.7 | 80.1 |
| Gross profit | 24.8 | 20.1 | 21.3 | 19.9 |
| Operating expenses (income): | | | | |
| Research and development | 1.3 | (4.6) | 0.4 | (0.7) |
| Sales and marketing | 18.0 | 25.2 | 19.5 | 25.8 |
| General and administrative | 15.3 | 20.0 | 16.7 | 19.4 |
| Valuation of equity instruments | - | - | - | 0.3 |
| Total operating expenses | 34.6 | 40.6 | 36.6 | 44.8 |
| Loss from operations | (9.8) | (20.5) | (15.3) | (24.9) |
| Other income (expense): | | | | |
| Other (expense) income | (0.3) | (0.1) | (0.5) | 0.3 |
| Interest expense, net | (1.6) | (3.4) | (1.9) | (2.9) |
| Loss before income taxes | (11.7) | (24.0) | (17.7) | (27.5) |
| Provision for income taxes | (0.0) | (0.1) | (0.0) | (0.1) |
| Net loss | (11.7) | % (24.1) | % (17.7) | % (27.6) |

Our net sales breakdown by business segment is as follows (in thousands):

| | Three months ended | | Nine months ended | |
|--|--------------------|---------|-------------------|----------|
| | September 30, | | September 30, | |
| | 2012 | 2011 | 2012 | 2011 |
| Solutions: | | | | |
| Net sales - solutions | \$2,066 | \$2,014 | \$5,811 | \$7,960 |
| Products: | | | | |
| Net sales - pool and commercial | 4,159 | 3,127 | 11,354 | 9,149 |
| Net sales - government products/R&D services | 1,679 | 905 | 3,713 | 2,590 |
| Total net sales - product segment | 5,838 | 4,032 | 15,067 | 11,739 |
| Total net sales | \$7,904 | \$6,046 | \$20,878 | \$19,699 |

Net sales of \$7.9 million for the third quarter of 2012 increased \$1.9 million, or 31%, from the prior year's third quarter. The increase was primarily in the Products segment. For the nine months ended September 30, 2012, net sales were \$20.9 million; a \$1.2 million or 6% increase, from the prior year. Products segment sales increased 28%,

or \$3.3 million, for the nine months, while Solutions sales decreased 27%, or \$2.1 million. Our Solutions segment backlog at September 30, 2012 and 2011 was \$2.6 million and \$854 thousand, respectively.

Revenues from our Products segment include, but are not limited to, revenues recognized upon shipping, and service at completion of installation. Revenues from our Solutions segment 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, 2011.

Gross Profit

Total gross profit was \$2.0 million, or 24.8 percent of net sales, for the three months ended September 30, 2012, compared to \$1.2 million, or 20.1 percent of net sales, for the three months ended September 30, 2011. The increase in gross profit was primarily the result of better Products segment gross margins; 26.8 percent compared to the prior year's comparable period of 22.0 percent. Solutions segment gross margins also improved to 19.1 percent of net sales from 16.3 percent for the third quarter. Total gross profit for the nine months ended September 30, 2012, was \$4.4 million, or 21.3 percent of net sales, compared to \$3.9 million, or 19.9 percent of net sales, for the prior year's comparable period. The increase in gross profits was due to higher net sales and improved gross profit margins in the Products segment, partially offset by lower gross margins in the Solutions segment as a result of lower sales. Gross margins for the Products segment were 23.6 percent of net sales for the nine months ended September 30, 2012, compared to 22.6 percent of net sales for last year's comparable period. Gross profit margins for the Solutions segment were 15.5 percent of net sales and 16.0 percent of net sales for the nine months ended September 30, 2012 and 2011, respectively.

Operating Expenses

Research and Development

Gross research and development expenses were \$621 thousand for the three months ended September 30, 2012, a 40 percent decrease from \$1.0 million for the three months ended September 30, 2011. The decrease was due primarily to lower project related expenses. For the nine months ended September 30, 2012, gross research and development expenses were \$2.5 million compared to \$3.1 million for the prior year's comparable period.

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

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

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

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|-------------------------------------|---------|------------------------------------|---------|
| Net Research & Development Expense | 2012 | 2011 | 2012 | 2011 |
| Total gross research and development expenses | \$621 | \$1,035 | \$2,509 | \$3,086 |
| Cost recovery through cost of sales | (398) | (1,160) | (1,792) | (2,263) |
| Cost recovery and other credits | (121) | (153) | (630) | (967) |
| Net research and development expense | \$102 | \$(278) | \$87 | \$(144) |

Sales and Marketing

Sales and marketing expenses were \$1.4 million, or 18.0 percent of net sales, in the three months ended September 30, 2012, compared to \$1.5 million, or 25.2 percent of net sales, in last year's comparable period; a decrease of 7 percent. The decrease is due to lower salary and benefit costs, and lower discretionary spending. For the nine months ended September 30, 2012, sales and marketing expenses were \$4.1 million, a 20 percent decrease from the prior year's nine month period. The decrease was due primarily to lower salaries and benefits, lower commission expense and lower discretionary spending.

General and Administrative

General and administrative expenses were \$1.2 million, or 15.3 percent of net sales, for the three months ended September 30, 2012 compared to \$1.2 million, or 20.0 percent of net sales, for the three months ended September 30, 2011. For the nine months ended September 30, 2012, general and administrative expenses were \$3.5 million compared to \$3.8 million in last year's comparable period; a nine percent decrease. The decrease was due primarily to lower amortization expense, legal fees and directors' fees.

Valuation of Equity Instruments

During the first quarter of 2011, we recognized a non-cash charge of \$56 thousand related to the valuation of our common stock upon the issuance of 412,000 shares to Lincoln Park Capital Partners, LLC. No valuation adjustments were made in 2012.

Other Income and Expenses

For the three months ended September 30, 2012 and 2011, interest expense was \$123 thousand and \$206 thousand, respectively. For the nine months ended September 30, 2012 and 2011, interest expense was \$388 thousand and \$581 thousand, respectively. Interest expense is primarily related to our debt, which includes the amortization of debt discounts and, in 2012, interest on our line of credit facility.

Net Loss

For the three months ended September 30, 2012 and 2011, the net loss was \$928 thousand and \$1.5 million, respectively. For the nine months ended September 30, 2012, we recorded a net loss of \$3.7 million, compared \$5.4 million in last year's comparable period; a \$1.7 million improvement on \$1.2 million higher sales.

Liquidity and Capital Resources

Cash and Cash Equivalents

At September 30, 2012, our cash and cash equivalents were \$380 thousand, compared to \$2.1 million at December 31, 2011; a decrease of \$1.8 million. The balance at September 30, 2012 includes restricted cash of \$27 thousand, compared to \$19 thousand of restricted cash at December 31, 2011. The restricted cash relates to funds received from a grant from/for a branch of the United States government. We had \$2.4 million in total debt as of September 30, 2012 and \$2.5 million as of December 31, 2011.

Cash Used in Operating Activities

For the nine months ended September 30, 2012, net cash used in operating activities was \$6.2 million compared to net cash used of \$2.7 million in 2011. Cash used in operating activities primarily consists of net losses adjusted for non-cash items, including depreciation, amortization, and stock-based compensation; and the effect of changes in working capital. The increase in cash used in operating activities for the 2012 nine month period was primarily due to an increase in trade accounts and retainage receivables from December 31, 2011, versus a decrease in the prior year's comparable period. However, days sales outstanding improved by 9 days from September 30, 2012 versus September 30, 2011.

Cash Used in Investing Activities

Net cash used in investing activities was \$159 thousand for the nine months ended September 30, 2012, and \$213 thousand for the same period in 2011, and consisted primarily of the purchase of property and equipment.

Cash Provided by Financing Activities

Net cash provided by financing activities was \$4.6 million for the nine months ended September 30, 2012, compared to \$682 thousand for the nine months ended September 30, 2011. For the nine months ended September 30, 2012, our credit line borrowings provided \$629 thousand of cash proceeds, and net cash proceeds from stock issuances provided

\$4.8 million. Between February 29, 2012 and March 2, 2012, we entered into Securities Purchase Agreements with ten investors, under which we sold 19,600,000 units, each of which consists of one share of our common stock, par value \$0.0001 per share, and one-half warrant to purchase one share of common stock. The purchase price of each unit was \$0.25, based on a formula involving the stock's 30 day average price prior to February 24, 2012. Each warrant entitles the holder to purchase one share of common stock at an exercise price of \$0.54. Each warrant is immediately separable from the unit and immediately exercisable, and expires three years from the date of issuance. We used the proceeds of the offering to retire \$838 thousand of debt during the first quarter of 2012, and for working capital purposes. Cash provided for the nine months ended September 30, 2011, resulted from the issuance of 412,000 shares of our common stock to Lincoln Park Capital Fund, LLC, and \$250 thousand received in a letter of credit agreement with our Chief Financial Officer, Mark Plush. For details of the Lincoln Park Capital Fund, LLC Purchase Agreement, reference is made to Note 12, Shareholders' Equity, of the Company's 2011 Form 10-K. The agreement with Lincoln Park Capital, LLC expired as of July 23, 2012, by the terms of the Purchase Agreement. For a full description of the Company's debt financing, reference is made to Note 10, Debt, of the Company's 2011 Form 10-K.

Debt

Credit Facilities

On December 22, 2011, we entered into a \$4.5 million revolving line of credit (“credit facility”) with Rosenthal & Rosenthal. The total loan amount available to us under the line of credit is equal to 85% of our net amount of eligible receivables, plus available inventory (the lesser of 50% of the lower of cost or market value of eligible inventory, or \$0.3 million). The credit facility is secured by a lien on our domestic assets. The interest rate for borrowing on accounts receivable is 8.5%, on inventories 10.0% and on overdrafts 13.0%. Additionally, there is an annual 1% facility fee on the entire amount of the credit facility, \$4.5 million, payable at the beginning of the year. The credit facility is a three year agreement, expiring on December 31, 2014, unless terminated sooner. There are liquidated damages if the credit facility is terminated prior to December 31, 2014, which are based on the maximum credit facility amount then in effect. The damages are: 3% if terminated prior to the first anniversary of the closing date, 2% if terminated prior to the second anniversary of the closing date, and 1% if terminated prior to the third anniversary of the closing date. We are required to comply with certain financial covenants, measured quarterly, including, as defined in the agreement: a tangible net worth amount and a working capital amount. We were in compliance with the financial covenants at September 30, 2012. Borrowings under the revolving line of credit were \$1.3 million at September 30, 2012, and \$701 thousand at December 31, 2011, and are recorded in our Condensed Consolidated Balance Sheets as a current liability under the caption “Credit line borrowings.”

Borrowings

Long-term debt, including current maturities, totaled \$1.0 million at September 30, 2012 and \$1.8 million at December 31, 2011. The change in long-term debt resulted from \$873 thousand in payments and \$101 thousand from the amortization of discounts on long-term debt. We were able to pay down debt with the proceeds from the Securities Purchase Agreement described in the “Cash Provided by Financing Activities” section above.

For details of a full description of the Company’s debt financing, reference is made to Note 10, Debt, of the Company’s 2011 Form 10-K.

Liquidity

Historically, we have incurred losses attributable to operational performance which has negatively impacted cash flows. As of September 30, 2012, we have an accumulated deficit of \$78.6 million. Although management continues to address many of the legacy issues that have historically burdened our financial performance, we still face challenges in order to reach profitability. In order for us to attain profitability and growth, we will need to successfully address these challenges, including the continuation of cost reductions throughout our organization, improvement in gross margins, execution of our marketing and sales plans for our turnkey energy-efficient lighting solutions business, execution of the \$23.1 million U.S. Navy supply contract, the development of new technologies into sustainable product lines and continued improvements in our supply chain performance.

We remain 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, we continue to review and pursue selected external funding sources, if necessary, to execute these objectives including, but not limited to, the following:

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

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

- loans or other debt instruments may have terms and/or conditions, such as interest rate, restrictive covenants, and control or revocation provisions, which are not acceptable to management or the Board of Directors,
- the current environment in capital markets combined with our capital constraints may prevent us from being able to obtain any debt financing,
- financing may not be available for parties interested in pursuing the acquisition of one or more of our operating units, and
- additional equity financing may not be available in the current capital 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, 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. 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, 2011.

Recent Accounting Pronouncements

In May 2011, the Financial Accounting Standards Board (“FASB”) issued ASU 2011-04, Fair Value Measurement, amending ASC Topic 820, which eliminates terminology differences between U.S. generally accepted accounting principles (“GAAP”) and International Financial Reporting Standards (“IFRS”) on the measurement of fair value and related fair value disclosures. While largely consistent with existing fair value measurement principles and disclosures, the changes were made as part of the continuing efforts to converge GAAP and IFRS. The adoption of this guidance was effective for interim and annual periods beginning after December 15, 2011, and its adoption did not have a material impact on the financial statements of the Company.

In June 2011, the FASB issued ASU 2011-05, Comprehensive Income, amending ASC Topic 220. Under ASU 2011-05, an entity has the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The guidance was issued to improve the comparability, consistency and transparency of financial reporting and to increase the prominence of items reported in other comprehensive income. The guidance is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. Its adoption did not have a material impact on the Company’s financial statements.

In July 2012, the FASB issued ASU 2012-02, Intangibles — Goodwill and Other, amending ASC Topic 350. Under the revised guidance, entities testing indefinite-lived intangible assets for impairment have the option of performing a qualitative assessment before calculating fair value. If entities determine, on the basis of qualitative factors, that it is more likely than not that the fair value of the indefinite-lived intangible is less than the carrying amount, the fair value calculation would be required. The ASU also requires that the same qualitative factors be considered when determining whether an interim impairment evaluation is necessary. The guidance is effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012, with early adoption permitted. The adoption of this guidance is not expected to have a material effect on our financial statements.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

As of September 30, 2012, we had British pounds sterling-denominated cash valued at \$56 thousand held in the United Kingdom, based on the exchange rate at that date. 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

There were no 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 1A. RISK FACTORS

Reference is made to the Risk Factors set forth in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2011 (the "Annual Report"). There have been no significant changes in those risk factors as set forth in the Annual Report.

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

Between February 29, 2012 and March 2, 2012, we entered into Securities Purchase Agreements with ten investors, under which we sold 19,600,000 units, each of which consists of one share of our common stock, par value \$0.0001 per share, and one-half warrant to purchase one share of common stock, and raised \$4.9 million. The purchase price of each unit was \$0.25, based on a formula involving the stock's 30 day average price prior to February 24, 2012. Each warrant entitles the holder to purchase one share of common stock at an exercise price of \$0.54. Each warrant is immediately separable from the unit and immediately exercisable, and expires three years from the date of issuance. We used the proceeds of the offering to retire debt and for working capital purposes. Eight of the ten investors are new investors and the largest single investment was \$1.0 million. During the third quarter of 2012, the Company registered the shares by filing an S-1 Registration Statement that was effective on August 13, 2012.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

The information required by this Item is set forth on the Exhibit Index that follows the signature page of this report.

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.

By: /s/ Joseph G. Kaveski

Date: November 14,
2012

Joseph G. Kaveski
Chief Executive Officer

By: /s/ Mark J. Plush
Mark J. Plush
Chief Financial Officer

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EXHIBIT INDEX

| Exhibit Number | Description of Documents |
|----------------|--|
| 3.1 | Form of Certificate of Incorporation of the Registrant. |
| 10.1 | Energy Focus, Inc. 1994 Employee Stock Purchase Plan, as amended (1) |
| 10.2 | Energy Focus, Inc. 2008 Incentive Stock Plan, as amended (2) |
| 31.1 | Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2 | Certification of Vice President of Finance and Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1 | Certification of Chief Executive Officer and Vice President of Finance and Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| *101 | The following financial information from the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2012, formatted in XBRL (eXtensible Business Reporting Language): (i) Condensed Consolidated Balance Sheets at September 30, 2012 and December 31, 2011, (ii) Condensed Consolidated Statements of Operations for the three and nine months ended September 30, 2012 and 2011, (iii) Condensed Consolidated Statements of Comprehensive Income (Loss) for the three and nine months ended September 30, 2012 and 2011, (iv) Condensed Consolidated Statements of Cash Flows for the nine months ended September 30, 2012 and 2011, (vi) the Notes to Condensed Consolidated Financial Statements. (3) |

*Pursuant to Regulation S-T, this interactive data file is deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, is deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, and otherwise is not subject to liability under these sections.

(1) Incorporated by reference from Appendix A to the Company's preliminary proxy statement on Form PRER14A filed on June 8, 2012.

(2) Incorporated by reference from Appendix B to the Company's preliminary proxy statement on Form PRER14A filed on June 8, 2012.

(3) In accordance with Rule 406T of Regulation S-T, the XBRL related information in Exhibit 101 to this Quarterly Report on Form 10-Q shall not be deemed to be "filed" for purposes of Section 18 of the Exchange Act, or otherwise subject to the liability of that section, and shall not be part of any registration statement or other document filed under the Securities Act or the Exchange Act, except as shall be expressly set forth by specific reference in such filing.