ELECTRIC CITY CORP
Form 10-K
March 21, 2006

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-K

þ **ANNUAL REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended: December 31, 2005

o **TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

Commission file number 001-16265

ELECTRIC CITY CORP.
(Name of small business issuer in its charter)

Delaware	**36-4197337**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
1280 Landmeier Road, Elk Grove Village, IL	**60007-2410**
(Address of principal executive offices)	(Zip Code)

Issuer s telephone number (847) 437-1666
Securities registered under Section 12(b) of the Exchange Act:

Title of each class	**Name of each exchange on which registered**
Common Stock $0.0001 par value	American Stock Exchange

Securities registered under Section 12(g) of the Exchange Act:
None

(Title of class)

Indicate by checkmark if the registrant is a well-know seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No þ

Indicate by checkmark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No þ

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated Filer o Accelerated Filer o Non-Accelerated Filer þ

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

The aggregate market value of the registrant s common stock held by non-affiliates was $36,398,311 based on the reported last sale price of common stock on June 30, 2005, which was the last business day of the registrant s most recently completed second fiscal quarter. For purposes of this computation, all executive officers, directors and 10% stockholders were deemed affiliates. Such a determination should not be construed as an admission that such executive officers, directors or 10% stockholders are affiliates.

As of March 15, 2006, there were 51,475,066 shares of common stock, $0.0001 par value, of the Company issued and outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

DOCUMENT DESCRIPTION	**10-K PART**
Portions of the Registrant s notice of annual meeting of shareowners and proxy statement to be filed pursuant to Regulation 14A within 120 days after Registrant s fiscal year end of December 31, 2005 are incorporated by reference into Part II, Item 5 and Part III of this Report.	II, ITEM 5 III

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PART I

Item 1. Description of Business

Included in this report, exhibits and associated documents are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, as well as historical information. Although we believe that the expectations reflected in such forward-looking statements are reasonable, we can give no assurances that such expectations reflected in such forward-looking statements will prove to be correct. Our actual results could differ materially from those anticipated in forward-looking statements as a result of certain factors, including matters described in the section titled Management s Discussion and Analysis of Financial Condition and Results of Operations. Forward-looking statements include those that use forward-looking terminology, such as the words anticipate, believe, estimate, expect, hope, intend, may, project, plan, should, and similar expressions, including when used in the negative. Although we be that the expectations reflected in these forward-looking statements are reasonable and achievable, such statements involve risks and uncertainties and no assurance can be given that the actual results will be consistent with these forward-looking statements.

Unless the context otherwise requires, Electric City, the Company, we, our, us and similar expressions refers Electric City Corp. and its subsidiaries.

Overview/History

We are a developer, manufacturer and integrator of energy saving technologies and building automation controls as well as an independent developer of scalable, negative power systems. Our premier energy saving products are the EnergySaver system, which reduces energy consumed by lighting with minimal lighting level reduction and the eMAC system, which provides intelligent control and continuous monitoring of HVAC and lighting equipment via wireless communication technology to reduce energy usage and improve system reliability. Our technology has been installed in applications in commercial buildings, factories and office structures, as well as street lighting and parking lot lighting. Our GlobalCommander integrates with the EnergySaver allowing us to link multiple EnergySaver units together and to provide remote communications, measurement and verification of energy savings.

In addition to our EnergySaver and eMAC systems, we also provide, through our subsidiary, Great Lakes Controlled Energy Corporation, a Delaware Corporation (Great Lakes), integrated building and environmental control solutions for commercial and industrial facilities.

Until June 1, 2003, we also manufactured custom electrical switchgear through Switchboard Apparatus Inc. (Switchboard), a wholly owned subsidiary located in Broadview Illinois. In an effort to refocus our resources and shed the continuing losses from the switchgear business, we sold the operating assets of Switchboard to a group of investors that included the President of Switchboard, effective as of May 31, 2003.

On December 5, 1997, we were initially formed as Electric City LLC, a Delaware limited liability company. On June 5, 1998, we changed from a limited liability company into a corporation by merging Electric City LLC into Electric City Corp., a Delaware corporation.

On June 10, 1998, Electric City issued 1,200,272 shares of our common stock with a fair market value of $1,200,272, representing approximately six (6%) percent of Electric City s then issued and outstanding common stock, to the approximately 330 shareholders of Pice Products Corporation (Pice), an inactive, unaffiliated company with minimal assets, pursuant to a merger agreement under which Pice was merged with and into Electric City. The purpose of the merger was to substantially increase the

number of our shareholders to facilitate the establishment of a public trading market for our common stock. Trading in our common stock commenced on August 14, 1998 through the OTC Bulletin Board under the trading symbol ECCC .

In May 1999, we purchased most of the assets of Marino Electric, Inc., an entity engaged in the business of designing and manufacturing custom electrical switchgear and distribution panels.

On August 31, 2000, pursuant to an Agreement and Plan of Merger among us, Switchboard Apparatus, Inc. and Switchboard Apparatus s stockholders, we acquired Switchboard Apparatus. In connection with the acquisition, Switchboard Apparatus was merged into our wholly owned subsidiary, with our subsidiary continuing as the surviving corporation under the name Switchboard Apparatus, Inc.

On June 7, 2001, pursuant to an Agreement and Plan of Merger by and among us, Electric City Great Lakes Acquisition Corporation, Great Lakes Controlled Energy Corporation (Great Lakes) and Great Lakes stockholders, we acquired Great Lakes. Great Lakes is an independent systems integrator and facilities support specialist and focuses on building automation controls for lighting and HVAC systems for commercial applications. Great Lakes is also a national representative and distributor of select energy metering and control systems. In connection with the acquisition, Great Lakes was merged into our wholly-owned subsidiary Electric City Great Lakes Acquisition Corporation, with our subsidiary continuing as the surviving corporation under the name Great Lakes Controlled Energy Corporation.

On June 3, 2003, the Company entered into an asset purchase agreement with Hoppensteadt Acquisition Corp., whereby Hoppensteadt acquired all of the assets, except for certain receivables and cash, and assumed all of the liabilities, except for bank debt, of Switchboard Apparatus, the Company Power Management segment, as of May 31, 2003.

On May 3, 2005, pursuant to an Agreement and Plan of Merger dated as of April 28, 2005, by and among Electric City Corp., MPG Acquisition Corporation, a wholly-owned subsidiary of Electric City (Merger Subsidiary), and Maximum Performance Group, Inc. (MPG), Electric City acquired MPG through the merger of MPG with and into Merger Subsidiary, with Merger Subsidiary continuing as the surviving corporation under the name Maximum Performance Group, Inc. MPG is a technology based provider of energy and asset management products and services. MPG manufactures and markets its eMAC line of controllers for HVAC and lighting applications. The eMAC line of controllers provide intelligent control and continuous monitoring of HVAC and lighting equipment via wireless communication technology to reduce energy usage and improve system reliability. MPG, has offices in New York, New York and San Diego, California.

Products And Services

The Company currently manufactures products or provides services under two distinct business segments. The energy technology segment includes the manufacturing and sale of the EnergySaver, GlobalCommander, eMAC and uMAC product lines. In addition, this segment markets the Virtual Negawatt Power Plan (VNPP), which is essentially a negative power system designed for utilities as a demand response system. The building control and automation business segment is served by our subsidiary, Great Lakes Controlled Energy Corporation, which specializes in the installation and maintenance of building control and automation systems. See note 21 to the consolidated financial statements for additional information regarding the segments of our business.

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EnergySaver

The EnergySaver system is a state-of-the-art lighting control system that reduces energy consumption of indoor and outdoor commercial, institutional and industrial ballasted lighting systems, while maintaining appropriate lighting levels. The EnergySaver is a freestanding enclosure that contains control panels with electrical parts and is connected between the incoming power line and the building s electrical lighting circuits. The EnergySaver also contains a microprocessor with software that allows the customer to control the amount of energy savings desired which, depending on the application, is typically between 20% and 30%, and provides self-diagnosis and self-correction. The customer can access the EnergySaver s microprocessor directly or remotely via modem, network or two-way radio.

The EnergySaver is manufactured to varying sizes and capacities to address differing lighting situations. We can interface our EnergySaver products with most new and existing lighting panels, ballasts and lamps without modification. In addition, the EnergySaver system reduces the power consumed by lamps, resulting in a reduction of heat generated within the lighting system, which enhances ballast and lamp life and reduces the amount of air conditioning necessary to cool the building.

GlobalCommander

The GlobalCommander system is an advanced lighting controller designed to permit central control and monitoring of multiple EnergySaver units and allows for large-scale demand side management and savings measurement and verification without turning off the user s lights. The GlobalCommander bundles the EnergySaver technology with an area-wide communication package to allow for maximum energy reductions across entire systems in response to the guidelines of a customer s facility manager. In addition, the GlobalCommander has the ability to measure and store information about the actual savings generated from the use of the EnergySaver. This information, which can be viewed in a tabular or graphical format and can be downloaded to a user s computer, is often required for a customer to qualify for utility incentives for energy savings and curtailment. The GlobalCommander also allows customers to control their facilities loads and lighting requirements from a single control point. This single-point control is available for a virtually unlimited number of remote facilities and can be accessed through the Internet, intranet or over standard telephone lines through dial-up modems.

Virtual Negawatt Power Plan

The combined technology of the EnergySaver and GlobalCommander led to the development of our Virtual Negawatt Power Plan (VNPP), which is essentially a negative power system which we market primarily to utilities as a demand response system. The VNPP allows a utility to remotely control commercial, industrial and government lighting systems over a managed and secure Internet protocol (IP) network. Through the use of the EnergySaver/GlobalCommander system, the utility is able to reduce electric demand requirements during periods of peak demand, providing instantaneous control, measurement and verification of load reduction. Thus, at times when electric power demand is especially high (such as summer afternoons), the electric utility can use the VNPP to reduce demand. The demand reduction can be specifically placed across a utility grid targeting potential hot spots such as particular substations. We believe the Electric City VNPP is the first demand response system to provide this level of control to a utility without requiring active customer participation and without impacting a customer s operations or ability to do business. For additional information on the VNPP program please see Item 7 Management s Discussion and Analysis or Plan of Operations.

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eMAC & uMAC

The eMAC system is comprised of a heating, ventilating and air conditioning (HVAC) controller with wireless communication capabilities and a central, server based, Internet accessible software that monitors and controls the operation of the connected HVAC units. The eMAC system is designed for use in commercial and industrial applications with packaged (primarily rooftop) HVAC equipment of 2 to 40 tons (1 ton = 12,000 Btu/hr cooling capacity) and up to 500,000 Btu/hr of heating capacity.

The eMAC controller is contained in a small box that is mounted on the exterior of a customer s HVAC unit. The controller is wired into the HVAC equipment and monitors up to 126 points of the equipment s operation. In addition, each eMAC contains a Pentech Energy Recovery Controller (PERC), a patented third generation microprocessor based technology.

PERC was developed by Pentech Solutions, a predecessor company to Maximum Performance Group, and is designed to dynamically match a HVAC system s output to any given load condition, thereby improving the operating efficiency of the equipment. Since most HVAC systems are designed to maintain comfortable environmental conditions on both the hottest and coldest days likely to be experienced, there exists substantial excess system capacity on most days of the year. Due to this excess capacity the system quickly satisfies a thermostat s call for heating or cooling, and in doing so overshoots the thermostat set point and leaves Btu s of heat or cooling in the heat exchanger, cooling coils and air ducts. The PERC controller acts to correct this by periodically turning off the air conditioner s compressor and condenser fan while continuing to run the evaporator fan, thereby continuing to deliver cooling to the conditioned space utilizing the energy stored in the cooling coils, heat exchanger and air ducts. In heating applications, PERC periodically closes the gas valve while continuing to operate the indoor air fan, delivering heated air into the space utilizing the heat stored in the heat exchanger and air ducts. At the same time the PERC controller is monitoring the rate of temperature change in the conditioned space in order of avoid overshooting the desired temperature setting. The PERC technology typically will result in energy savings of 15% to 20% for our end user customers.

The wireless communication capabilities of the eMAC allow us to monitor and remotely manage the operation of a customer s HVAC equipment. A customer can log on to our eMAC web site and obtain information regarding the operation of their HVAC equipment and change equipment operating parameters, such as hours of operation and temperature. The eMAC will also send alarms to our central server when any of the up to 126 monitored points of operation fall outside predetermined operating ranges. This often permits us to react to a potential equipment problem before the occupants of the space are aware of an equipment malfunction. We charge our customers for this ability to communicate and remotely monitor and mange their equipment, though we often include an initial monitoring period with the purchase of the eMAC so that our customers can become familiar with the benefits of this service.

The uMAC is a version of the eMAC which has been simplified to remotely control the operation of a facility s lights via wireless communications. Using the uMAC a customer can remotely, via the Internet, turn lights on and off and change the daily schedule for the operation of a facility s lighting.

Building Control and Automation

Through our wholly owned subsidiary, Great Lakes Controlled Energy Corporation, we provide integration of building and automation control systems for commercial and industrial customers. Great Lakes has been providing building automation services for over 20 years and is an authorized distributor for Teletrol Systems Inc., WattStopper Inc. and Power Measurement Ltd., and is a dealer for Novar Controls Corporation and ABB Drives and Motors. Building and environmental control systems are networks of sensors and actuators controlled by a central computer. The sensors monitor building environmental conditions, such as temperature, humidity and light levels, and will turn on and off heating units, chillers, pumps, lights, or other equipment as needed to maintain environmental conditions within a desired range. The systems also report to the central operator when there is a problem with any of the equipment on the network or when any of the monitored conditions fall outside of preset limits. Great Lakes became a subsidiary of Electric City in June 2001. In January 2006, we made the decision to sell Great Lakes in order to focus exclusively on our Energy Technology products. We entered into a Letter of Intent on February 27, 2006 to sell Great Lakes and we expect to close on this transaction by the end of March 2006. See note 21 to our audited financial statements for additional information regarding our Building Automation and Control segment.

Marketing, Sales and Distribution

The majority of our sales are derived through the efforts of our internal sales force. Prior to late 2005, each of our subsidiaries had their own sales force which primarily sold only their products. In late 2005 we began to integrate our subsidiaries and set up geographic profit centers in which our salespeople will sell all of the Company s products. Initially we will be organized into three profit centers: East Coast (managed out of our New York office), Midwest (managed out of our Chicago office) and West Coast (managed out of our San Diego office). We believe our proprietary energy technologies differentiate us from other providers of energy solutions and provide our customers superior returns on their investment.

In addition to our internal sales force we have established relationships with distributors (also referred to as State Representatives) to market and distribute our EnergySaver products to end-users. The use of third party distributors has become a less important part of our overall sales and marketing strategy during the past couple of years, with the bulk of our sales coming through our internal sales force.

As of December 31, 2005, we had five distributor/state representative agreements covering Arizona, California, Illinois, Indiana and Nevada. Each distributor is responsible for developing and managing a sales network within its respective territory. Typically the distributor does this by establishing direct relationships with end-users or through dealerships within the territory and overseeing the sales, installation and maintenance of our products by those dealerships. If a distributor sells any of our products outside its territory, such distributor operates as a dealer, meaning it manages end-user sales only. The distributor earns a commission on any sale of our products in its territory whether initiated by the distributor itself, a dealer, or by us.

Our standard distributor agreement have terms of 10 years and gives the distributor certain exclusive rights of distribution in a particular territory, includes sales quotas that increase periodically throughout the term of the agreement, and requires the distributor to make payment to us within 30 to 60 days of product shipment. The agreement contains penalties for failure to meet quotas or make payments, including the loss of certain exclusive rights of distribution. Currently, all of our distributors have violated the terms of their agreements for failing to meet their quotas. We are working with our distributors to address these issues. The standard distributor agreement can be terminated at our discretion if the distributor fails to meet the terms of the distributor agreement.

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Our Utility Development area is responsible for marketing the VNPP to utilities. Once a utility signs a VNPP agreement we work jointly with the utility to sign up energy users to participate in the curtailment program by agreeing to the installation of the EnergySaver in their facilities at no cost to the user.

Great Lakes sells its building automation control systems either directly to end-users (typically commercial or industrial building owners) or by bidding on contracts let by general contractors for new construction or building renovation projects.

Customers

During 2005, one customer, Kohl s Department Stores, accounted for approximately 30% of our consolidated billings. Kohl s is a customer of our energy technology segment. During 2004, sales to two customers accounted for approximately 57% of our total consolidated revenue. Our largest customers for 2004 were Hill Mechanical Group (46%) and Public Energy Solutions (11%). Hill Mechanical Group is a customer of our building automation controls business, while Public Energy Solutions is an EnergySaver dealer. During 2003, four customers accounted for approximately 63% of our total consolidated revenue. The top four customers during 2003 were Electric City of Pennsylvania (10%), Hill Mechanical Group (26%), Jacobsen Power (12%) and M&A Railroad and Electric Supply (15%). Hill Mechanical Group and Jacobsen Power were both customers of our building automation controls business, while Electric City of Pennsylvania and M&A Railroad and Electric Supply were EnergySaver dealers. M&A Railroad and Electric Supply ceased to be a dealer in December 2003 and Electric City of Pennsylvania ceased to be a dealer in June 2005.

In late 2003, we signed a 13 year contract with Commonwealth Edison to provide up to 50 megawatts of demand curtailment through our VNPP program. In November 2004, we entered into a 10 year VNPP contract with PacifiCorp to provide up to 27 megawatts of demand curtailment. Under these contracts, we place our EnergySaver equipment in commercial and industrial Customer Hosts buildings at no cost to the Customer Host. In exchange for allowing us to reduce the power to their lighting system (without turning off their lights) during periods of peak energy demand, the Customer Host is allowed to operate the EnergySaver at a 3% to 5% level during non-curtailment periods. The utility companies have agreed to pay us for the availability of this demand reduction and we will recognize revenue under these contracts over the period for which demand reduction is provided. As of December 31, 2005 we had installed 135 EnergySavers at 85 different Customer Host sites under these programs at a cost of approximately $1.4 million. We recognized our first revenue under the program and began amortizing the cost of the related EnergySaver units during the fourth quarter of 2005. Further shipments under these programs were postponed in late 2005 due to the high capital requirements of these programs.

Competition

There are a number of products on the market that directly or indirectly compete with the EnergySaver products. These competing products can be categorized into three general types:

- those that convert AC to DC at a central location,
- those that pulsate the power to the lighting system; and
- other control products similar to the EnergySaver system.

Products that fall into the first category convert AC to DC at a central location and do so more efficiently than it is done by the standard electronic ballast in each light fixture. The main drawback to this technology is that the transmission of DC power over any distance is generally less efficient and more dangerous than transmitting AC power. This technology also requires the rewiring of every light fixture on the circuit.

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Products that pulsate the power in the lighting system turn the power off and on so quickly (120 times/second) that the lights remain on. This process, which is generally known as wave chopping, distorts the AC waveform and thereby produces harmonics in a building s electrical system that can damage other electrical components such as electric motors and electronic devices. The process also contributes to the reduction of life of lamps and ballasts in lighting fixtures.

Control products control power consumption at the lights, at the lighting circuit or at the control panel. Products that control the power at the lights or at the lighting circuit must be wired to each fixture or to each circuit, resulting in high installation cost, which makes these products less competitive from an economic perspective. The EnergySaver controls power consumption at the lighting panel, making it much simpler and less expensive to install and maintain. There are other products on the market that also control power consumption at the lighting panel, but the EnergySaver is the only product that we are aware of that offers total real-time variability of savings levels, remote communications and savings measurement and verification capabilities.

While there are other HVAC controllers that provide energy saving benefits similar to the eMAC, we are not aware of any competing product available at a comparable cost to the eMAC that provides the communications, remote monitoring and diagnostic features of the eMAC. Large, national control companies provide systems that can do much of what the eMAC can do, but the installed cost of such systems make them impractical for smaller applications, which is the markets we are targeting with the eMAC.

Great Lakes Controlled Energy competes against both large national controls companies and smaller regional distributors of building controls. Two of the large national controls companies that Great Lakes competes with are Siemens and Johnson Controls, both of whom have significantly greater financial and operating resources than Great Lakes. Great Lakes sells its products and services based on system capabilities, experience, service and price.

Manufacturing

Our EnergySaver product line is manufactured at our facilities in Elk Grove Village, Illinois, with manufacturing and assembly scaled to order. Since the manufacturing process that we are currently performing only involves the assembly of components manufactured by others, we believe there are many contract manufacturers located across the country that could assemble our EnergySaver product for us with relatively little lead time should we decide to outsource some or all of the manufacturing to contract manufacturers.

The eMAC is manufactured for us by a contract manufacturer in southern California. We believe that this contract manufacturer has sufficient capacity to handle our anticipated growth in eMAC sales for the foreseeable future. In addition, we believe that there are many contract manufacturers across the country that could manufacture the eMAC for us if for some reason our current contract manufacturer could not meet our needs.

The primary components for the EnergySaver and eMAC are sourced from multiple manufacturers. We are in continuous discussion with additional parts suppliers, seeking to ensure lowest cost pricing and reliability of supply.

During 2005, approximately 20% of our consolidated material purchases were made from four suppliers. Purchases from any one supplier will vary year-to-year depending on sales and inventory levels. None of these four suppliers sell the Company proprietary products that we could not purchase from other vendors.

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Compliance With Environmental Laws

Neither the Company s production nor sales of its products in any material way generate activities or materials that require compliance with federal, state or local environmental laws.

Research and Development

The Company, through the day-to-day use of the EnergySaver and eMAC and their components and their use at various testing sites around the country, develops modifications and improvements to its products. Total research and development costs charged to operations were approximately $395,000, $150,000, and $70,000 for the years ended December 31, 2005, 2004 and 2003, respectively.

Intellectual Property

Certain technologies underlying the EnergySaver products have been patented in the U.S. and Italy by Giorgio Reverberi. A U.S. patent application was filed by Mr. Reverberi in November 1997, and a patent was issued in June 2000.

Since January 1, 1998, we, along with Mr. Reverberi and Mr. Joseph Marino, have entered into a number of agreements relating to the license of the EnergySaver technology, which grant us the exclusive license rights of Mr. Reverberi s patent of the EnergySaver technology in all of North America, Central America, South America (excluding the countries of Argentina, Brazil, Chile, Paraguay and Uruguay) and the Caribbean (except Cuba), as well as Africa (excluding the countries of Algeria, Libya, Morocco and Tunisia). Our license expires upon the expiration of Mr. Reverberi s last expiring patent, which we expect to be on or around November 2017. If either party materially breaches the license and fails to cure the breach within 180 days after notice by the other party of the breach, the other party can terminate the license. We pay Mr. Reverberi a royalty of $200 and Mr. Marino a royalty of $100 for each EnergySaver product we make or sell in territories in which Mr. Reverberi holds a valid patent.

We have applied for and/or received several patents on improvements we have made to the core technology developed by Mr. Reverberi. In addition, MPG has several patents on various aspects of the eMAC system. As of December 31, 2005, we had nine issued patents and three patents pending before the U.S. Patent and Trademark Office, as well as foreign patent offices. In addition we have received three trademarks and have two additional trademarks pending.

Employees

As of March 15, 2006, we had 39 full time employees and two part time employees, of which nine were management and corporate staff, four were engineers, nine were engaged in sales and marketing, 14 were engaged in field service and five were engaged in manufacturing. Of those employees engaged in manufacturing, four are covered by collective bargaining agreements between Electric City and the International Brotherhood of Electrical Workers (IBEW), which is affiliated with the American Federation of Labor and Congress of Industrial Organizations (AFL-CIO). In May of 2005 we renewed the collective bargaining agreement covering all union employees. The new agreement will expire on May 31, 2008.

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Item 1A. Risk Factors

The following disclosure of risk factors include all material risks known to us at this time. Additional risks we are not presently aware of or that we currently believe are immaterial may prove to impair our business and financial performance. Our business could be harmed by any of these risks, whether stated or unstated. We operate in a continually changing business environment and may as a result enter into new businesses and product lines. We cannot predict new risk factors that may arise in the future, and we cannot assess the impact, if any, of these new risk factors on our businesses or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those projected in any forward-looking statements. Accordingly, you should not rely on forward-looking statements as a prediction of actual results. In addition, our estimates of future operating results are based on our current complement of businesses, which is constantly subject to change as we continue to assess and refine our business strategy. If any of the following risks actually occur, our business, results of operations, and financial condition could be adversely affected in a material manner.

Risks Related to Our Business

We have a limited operating history upon which to evaluate our potential for future success.

We were formed in December 1997. To date, we have generated limited revenues from the sale of our products and do not expect to generate significant revenues until we sell a significantly larger number of our products. Accordingly, we have only a limited operating history upon which you can base an evaluation of our business and prospects. The likelihood of our success must be considered in light of the risks and uncertainties frequently encountered by early stage companies like ours in an evolving market. If we are unsuccessful in addressing these risks and uncertainties, our business will be materially harmed.

We have incurred significant operating losses since inception and may not achieve or sustain profitability in the future.

We have experienced operating losses and negative cash flow from operations since our inception and we currently have an accumulated deficit. These factors raise substantial doubt about our ability to continue as a going concern. Our ability to continue as a going concern is ultimately dependent on our ability to raise additional capital and to increase sales to a level that will allow us to operate profitably and sustain positive operating cash flows. Although we are continuing our efforts to improve profitability through expansion of our business in both current and new markets, we must overcome significant manufacturing hurdles, including gearing up to produce large quantities of product or arranging to outsource the production of our products, and marketing hurdles, including market acceptance, in order to sell large quantities of our products. In addition, we may be required to reduce the prices of our products in order to increase sales. If we reduce product prices, we may not be able to reduce product costs sufficiently to achieve acceptable profit margins. As we strive to grow our business, we expect to spend significant funds (1) for general corporate purposes, including working capital, marketing, recruiting and hiring additional personnel; and (2) for research and development. To the extent that our revenues do not increase as quickly as these costs and expenditures, our results of operations and liquidity will be materially adversely affected. If we experience slower than anticipated revenue growth or if our operating expenses exceed our expectations, we may not achieve profitability. Even if we achieve profitability in the future, we may not be able to sustain it.

Our auditors have modified their opinion to our audited financial statements for the year ended December 31, 2005 to include an emphasis paragraph, stating that our continuing losses and negative cash flow from operations raise substantial doubt about our ability to continue as a going concern. Our management has developed a plan that includes among other things, raising additional capital to fund

operations until our sales and internally generated cash flow can support our ongoing operations. Whether we can succeed in implementing this plan remains to be seen.

Our independent registered public accountants have issued a going concern opinion raising doubt about our financial viability.

As a result of our continuing losses and negative cash flows, our independent registered public accounting firm, BDO Seidman, LLP, issued a going concern opinion in connection with their audit of our financial statements for the year ended December 31, 2005. This opinion expressed substantial doubt as to our ability to continue as a going concern. The going concern opinion could have an adverse impact on our ability to execute our business plan, result in the reluctance on the part of certain suppliers to do business with us, result in the inability to obtain new business due to potential customers concern about our ability to deliver product, or adversely affect our ability to raise additional capital.

Failure to replace significant customer could materially and adversely affect our results of operations and financial condition.

We have historically derived a significant portion of our annual revenue from a limited number of customers. Seldom has any one customer represented 10% or more of our revenues for more than one year in a row. This requires that we continually replace major customers whose needs we have satisfied, with one or more new customers. The failure to replace a major customer could have a significant negative effect on our results of operations and financial condition.

A decrease in electric retail rates could lessen demand for our products.

Our principal products, our EnergySaver and eMAC products, have the greatest profit potential in areas where commercial electric rates are relatively high. However, retail electric rates for commercial establishments in the United States may not remain at their current levels. Due to a potential overbuilding of power generating stations in certain regions of the United States, wholesale power prices may decrease in the future. Because the price of commercial retail electric power is largely attributed to the wholesale cost of power, it is reasonable to expect that commercial retail rates may decrease as well. In addition, much of the wholesale cost of power is directly related to the price of certain fuels, such as natural gas, oil and coal. If the prices of those fuels decrease, the prices of the wholesale cost of power may also decrease. This could result in lower electric retail rates and reduced demand for energy saving devices such as our EnergySaver and eMAC products.

We have a license to use certain patents and our ability to sell our products may be adversely impacted if the license expires or is terminated.

We have entered into a license agreement with Messrs. Giorgio Reverberi and Joseph Marino with regard to the core technology used in our EnergySaver product. Mr. Reverberi holds a U.S. patent and has applied for several patents in other countries. Pursuant to the terms of the license, we have been granted the exclusive right to manufacture and sell products containing the load reduction technology claimed under Mr. Reverberi s U.S. patent or any other related patent held by him in the U.S., the remainder of North America, parts of South America and parts of Africa. However, the exclusive rights that we received may not have any value in territories where Mr. Reverberi does not have or does not obtain protectable rights. The term of the license expires when the last of these patents expires. We expect that these patents will expire around November 2017. The license agreement may be terminated if we materially breach its terms and fail to cure the breach within 180 days after we are notified of the breach. If our license is terminated it could impact our ability to manufacture, sell or otherwise commercialize products in those countries where Mr. Reverberi holds valid patents relating to our products, including the United States.

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If we are not able to protect our intellectual property rights against infringement, or if others obtain intellectual property rights relating to energy management technology, we could lose our competitive advantage in the energy management market.

We regard our intellectual property rights, such as patents, licenses of patents, trademarks, copyrights and trade secrets, as important to our success. Although we entered into confidentiality and rights to inventions agreements with our employees and consultants, the steps we have taken to protect our intellectual property rights may not be adequate. Third parties may infringe or misappropriate our intellectual property rights or we may not be able to detect unauthorized use and take appropriate steps to enforce our rights. Failure to take appropriate protective steps could materially adversely affect any competitive advantage we may have in the energy management market. Furthermore, our license to use Mr. Reverberi s patents may have little or no value to us if Mr. Reverberi s patents are not valid. In addition, patents held by third parties may limit our ability to manufacture, sell or otherwise commercialize products and could result in the assertion of claims of patent infringement against us. If that were to happen, we could try to modify our products to be non-infringing, but we might not be successful or such modifications might not avoid infringing on the intellectual property rights of third parties.

Claims of patent infringement against us, regardless of merit, could result in the expenditure of significant financial and managerial resources by us. We may be forced to seek to enter into license agreements with third parties (other than Mr. Reverberi) to resolve claims of infringement by our products of the intellectual property rights of third parties. These licenses may not be available on acceptable terms or at all. The failure to obtain such licenses on acceptable terms could have a negative effect on our business.

David Asplund, our new Chief Executive Officer, has limited experience operating a Company such as ours and no direct industry experience.

Mr. Asplund, who has been on our Board since June 2002, has a degree in mechanical engineering and has had a successful career in the financial industry. Mr. Asplund founded an investment banking firm in 1999 and operated the firm as its president for six years, but Mr. Asplund has not operated a manufacturing company. His past experience does not assure that he will be successful in his new role as CEO of Electric City.

If we are unable to achieve or manage our growth, it will adversely affect our business, the quality of our products and our ability to attract and retain key personnel.

If we succeed in growing our sales as we need to do, we will be subject to the risks inherent in the expansion and growth of a business enterprise. Growth in our business will place a strain on our operational and administrative resources and increase the level of responsibility for our existing and new management personnel. To manage our growth effectively, we will need to:

- further develop and improve our operating, information, accounting, financial and other internal systems and controls on a timely basis;
- improve our business development, marketing and sales capabilities; and
- expand, train, motivate and manage our employee base.

Our systems currently in place may not be adequate if we grow and may need to be modified and enhanced. The skills of management currently in place may not be adequate if we experience significant growth.

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If our management fails to properly identify companies to acquire and to effectively negotiate the terms of these acquisition transactions, our growth may be impaired.

As part of our growth strategy we intend to seek to acquire companies with complementary technologies, products and/or services. Our management, including our Board of Directors, will have discretion in identifying and selecting companies to be acquired by us and in structuring and negotiating these acquisitions. In general, our Common Stockholders may not have the opportunity to approve these acquisitions, although the holders of Series E Convertible Preferred Stock do have certain rights to approve acquisitions. In addition, in making acquisition decisions, we will rely, in part, on financial projections developed by our management and the management of potential target companies. These projections will be based on assumptions and subjective judgments. The actual operating results of any acquired company or the combination of us and an acquired company may fall significantly short of projections.

We may be unable to acquire companies that we identify as targets for various reasons, including:

- our inability to interest such companies in a proposed transaction;
- our inability to agree on the terms of an acquisition;
- incompatibility between our management and management of a target company; and
- our inability to obtain any required approvals of the holders of the Series E Convertible Preferred Stock, or our lender, or if required, the holders of our Common Stock.

If we cannot consummate acquisitions on a timely basis or agree on terms at all, or if we cannot acquire companies with complementary technologies, products and/or services on terms acceptable to us, our future growth may be impaired.

Our growth may be impaired and our current business may suffer if we do not successfully address risks associated with acquisitions.

Since January 1, 2000, we have acquired three companies; Switchboard Apparatus, Great Lakes Controlled Energy and Maximum Performance Group, Inc., one of which (Switchboard Apparatus) we subsequently sold and we have recently signed a letter of intent to sell Great Lakes. Our future growth may depend, in part, upon our ability to successfully identify, acquire and operate other complementary businesses. We may encounter problems associated with such acquisitions, including the following:

- difficulties in integrating acquired operations and products with our existing operations and products;
- difficulties in meeting operating expectations for acquired businesses;
- diversion of management s attention from other business concerns;
- adverse impact on earnings of amortization or write-offs of goodwill and other intangible assets relating to acquisitions; and
- issuances of equity securities that may be dilutive to existing stockholders to pay for acquisitions.

If our products do not achieve or sustain market acceptance, our ability to compete will be adversely affected.

To date, we have not sold our EnergySaver or eMAC product lines or any other products in very large quantities and a sufficient market may not develop for them. Significant marketing will be required in order to establish a sufficient market for these products. The technology underlying our products may not become a preferred technology to address the energy management needs of our customers and potential customers. Failure to successfully develop, manufacture and commercialize products on a timely

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and cost-effective basis will have a material adverse effect on our ability to compete in the energy management market or to survive as a business.

Failure to meet customers expectations or deliver expected technical performance could result in losses and negative publicity.

Customer engagements involve the installation of energy management equipment that we design to help our clients reduce energy/power consumption. We rely on outside contractors to install our EnergySaver and eMAC products. Any defects in this equipment and/or its installation or any other failure to meet our customers expectations could result in:

- delayed or lost revenues due to adverse customer reaction;
- requirements to provide additional products, replacement parts and/or services to a customer at no charge;
- negative publicity regarding us and our products, which could adversely affect our ability to attract or retain customers; and
- claims for substantial damages against us, regardless of whether we have any responsibility for such failure.

If sufficient additional funding is not available to us, the commercialization of our products and our ability to grow is likely to be hindered.

Our operations have not generated positive cash flow since the inception of the Company in 1997. We have funded our operations through the issuance of common and preferred stock and secured debt. Our ability to continue to operate until our cash flow turns positive may depend on our ability to continue to raise funds through the issuance of equity or debt. If we are not successful in raising additional funds, we might have to significantly scale back or delay our growth plans, or possibly cease operations altogether. Any reduction or delay in our growth plans could materially adversely affect our ability to compete in the marketplace, take advantage of business opportunities and develop or enhance our products. If we should have to cease operations altogether, your investment is likely to be lost.

Raising additional capital or consummation of additional acquisitions through the issuance of equity or equity-linked securities could dilute your ownership interest in us.

It is likely that we will need to obtain additional funds in the future to grow our product development, manufacturing, marketing and sales activities at the pace that we intend, to continue to fund operating losses until our cash flow turns positive, or to fund acquisitions. If we determine that we do need to raise additional capital in the future and we are not successful in doing so, we might have to significantly scale back or delay our growth plans, reduce staff and delay planned expenditures on research and development and capital expenditures in order to continue as a going concern. Any reduction or delay in our growth plans could materially adversely affect our ability to compete in the marketplace, take advantage of business opportunities and develop or enhance our products.

If we receive additional funds through the issuance of equity securities or convertible debt securities, our existing stockholders will likely experience dilution of their present equity ownership position and voting rights. Depending on the number of shares issued and the terms and conditions of the issuance, new equity securities could have rights, preferences, or privileges senior to those of our Common Stock. Depending on the terms, Common Stock holders may not have approval rights with respect to such issuances, although our Series E Convertible Preferred Stock may have such rights.

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Failure to effectively market our energy management products could impair our ability to sell significant quantities of these products.

One of the challenges we face in commercializing our energy management products is demonstrating the advantages of our products over competitive products. To do this, we will need to further develop our marketing and sales force. In addition to our internal sales force, we rely on third parties to market and sell our products. We currently maintain a number of relationships and have a number of agreements with third parties regarding the marketing and distribution of our EnergySaver products and depend to some degree upon the efforts of these third parties in marketing and selling these products. Maintenance of these relationships is based primarily on an ongoing mutual business opportunity and a good overall working relationship. The current contracts associated with certain of these relationships allow the distributors to terminate the relationship upon 30 days written notice. We recently terminated two distributors for failing to meet their sales quotas. Without these relationships, our ability to market and sell our EnergySaver products could be harmed and we may need to divert even more resources to increasing our internal sales force. If we are unable to expand our internal sales force and maintain our third party marketing relationships, our ability to generate significant revenues may be harmed.

The distribution rights we have granted to third parties in specified geographic territories may make it difficult for us to grow our business in such territories if those distributors do not successfully market and support our products in those territories. We have in the past been, and may in the future be, involved in disputes with distributors that have distribution rights in specified geographic territories but are not achieving our goals. During 2000, we repurchased for cash and stock consideration the distribution rights from three distributors that were not meeting our sales goals. We recently settled a dispute with a former distributor to avoid the cost of further litigation. All of our distributors are currently in violation of their agreements with us for failing to meet their sales quotas. We may have to expend additional funds, incur debt or issue additional securities in the future to repurchase other distribution rights or pursue legal action to enforce our rights under distributor agreements that we have granted or may grant in the future.

If we do not successfully compete with others in the very competitive energy management market, we may not achieve profitability.

In the energy management market, we compete with other manufacturers of energy management products that are currently used by our potential customers. Many of these companies have substantially greater financial resources, larger research and development staffs and greater manufacturing and marketing capabilities than us. Our competitors may provide energy management products at lower prices and/or with superior performance. If we are unable to successfully compete with conventional and new technologies our business may be materially harmed.

Product liability claims could result in losses and could divert our management s time and resources.

The manufacture and sale of our products creates a risk of product liability claims. Any product liability claims, with or without merit, could result in costly litigation and reduced sales, cause us to incur significant expenses and divert our management s time, attention and resources. We do have product liability insurance coverage; however, there is no assurance that such insurance is adequate to cover all potential claims. The successful assertion of any such claim against us could materially harm our liquidity and operating results.

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Our current internal manufacturing capacity is limited and if demand for our products increases significantly and we are unable to increase our capacity quickly and efficiently our business could suffer.

Our EnergySaver products are manufactured at our facilities. To be financially successful, we must manufacture our products, including our EnergySaver products, in substantial quantities, at acceptable costs and on a timely basis. While we have produced approximately 1,600 EnergySaver units over the past seven years, we have never approached what we believe is our production capacity. To produce larger quantities of our EnergySaver products at competitive prices and on a timely basis, we will have to further develop our processing, production control, assembly, testing and quality assurance capabilities. If our production requirements exceed our internal capacity we plan to contract with outside manufacturers to produce individual components and/or entire EnergySaver units. Since the manufacturing process that we are currently performing only involves the assembly of components manufactured by others, we believe there are many contract manufacturers located across the country that could assemble our EnergySaver product for us with relatively little lead time. We have had discussions with several potential contract manufacturers and they have produced units on a trial basis, but their ability to deliver significant quantities of product in a timely manner with acceptable quality is still unproven. We may be unable to manufacture our EnergySaver products in sufficient volume and may incur substantial costs and expenses in connection with manufacturing larger quantities of our EnergySaver products. If we are unable to make the transition to large-scale commercial production successfully, our business will be negatively affected. We could encounter substantial difficulties if we decide to outsource the manufacturing of our products, including delays in manufacturing and poor production quality.

Risks Related to Our Common Stock

Due to the current market price of our Common Stock, in conjunction with the fact that we are a relatively small company with a history of operating losses, the future trading market for our stock may not be active on a consistent basis, which may make it difficult for you to sell your shares.

The trading volume of our stock in the future depends in part on our ability to increase our revenue and reduce or eliminate our operating losses, which should increase the attractiveness of our stock as an investment, thereby leading to a more liquid market for our stock on a consistent basis. If we are unable to achieve these goals, the trading market for our stock may be negatively affected, which may make it difficult for you to sell your shares. In addition, if we fail to continue to meet the American Stock Exchange s requirements for continued listing we may be forced to move to the over-the-counter bulletin board, which may result in reduced liquidity and increased volatility for our stock. If an active and liquid trading market does not exist for our Common Stock, you may have difficulty selling your shares.

The need to raise additional capital will most likely be dilutive to our current stockholders and could result in new investors receiving rights that are superior to those of existing stockholders.

Since September 2001, we have issued shares of our preferred stock (including shares issued as dividends) that as of March 15, 2006 are convertible into 22,912,400 shares of our Common Stock. These shares of preferred stock are currently accruing dividends at the rate of 6% per year, though prior to March 22, 2004 they were accruing at the rate of 10% per year. To date we have issued shares of convertible preferred stock in satisfaction of accrued dividends convertible into 8,383,410 shares of Common Stock. The preferred stockholders all have rights that are superior to the rights of our common stockholders, including:

a liquidation preference of $200 per share under our Series E Preferred (the only series of preferred which is currently outstanding);

special approval rights in respect of certain actions by the Company, including any issuance of shares of capital stock by the Company that would have the right to receive dividends or the right to participate in any distribution upon liquidation which will be senior to or equal to the rights of the Series E Preferred (other than to pay dividends on the Series E Preferred and under certain other limited exceptions such as conversion of outstanding convertible securities) and any acquisition, sale, merger, joint venture, consolidation or reorganization involving the Company or any of its subsidiaries;

a conversion price that may be below the market price of our Common Stock;

the right to elect up to four directors;

the right to vote with the holders of Common Stock on an as converted basis on all matters on which holders of our Common Stock are entitled to vote, except (if more than 19,999 shares of Series E Preferred are outstanding) with respect to the election of directors or as otherwise provided by law;

a right of first offer on the sale of equity by the Company in a private transaction; and

anti-dilution protection that would adjust the conversion price on their preferred shares and the exercise price on their related warrants in the event we issue common equity at a price which is less than the conversion price or exercise price of their securities.

These rights associated with our preferred stock are substantially different than the rights of our common stockholders and may materially decrease the value of our Common Stock.

Due to the concentration of holdings of our stock, four investors may be able to control matters requiring common stockholder approval or could cause our stock price to decline through future sales because they beneficially own a large percentage of our Common Stock.

There are 51,475,066 shares of our Common Stock outstanding as of March 15, 2006, of which Joseph C. Marino beneficially owns approximately 13%, Richard Kiphart (our Chairman) beneficially owns approximately 16%, Security Benefit beneficially owns approximately 14% and Laurus Master Fund Ltd. (Laurus) beneficially owns approximately 15% (each of the aforementioned percentages includes stock options and warrants that are currently exercisable and in the case of Mr. Kiphart include stock issuable upon conversion of Series E Convertible Preferred Stock, and in the case of Laurus includes shares issuable upon conversion of convertible debt and the exercise of warrants which possess exercise caps that require 76 days notice prior to acquiring shares in excess of 4.99%). As a result of their significant ownership, Mr. Marino, Mr. Kiphart, Security Benefit and Laurus may have the ability to exercise a controlling influence over our business and corporate actions requiring common stockholder approval, including the election of our directors (other than those directors to be chosen by the holders of our preferred stock), a sale of substantially all of our assets, a merger between us and another entity or an amendment to our certificate of incorporation. This concentration of ownership could delay, defer or prevent a change of control and could adversely affect the price investors might be willing to pay in the future for shares of our Common Stock. Also, in the event of a sale of our business, Mr. Marino, Mr. Kiphart, Security Benefit and Laurus could be able to elect to receive a control premium to the exclusion of other common stockholders.

A significant percentage of the outstanding shares of our Common Stock, including the shares beneficially owned by Mr. Marino, Mr. Kiphart, Security Benefit and Laurus, can be sold in the public market from time to time, subject to limitations imposed by Federal securities laws, and in the case of Mr. Kiphart, by trading agreements entered into with us. The market price of our Common Stock could decline as a result of sales of a large number of our presently outstanding shares of Common Stock by Mr. Marino, Mr. Kiphart, Security Benefit, Laurus or other stockholders in the public market or due to the

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perception that these sales could occur. This could also make it more difficult for us to raise funds through future offerings of our equity securities or for you to sell your shares if you choose to do so.

Provisions of our charter and by-laws, in particular our blank check preferred stock, could discourage an acquisition of our company that would benefit our stockholders.

Provisions of our charter and by-laws may make it more difficult for a third party to acquire control of our company, even if a change in control would benefit our stockholders. In particular, shares of our preferred stock have been issued and may be issued in the future without further stockholder approval and upon those terms and conditions, and having those rights, privileges and preferences, as our Board of Directors may determine (subject to certain approval rights of our Series E Preferred). The rights of the holders of our Common Stock will be subject to, and may be adversely affected by, the rights of the holders of any of our preferred stock which is currently outstanding or which may be issued in the future. The issuance of our preferred stock, while providing desirable flexibility in pursuing possible additional equity financings and other corporate purposes, could have the effect of making it more difficult for a third party to acquire control of us. This could limit the price that certain investors might be willing to pay in the future for shares of our Common Stock and discourage these investors from acquiring a majority of our Common Stock. In addition, the price that future investors may be willing to pay for our Common Stock may be lower due to the conversion price and exercise price granted to investors in any such private financing.

Item 1B. Unresolved Staff Comments

None

Item 2. Properties

Our headquarters and the EnergySaver system production facility are located at 1280 Landmeier Road in Elk Grove Village, Illinois. This facility is approximately 13,000 square feet and houses the corporate headquarters, manufacturing operations and warehouse. We acquired this facility in August 1998 with a combination of stock and cash. The cash portion of the purchase price was financed through a mortgage on the building. The mortgage was refinanced in December 2005, bears interest at the rate of prime (currently 7.50%) plus 0.5%, and is payable in monthly installments of $3,000 plus interest, until a final balloon payment which is due on February 2007. There is no penalty for prepayment of the mortgage. As of February 28, 2006, the outstanding principal amount of the mortgage was $556,000.

On June 7, 2001, we acquired Great Lakes Controlled Energy Corporation (Great Lakes). Great Lakes currently operates its business from a facility located in Elk Grove Village, Illinois, which is approximately 10,000 square feet. In connection with our acquisition of Great Lakes, we entered into a three-year building lease beginning on the date of the acquisition. Effective June 7, 2004, the lease was extended through June 7, 2006. The building is owned by the former shareholders of Great Lakes, Eugene Borucki and Denis Enberg, both of whom are currently employed by the Company.

On May 3, 2005, we acquired Maximum Performance Group, Inc (MPG). MPG currently leases a 2,800 square foot office in New York City and a 3,100 square foot office in San Diego, California. The New York office lease has a term of five years and will expire in September 2010. The San Diego lease expired during 2005 and is currently operating on a month to month basis with a 90 day termination notice requirement.

We believe that the space and location of our current facilities in combination with the current and planned outsourcing of a portion of our manufacturing will be sufficient to reach a level of production projected for the current year.

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Item 3. Legal Proceedings

From time to time, the Company has been a party to routine pending or threatened legal proceedings and arbitrations that are routine and incidental to its business. Based upon information presently available, and in light of legal and other defenses available to the Company, management does not consider the liability from any threatened or pending litigation to be material to the Company.

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

The Secured Convertible Term Loan entered into in November 2005 required the consent of the holders of our preferred stock, which were obtained in connection with the transaction.

No other matters were submitted to a vote of security holders during the three months ended December 31, 2005.

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PART II

Item 5. Market for Common Equity and Related Stockholder Matters

Our common stock has traded since December 12, 2000 on the American Stock Exchange under the symbol ELC.

The following table sets forth the quarterly high and low selling prices for our common stock as reported on The American Stock Exchange since January 1, 2004.

	Common Stock	
	High	Low
Fiscal Year Ended December 31, 2004:		
Fiscal Quarter Ended March 31, 2004	$ 2.47	$ 1.70
Fiscal Quarter Ended June 30, 2004	$ 2.08	$ 1.55
Fiscal Quarter Ended September 30, 2004	$ 1.93	$ 1.11
Fiscal Quarter Ended December 31, 2004	$ 1.42	$ 1.05
Fiscal Year Ended December 31, 2005:		
Fiscal Quarter Ended March 31, 2005	$ 1.30	$ 0.86
Fiscal Quarter Ended June 30, 2005	$ 1.07	$ 0.81
Fiscal Quarter Ended September 30, 2005	$ 1.24	$ 0.67
Fiscal Quarter Ended December 31, 2005	$ 0.91	$ 0.50

Holders

As of March 15, 2006, we had approximately 6,000 holders of record of our common stock and 51,475,066 shares of common stock outstanding.

Dividends

For the three months ended December 31, 2005, we declared and paid the following dividends on our Convertible Preferred Stock:

On December 14, 2005, the Board of Directors authorized payment of dividends payable on our Series E Convertible Preferred Stock for the calendar quarter ending December 31, 2005 to shareholders of record of our Series E Convertible Preferred Stock as of December 31, 2005. The dividends were paid with 3,491 additional shares of Series E Convertible Preferred Stock. Each share of Series E Convertible Preferred Stock is convertible into 100 shares of our common stock.

For a further discussion regarding preferred stock dividends, see Item 7 Management s Discussion and Analysis or Plan of Operations Preferred Stock Dividends.

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We have never declared or paid any cash dividends on our common stock and we do not anticipate paying any cash dividends in the foreseeable future. We may not pay cash dividends on any of our capital stock (other than the Series E Convertible Preferred Stock) without the consent of at least 66-2/3% of the Series E Convertible Preferred Stock, and the consent of our secured lender. See Item 7 Management s Discussion and Analysis of Results of Operations and Financial Condition Liquidity and Capital Resources.

Recent Sales of Unregistered Securities

During the twelve months ended December 31, 2005, we issued the securities listed below (in addition to those securities listed under the preceding Dividends and to those issuances which we have reported on Form 10-Q during the past year):

In November 2005, we entered into a securities purchase agreement with Laurus Master Fund, Ltd. (Laurus) whereby we issued to Laurus a $5 million secured convertible term note and a warrant to purchase 2 million shares of our common stock at $1.16 per share anytime prior to November 22, 2012. The warrants were valued at $920,000 using a modified Black-Sholes option pricing model. The value of the warrants was recorded as a discount to the term loan and will be amortized over the term of the underlying debt utilizing the effective interest method.

The sales and issuances of common stock, debt instruments and warrants to purchase common stock in private placements listed above were made by us in reliance upon the exemptions from registration provided under Sections 4(2) and 4(6) of the Securities Act of 1933, as amended, and Rule 506 of Regulation D, promulgated by the SEC under federal securities laws and comparable exemptions for sales to accredited investors under state securities laws. The offers and sales were made to accredited investors as defined in Rule 501(a) under the Securities Act and no general solicitation was made by us or any person acting on our behalf; the securities sold were subject to transfer restrictions, and the certificates for those shares contained an appropriate legend stating that they had not been registered under the Securities Act and may not be offered or sold absent registration unless sale is pursuant to an exemption therefrom.

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Item 6. Selected Financial Data

The information set forth below is not necessarily indicative of results of future operations, and should be read in conjunction with Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations, and the Consolidated Financial Statements and notes thereto included in Item 8, Financial Statements and Supplementary Data, of this Form 10-K, which are incorporated herein by reference, in order to understand further the factors that may affect the comparability of the financial data presented below.

ELECTRIC CITY CORP. AND SUBSIDIARIES
Selected Financial Data

	Year ended December 31,				
	2005	2004	2003	2002 *(1)*	2001 (2)
Statement of Operations Data:					
Revenue	$ 4,854,772	$ 2,412,635	$ 4,631,833	$ 5,534,522	$ 2,167,660
Cost of sales	4,489,227	2,302,104	4,441,687	5,339,352	1,943,895
Selling, general and administrative	6,450,836	4,643,203	4,290,078	6,043,585	8,170,351
Impairment loss	242,830			108,000	
Operating loss	(6,328,121)	(4,532,672)	(4,099,932)	(5,956,415)	(7,946,586)
Other income (expense)	(544,617)	(626,690)	(355,359)	(33,615)	(3,401,494)
Loss from continuing operations	(6,872,738)	(5,159,362)	(4,455,291)	(5,990,030)	(11,348,080)
Loss from discontinued operations			(1,026,651)	(1,017,897)	(1,622,997)
Cumulative effect of accounting change				(4,103,872)	
Net loss	(6,872,738)	(5,159,362)	(5,481,942)	(11,111,799)	(12,971,077)
Basic and diluted loss per common share from continuing operations	$ (0.18)	$ (0.25)	$ (0.27)	$ (0.33)	$ (1.05)
Basic and diluted loss per common share	(0.18)	(0.25)	(0.30)	(0.49)	(1.10)
Weighted average common shares outstanding	47,859,964	39,901,387	33,761,489	31,213,165	30,048,043
Balance Sheet Data:					
Cash and cash equivalents	$ 4,229,150	$ 1,789,808	$ 2,467,023	$ 1,555,904	$ 5,486,073

Working capital	646,483	263,304	2,050,157	3,546,270	7,470,046
Total assets	17,098,974	6,479,320	7,353,627	8,908,551	16,435,863
Long-term debt, including current portion	4,980,032	1,230,353	1,348,645	1,089,791	1,434,018
Total stockholders equity	4,377,637	1,780,271	3,040,932	4,284,291	12,456,833

(1) In the year ended December 31, 2002, we adopted FAS 142 Goodwill and Other Intangible Assets , which required us to test our intangible assets for possible impairment. As a result of this testing we determined the goodwill associated with the Power Management segment was impaired and recorded a write-down of the asset in the amount of $4,103,872, which was reported as a cumulative effect of accounting change in 2002. For a further discussion of these items please refer to Management s Discussion and Analysis or Plan of Operation.

(2) On January 1, 2002, the

Company adopted Statement of Financial Accounting Standards (SFAS) No. 142, which among other things provides that good will no longer be amortized, as a result the Company has not record any goodwill amortization beginning in 2002, whereas it recorded approximately $555,000 and $397,000 in 2001 and 2000, respectively.

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Item 7. Management s Discussion and Analysis or Plan of Operation

The following discussion should be read in conjunction with the consolidated financial statements and related notes which appear elsewhere in this report on Form 10-K. The discussion contains forward-looking statements within the meaning of the Private Securities Litigation Act of 1995. Such statements consist of any statement other than a recitation of historical fact and can be identified by the use of forward-looking terminology such as may, expect, anticipate, estimate or continue or the negative of such terms or other variations of such terms or comparable terminology. You are cautioned that all forward-looking statements are necessarily speculative and there are certain risks and uncertainties that could cause actual events or results to differ materially from those referred to in such forward-looking statements. We do not have a policy of updating or revising forward-looking statements and, therefore, you should not assume that our silence over time means that actual events are bearing out as estimated in such forward-looking statements.

We have a limited operating history. All risks inherent in an inexperienced enterprise are inherent in our business.

Critical Accounting Policies and Estimates

The discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amount of assets and liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities at the date of our financial statements. Actual results may differ from these estimates under different assumptions or conditions. Critical accounting policies are defined as those that are reflective of significant judgments and uncertainties, and potentially result in materially different results under different assumptions and conditions. We believe that our critical accounting policies are limited to those described below. For a detailed discussion on the application of these and other accounting policies, see Note 3 in the notes to the consolidated financial statements.

Use of Estimates

Preparation of the consolidated financial statements in accordance with accounting principles generally accepted in the United States requires management to make estimates and assumptions affecting the reported amounts of assets, liabilities, revenues and expenses and related contingent liabilities. On an on-going basis, the Company evaluates its estimates, including those related to revenues, bad debts, warranty accrual, income taxes and contingencies and litigation. The Company bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions.

Revenue Recognition

We recognize revenue when all four of the following criteria are met: (i) persuasive evidence has been received that an arrangement exists; (ii) delivery of the products and/or services has occurred; (iii) the selling price is fixed or determinable; and (iv) collectibility is reasonably assured. In addition, we follow the provisions of the Securities and Exchange Commission s Staff Accounting Bulletin No. 104, Revenue Recognition, which sets forth guidelines in the timing of revenue recognition based upon factors such as passage of title, installation, payments and customer acceptance. Any amounts received prior to satisfying our revenue recognition criteria is recorded as deferred revenue.

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Our MPG subsidiary often bundles contracts to provide monitoring services and web access with the sale of its eMAC hardware. As a result, these sales are considered to be contracts with multiple deliverables which at the time the hardware is delivered and installed includes undelivered services essential to the functionality of the product. Accordingly, we defer the revenue for the product and services and the cost of the equipment and installation and recognize them over the term of the monitoring contract. The monitoring contracts vary in length from 1 month to 5 years.

We have entered into agreements in which we have contracted with utilities to establish a Virtual Negawatt Power Plan (VNPP). Under these contracts, we install Energy Saver units at participating host locations, who are customers within the utility s territory. The participating customer hosts receive the benefit of reduced utility costs through the operation of the units. We are able to reduce electric demand requirements during periods of peak demand, providing nearly instantaneous control, measurement and verification of load reduction. The utility companies will pay us for the availability of this demand reduction and we recognize revenue under these contracts over the period for which the demand reduction is provided. Revenue of $15,781 was recognized from these contracts during the fourth quarter of 2005. No revenue was recognized under such contracts for the years ended December 31, 2004 and 2003. The cost of the energy saver units currently at host locations under such VNPP programs is included in fixed assets and depreciated over the term these units will be used under the existing contracts.

Profit Recognition on Long-Term Contracts

We account for revenues on long-term contracts under the percentage of completion method in conjunction with the cost-to-cost method of measuring the extent of progress toward completion. Any anticipated losses on contracts are charged to operations as soon as they are determinable. Prior to the second quarter of 2005, due to our limited experience estimating the profitability on our long-term contracts, we deferred all contract related profits (i.e. assumed zero profit) until completion of the contract when the actual profit on the contract was known. Starting in the second quarter of 2005 we began recognizing contract related profits based on the projected profits for the contract, consistent with the AICPA s Statement of Position 81-1 (SOP 81-1).

Allowance for Doubtful Accounts

We maintain an allowance for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. The allowance is largely based upon specific knowledge of customers from whom collection is determined to be doubtful and our historical collection experience with such customers. If the financial condition of our customers or the economic environment in which they operate were to deteriorate, resulting in an inability to make payments, or if our estimates of certain customer s ability to pay are incorrect, additional allowances may be required. During 2005, we increased our allowance by $97,000 and wrote-off $13,000. As of December 31, 2005 our allowance for doubtful accounts was approximately $325,000, or 15.7% of the outstanding accounts receivable.

Impairment of Long-Lived Assets.

We record impairment losses on long-lived assets used in operations when events and circumstances indicate that the assets might be impaired and the undiscounted cash flows estimated to be generated by those assets are less than the carrying amount of those items. Our cash flow estimates are based on historical results adjusted to reflect our best estimate of future market and operating conditions. The net carrying value of assets not recoverable is reduced to fair value. Our estimates of fair value represent our best estimate based on industry trends and reference to market rates and transactions.

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Goodwill

We have made acquisitions in the past that included a significant amount of goodwill and other intangible assets. Under generally accepted accounting principles in effect through December 31, 2001, these assets were amortized over their estimated useful lives, and were tested periodically to determine if they were recoverable from operating earnings on an undiscounted basis over their useful lives. Effective in 2002, goodwill is no longer amortized but is subject to an annual (or under certain circumstances more frequent) impairment test based on its estimated fair value. Estimated fair value is less than value based on undiscounted operating earnings because fair value estimates include a discount factor in valuing future cash flows. There are many assumptions and estimates underlying the determination of an impairment loss, including economic and competitive conditions, operating costs and efficiencies. Another estimate using different, but still reasonable, assumptions could produce a significantly different result. As part of our 2003 and 2004 year-end assessment, we updated our long-term projections for the building automation and controls business and estimated the fair value based on the discounted current value of the expected future cash flows. We then compared the implied fair value of the goodwill to its carrying value and determined that the value of the goodwill was not impaired. In February 2006 we signed a non-binding letter of intent to sell Great Lakes Controlled Energy. To determine if our goodwill would be impaired as a result of the expected sale, we compared the carrying value of the goodwill related to Great Lakes to the expected sale price of the business and determined that the goodwill is impaired. As a result we have recorded an impairment loss as of December 31, 2005 of $242,830. It is possible that upon completion of future impairment tests, as the result of changes in facts or circumstances, we may have to take additional charges in future periods to recognize a further write-down of the value of the goodwill attributed to our acquisitions to their estimated fair values.

Material Trends and Uncertainties

From time to time changes occur in our industry or our business that makes it reasonably likely that aspects of our future operating results will be materially different than historical operating results. Sometimes these matters have not occurred, but their existence is sufficient to raise doubt regarding the likelihood that historical operating results are an accurate gauge of future performance. We attempt to identify and describe these trends, events, and uncertainties to assist investors in assessing the likely future performance of the Company. Investors should understand that these matters typically are new, sometimes unforeseen, and often are fluid in nature. Moreover, the matters described below are not the only issues that can result in variances between past and future performance nor are they necessarily the only material trends, events, and uncertainties that will affect the Company. As a result, investors are encouraged to use this and other information to judge for themselves the likelihood that past performance will be indicative of future performance.

The trends, events, and uncertainties set out in the remainder of this section have been identified as those we believe are reasonably likely to materially affect the comparison of historical operating results reported herein to either other past period results or to future operating results. These trends, events and uncertainties include:

Changes in our senior management and on our Board of Directors. In January 2006, our Chief Executive Officer for the past six years, Mr. John Mitola, resigned and was replaced by one of our Board members, Mr. David Asplund. At approximately the same time, Mr. Robert Manning, the Chairman of our Board of Directors for the past 5-1/2 years announced his retirement. Mr. Manning s seat on the Board of Directors was filled by Mr. Richard Kiphart, an investor in the Company, and Mr. Kiphart was also elected to serve as our Chairman until our next meeting of stockholders. We also recently added Messrs. Daniel Parke, William Carey and Gregory Barnum to our Board of Directors. These changes in our Senior Management and Board of Directors may result in changes to our business plan, such as the planned sale of Great Lakes Controlled Energy. The disposal of this business will result in a reduction in

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revenue and could result in a charge to earnings during 2006. The Building Automation Controls business was responsible for approximately 25% of our 2005 revenue and posted an operating loss of $305,497 during 2005, including a $242,830 charge related to the impairment of goodwill and the allocation of corporate overhead. This business was expected to record revenue of approximately $2 million during 2006 and little to no operating profit.

The acquisition of Maximum Performance Group. In May of 2005 we acquired Maximum Performance Group, Inc. (MPG), the manufacturer of the eMAC line of HVAC and lighting controllers. MPG was responsible for approximately 20% of our consolidated revenue for 2005 and 33% of our operating loss. We believe that MPG has the potential for significantly better performance in future periods and that the 2005 results were heavily influenced by disruptions related to the acquisition and integration with Electric City. MPG s products have historically had margins that are generally better than those of our existing businesses, therefore we believe its profitability should improve with increases in revenue. We recently announced new contracts at MPG that should contribute to improved results during 2006.

Customer concentrations. We have historically relied on a small number of customers each year for a significant portion of our revenue. Seldom has a customer that represented 10% or more of our revenues in one year also represented more than 10% of our revenue in the following year. This means that we have had to find major new customers each year to replace major customers whose needs have been satisfied from the prior year. We hope that some of the changes that we are currently implementing to our sales strategy will decrease our dependence on large customers, thereby diversifying our customer base and reducing the risk of associated with having to replace a customer once we have completed our contract with them. We believe that the monitoring services MPG sells will also help to mitigate this risk because they represent a base of recurring contract revenue. While this monitoring revenue only represented approximately 10% of our 2005 consolidated revenue, we believe it will continue to grow with the continued sale of eMACs.

Results of Operations

During the twelve-month period ended December 31, 2005, we incurred a net loss of $6.9 million and used $7.0 million of cash for operating activities. Primarily as a result of our continuing losses and lack of liquidity our independent registered public accounting firm modified their opinion on our December 31, 2005 Consolidated Financial Statement to contain a paragraph wherein they expressed a substantial doubt about our ability to continue as a going concern. We have taken steps to improve our current liquidity and provide the growth capital necessary to fund our plan for 2006 and for future growth. Our efforts to raise additional capital are discussed below.

Our revenues reflect the sale of our products and services, net of allowances for returns and other adjustments. Electric City s sales are generated from the sale of products and services, primarily in the U.S. One customer accounted for approximately 30% of our consolidated billing during the year ended December 31, 2005 and two customers collectively accounted for 57% of our consolidated revenue during the year ended December 31, 2004.

Our cost of goods sold consists primarily of materials and labor. Also included in our cost of goods sold are freight, the costs of operating our manufacturing facility, charges from the contract manufacturer that manufactures the eMAC line of controllers, charges from outside contractors used to install our product in our customers facilities, depreciation, charges for potential future warranty claims and royalty costs related to EnergySaver sales.

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Sales and gross profits depend in part on the volume and mix of products sold during any given period. Generally our proprietary products have a higher gross profit margin than products and services that we purchase and resell.

A portion of our operating expense is relatively fixed, such as the cost of our facilities. Accordingly, an increase in the volume of sales will generally result in an increase to our gross margins since these fixed expenses do not increase proportionately with sales. We have never fully utilized the manufacturing capacity of our facilities and, therefore, believe that the fixed nature of some of our expenses would contribute to an increase in our gross margin in future periods if sales volumes increase. In particular we believe that our facility in Elk Grove Village can support a sales level of EnergySavers of approximately $15 million to $20 million without a significant additional investment in fixed assets. It is our intent to outsource manufacturing to third party contract manufacturers once we approach the capacity of our current facility.

Selling, general and administrative (SG&A) expenses include the following components:

- direct labor and commission costs related to our employee sales force;
- expenses related to our non-manufacturing management, supervisory and staff salaries and employee benefits;
- commission costs related to our independent sales representatives and our distributors;
- costs related to insurance, travel and entertainment and office supplies and the cost of non-manufacturing utilities;
- costs related to marketing and advertising our products;
- legal and accounting expenses;
- research and development expenses;
- costs related to administrative functions that serve to support the existing businesses of the Company, as well as to provide the infrastructure for future growth.

Interest expense for continuing operations includes the costs and expenses associated with working capital indebtedness, the mortgage on our headquarters building, convertible term loans, and various auto loans, all as reflected on our current and prior financial statements. Also included in interest expense is amortization of debt discount and deferred financing costs. The debt discount includes the fair value of the warrants issued to Laurus Master Fund in 2003 and 2005, as well as the value of the beneficial conversion feature attributed to the Convertible Term Loan which we entered into in 2003.

Twelve-Month Period Ended December 31, 2005 Compared With the Twelve-Month Period Ended December 31, 2004

Revenue. Our revenue increased $2,442,137, or 101.2% to $4,854,772 during the year ended December 31, 2005 from $2,412,635 during the year ended December 31, 2004. Approximately $950,000 or 39% of the increase was due to the acquisition of Maximum Performance Group in May 2005. EnergySaver related sales increased approximately $1,700,000 during 2005 over the year earlier period as the result of increased EnergySaver sales. Unit sales of EnergySavers increased 198% from 67 units in 2004 to 200 units in 2005. One customer was responsible for a significant portion of this increase. We are continuing to ship product to this customer into 2006, but at a reduced level. Approximately $325,000 of the increase in revenue was due to a short term utility consulting project completed in May 2005. Revenue for 2005 also included VNPP curtailment services of approximately $16,000. We hope to see continued improvement in EnergySaver and eMAC sales as a result of a recent restructuring of our sales strategy that places an increase emphasis on commercial sales. We expect a decline in revenue if we close on the sale of our Building Automation Control business, but we expect this to be at least partially offset by a full year of MPG revenue.

Gross Profit. Our consolidated gross profit increased $255,014, or 231% in 2005 to $365,545 from $110,531 and our gross profit margin improved to 7.5% in 2005 from 4.6% in 2004. The increase in gross profit was due to recognition of profit on a building automation control project that was completed during the first quarter; to a consulting assignment completed in May 2005 by the Energy Technology segment; and to improved margins on EnergySaver sales primarily as the result of increased volume. The profit on the building automation control project and the consulting assignment are not likely to be repeated in future periods. Our margins on EnergySaver and eMAC sales are expected to improve during 2006 as sales of these products increase.

SG&A Expenses. Selling, general and administrative expenses increased $1,807,633 or 38.9% to $6,450,836 during 2005 from $4,643,203 in 2004. The acquisition and integration of Maximum Performance Group in May 2005 was responsible for approximately $1,840,000 of the increase. We expect SG&A to increase moderately during 2006 as the result of a full twelve months of expense from Maximum Performance Group and the implementation of FAS 123 (R) which requires that we expense employee options beginning in the first quarter of 2006.

Impairment Loss. We incurred an impairment loss of $242,830 during 2005 related to the reduction in carrying value of goodwill associated with the acquisition of Great Lakes Controlled Energy. In February 2006 we signed a non-binding letter of intent to sell Great Lakes Controlled Energy. We compared the carrying value of the goodwill related to Great Lakes to the expected sale price of the business and determined that the goodwill was impaired. As a result we recorded an impairment loss as of December 31, 2005 of $242,830. There was no impairment loss recorded in 2004.

Other Non-Operating Income (Expense). Other non-operating expense is comprised of interest expense and interest income. Interest expense declined $45,841 to $603,354 during 2005 from $649,195 during 2004. Amortization of the deferred issuance costs and debt discount related to the Laurus revolver and convertible term loans, which are included in interest expense, declined $409,026 to $165,411 for 2005 from $574,437 during 2004. The deferred issuance costs and debt discount are being amortized using the effective interest method, thus decline as the outstanding balance on the related term loan is repaid or converted. During January 2004, Laurus converted a portion of its term loan resulting in accelerated recognition of $193,000 in amortization expense. No such conversions occurred during 2005. Other interest expense increased $203,149 primarily as a result of borrowings under the revolver, a new $5,000,000 term loan entered into in late November 2005, and higher interest rates. There were no borrowings under the revolver during 2004. During the second quarter of 2005 we issued a 5 year warrant to purchase 400,000 shares of our common stock at $1.00 per share to Laurus in exchange for its consent and waiver to permit us to complete a sale of common stock and warrants to a group of investors for gross proceeds of $5,625,000 and to acquire MPG. This warrant was valued at $160,000 using a modified Black-Sholes option pricing model and the value was charged to interest expense during the period. Interest income increased $36,232 to $58,737 during 2005 from $22,505 earned in 2004. The increase in interest income was due to higher average invested cash balances and increases in the interest rates paid on the invested balances.

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Preferred Stock Dividends. The dividend expense recognized during 2005 and 2004 was comprised of the following:

Year ended December 31,	**2005**	**2004**
Accrual of dividend on Series A Convertible Preferred	**$**	**$ 540,705**
Accrual of Series C Preferred dividend		**53,206**
Accrual of Series D Preferred dividend		**35,932**
Accrual of Series E Preferred dividend	**1,366,900**	**1,006,937**
Deemed dividend associated with beneficial conversion price on shares issuable in satisfaction preferred dividends		**1,127,021**
Deemed dividend associated with the redemption and exchange of outstanding preferred stock		**1,860,458**
Deemed dividend associated with change in the expiration date of warrants to purchase shares of preferred stock		**15,000**
Deemed dividend associated with change in the exercise price of warrants to purchase shares of common stock	**484,455**	
Total	**$ 1,851,345**	**$ 4,639,259**

Our dividend expense for 2005 declined $2,787,914 or 60.1% to $1,851,345 from $4,639,259 in 2004. We accrued dividends of $1,366,900 and $1,636,780 on our Convertible Preferred Stock during 2005 and 2004, respectively. This decline in accrued dividends was the result of the reduction in the number of preferred shares outstanding and a reduction in the dividend rate that resulted from the redemption and exchange effected in March 2004. The dividends accrued during 2005 and 2004 were satisfied through the issuance of 13,669 shares of preferred stock (convertible into 1,366,900 shares of common stock) and 16,368 shares of preferred stock (convertible into 1,636,800 shares of common stock), respectively. We were required to recognize a non-cash deemed dividend of $1,127,021 during 2004 due to the fact that the conversion price on these dividend shares was lower than the market price of our common stock on the date of issue.

On April 28, 2005 we issued to five (5) institutional investors, for an aggregate gross purchase price of $5,625,000, 6,250,000 shares of the Company s common stock and 42 month warrants to purchase 3,125,000 additional shares of common stock at $1.05 per share. Due to the sale price of the securities issued as part of this transaction we were required to adjust the exercise price on warrants to purchase 5,054,830 shares if its common stock held by two investors who had participated in earlier equity offerings. The exercise prices on these warrants were reduced from $2.42 and $1.00, respectively to $0.90. We compared the value of the warrants with the old exercise price to the value of the warrants

with the reduced exercise price, through the use of a modified Black-Sholes option pricing model, and determined that the reduction in the exercise price had increased the value of the warrants by $484,445. Since these warrants were issued as part of a security offering the increase in value is considered to be a deemed dividend to the security holders. We recorded the deemed dividend by offsetting charges and credits to additional paid-in capital, without any effect on total stockholders equity.

As part of the redemption and exchange completed in March 2004, shares of old preferred stock were exchanged for shares of the new Series E preferred stock at the rate of 10 shares of old preferred for each share of new Series E preferred stock. Additionally, each share of old preferred stock was convertible into 10 shares of common stock, whereas each share of new Series E convertible preferred stock is convertible into 100 shares of common stock. Despite the fact that we believe the redemption and exchange transaction was favorable for the Company and its common stockholders (see note 17(k) to the financial statements), we were required to record a non-cash deemed dividend on the transaction of $1,860,458. For accounting purposes the transaction was viewed as a redemption for cash and shares of Series E Preferred stock. The non-cash deemed dividend was determined by comparing the fair value of the consideration given (the cash and the market value of the Series E Preferred) to the carrying value of the old preferred stock that was redeemed. The fair value of the consideration given exceeded the carrying value of the old preferred primarily due to the fact that the market price of our common stock was higher on the day the redemption and exchange transaction closed than it was when the shares of the old preferred stock were originally issued.

We also incurred a $15,000 deemed dividend during 2004 when we agreed to extend the expiration date on warrants to purchase shares of our Series E Convertible Preferred stock from September 30, 2004 to December 31, 2004. We agreed to extend these warrants to permit holders who participated in the redemption and exchange more time to exercise their warrants without violating the short swing trading rules of section 16(b) of the Securities Act of 1934 or our insider trading policy which prohibits the trading of our securities during certain blackout periods prior to the filing of our financial statements.

As is more fully described in Note 17(k) to our financial statements, we completed a redemption and exchange offering on March 22, 2004 in which we redeemed 538,462 shares of our outstanding Series A, Series C and Series D Convertible Preferred Stock (the Old Preferred), and exchanged the remaining 2,104,509 shares of Old Preferred into 210,451 shares of a new Series E Convertible Preferred Stock at the rate of 10 shares of Series E Convertible Preferred Stock for each share of Old Preferred. The Old Preferred Stock carried a dividend rate of 10% payable at the Company s election in cash or in additional shares of Preferred Stock during the first three years following issuance. After the third anniversary of issuance we were required to pay all dividends in cash and the dividend rate was to increase by 1/2% every six months until it reached 15%, where it would remain until the shares were converted or redeemed. The Series E Preferred carries a 6% dividend that is payable at the Company s election in cash or additional shares of Series E Preferred for as long as the shares remain outstanding. The reduction in the number of outstanding shares of preferred stock, in combination with the reduction in the dividend rate, significantly reduces the dilutive effect of the payment-in-kind dividend on our preferred stock in periods after March 22, 2004.

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Twelve-Month Period Ended December 31, 2004 Compared With the Twelve-Month Period Ended December 31, 2003

Revenue. Our revenue declined $2,219,198 or 47.9% to $2,412,635 during the year ended December 31, 2004 from $4,631,833 during the year earlier period. Revenue from the sale of EnergySaver related products and services declined $1,330,467 or 64.5% to $733,630 from $2,064,097 in 2003. Energy Saver unit sales declined 69.1% from 217 units in 2003 to 67 units during 2004 (excluding units shipped under the ComEd VNPP program). The decline in EnergySaver related revenue was directly attributable to our decision to focus on utility programs such as the ComEd and Pacificorp VNPP programs, rather than on commercial sales as we had in past years. As of December 31, 2004, we had shipped 89 EnergySavers to 52 customer hosts under the ComEd program, but we had not recognized revenue related to this program pending completion of an amendment to the existing agreement with ComEd. This amendment was never completed due to a delay in approval of regulatory changes necessary to implement portions of the amendment.

The ComEd VNPP is structured as a service agreement with a 13 year term in which Electric City will provide up to 50 MWs of curtailment capacity to ComEd at a fixed price per kilowatt of installed capacity, payable quarterly in arrears whether the capacity is used or not as the capacity is installed. We will recognize revenue and expense under the ComEd program over the life of the contract. The PacifiCorp program is similar to the existing ComEd contract, as a result revenue and expenses will be recognized over the 10-year term of the contract. Both contracts are structured such that there are no penalties for delivering less than the targeted curtailment capacities, but we will only be compensated for the actual capacity delivered.

Revenue at our building automation and controls segment declined 34.9% to $1,705,341 in 2004 from $2,618,486 in 2003. Revenue in this segment is recognized as work is completed and material is delivered to the job site, thus will vary based on the level of activity during a particular period. This segment completed two of the five long-term projects it was working on during the fourth quarter of 2003, one during the first quarter of 2004 and another during the fourth quarter of 2004. The last of the five long term projects was completed during the first quarter of 2005.

Gross Profit. Our consolidated gross profit declined $79,615 or 41.9% to $110,531during 2004, as compared to $190,146 earned during 2003, while our gross margin during 2004 increased to 4.6% from 4.1% in 2003. The EnergySaver related business generated a loss at the gross profit line of approximately $130,000 during 2004 as compared to earning a gross profit of approximately $296,000 during 2003. The decline in profitability was due primarily to the decline in revenue and the shift in focus to our utility programs. The building automation controls business recognized a gross profit of approximately $240,000 during 2004, as compared to a loss of approximately $106,000 in 2003. The improvement in the gross profit in 2004 was the result of recognition of profit on long term jobs that were completed during the year.

SG&A Expenses. Selling, general and administrative expenses increased $353,125 or 8.2% to $4,643,203 in 2004 from $4,290,078 in 2003. The increase in SG&A expense was primarily due to legal costs related to an arbitration we were involved in with a dealer which contributed to a $640,000 increase in legal expenses during 2004. If it were not for this legal expense our SG&A would have declined year over year as a result of reductions in labor costs, sales commissions to third party dealers and distributors and travel and entertainment expenses. The dealer arbitration was settled in February 2005.

Other Non-Operating Income (Expense). Other non-operating expense is comprised of interest expense and interest income. Interest expense increased $283,507 to $649,195 during 2004 from $365,688 in 2003. Almost all of the increase in interest expense during 2004 was due to a $268,815 increase in amortization of deferred issuance costs and the original issue discount. Interest expense

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included amortization expense totaling $574,437 for 2004 as compared to $305,622 for 2003. Interest income increased $12,176 or 117.9% to $22,505 for 2004 as compared to $10,329 for 2003. The increase in interest income is the result of higher interest rates earned on invested balances and higher average invested balances.

Discontinued Operations. During 2003 we agreed to sell substantially all of the assets and to transfer most of the liabilities of our Power Management segment to a group of investors that included members of the segment s management. The sale closed on June 3, 2003, effective as of May 31, 2003. As required by SFAS 144 we have presented the operating results as well as the loss on disposal for this segment as discontinued operations. During the twelve-month period ended December 31, 2003 the Power Management segment s operating loss was $262,503 and in addition, we recognized a $764,148 loss on the disposal of the segment during 2003.

Preferred Stock Dividends. The dividend expense recognized during 2004 and 2003 was comprised of the following:

Year ended December 31,	**2004**	**2003**
Accrual of dividend on Series A Convertible Preferred	**$ 540,705**	**$ 2,253,978**
Accrual of Series C Preferred dividend	**53,206**	**219,712**
Accrual of Series D Preferred dividend	**35,932**	**77,689**
Accrual of Series E Preferred dividend	**1,006,937**	
Deemed dividend associated with beneficial conversion price on shares issuable in satisfaction of preferred dividends	**1,127,021**	**1,879,554**
Deemed dividend associated with beneficial conversion feature of Series D Preferred stock		**386,984**
Deemed dividend associated with the redemption and exchange of outstanding preferred stock	**1,860,458**	
Deemed dividend associated with change in the expiration date of warrants to purchase shares of preferred stock	**15,000**	
Total	**$ 4,639,259**	**$ 4,817,917**

Our dividend expense for 2004 declined $178,658 or 3.7% to $4,639,259 from $4,817,917 for 2003. We accrued dividends of $1,636,780 and $2,551,379 on our Convertible Preferred Stock during 2004 and 2003, respectively. This decline in accrued dividends was the result of the reduction in the

number of preferred shares outstanding and a reduction in the dividend rate that resulted from the redemption and exchange effected in March 2004. Also contributing to the decline was a reduction in the number of preferred shares outstanding resulting from the voluntary conversion of shares of preferred stock into 1,956,700 shares of common stock. The dividends accrued during 2004 and 2003 were satisfied through the issuance of 16,368 shares of preferred stock (convertible into 1,636,800 shares of common stock) and 255,138 shares of preferred stock (convertible into 2,551,380 shares of common stock), respectively. We were required to recognize non-cash deemed dividends of $1,127,021 and $1,879,554 during 2004 and 2003, respectively, due to the fact that the conversion price on these dividend shares was lower than the market price of our common stock on the date of issue. As part of the redemption and exchange completed in March 2004, shares of old preferred stock were exchanged for shares of the new Series E preferred stock at the rate of 10 shares of old preferred for each share of new Series E preferred stock. Additionally, each share of old preferred stock was convertible into 10 shares of common stock, whereas each share of new Series E preferred stock is convertible into 100 shares of common stock. The decline in this deemed dividend is primarily the result of the reduction in the difference between the market price of our common stock and the conversion price of the dividend shares on the date of issuance of these dividend shares. In addition, despite the fact that we believe the redemption and exchange transaction was favorable for the Company and its common stockholders (see note 17(k) to the financial statements), we were required to record a non-cash deemed dividend on the transaction of $1,860,458. For accounting purposes the transaction was viewed as a redemption for cash and shares of Series E Preferred stock. The non-cash deemed dividend was determined by comparing the fair value of the consideration given (the cash and the market value of the Series E Preferred) to the carrying value of the preferred stock that was redeemed. The fair value of the consideration given exceeded the carrying value of the existing preferred primarily due to the fact that the market price of our common stock was higher on the day the redemption and exchange transaction closed than it was when the shares of the old preferred stock were originally issued. We also incurred a $15,000 deemed dividend during 2004 when we agreed to extend the expiration date on warrants to purchase shares of our Series E Convertible Preferred stock from September 30, 2004 to December 31, 2004. We agreed to extend these warrants to permit holders who participated in the redemption and exchange more time to exercise their warrants so that if they chose to exercise they could do so without violating the short swing trading rules of section 16(b) of the Securities Act of 1934 or our insider trading policy which prohibits the trading of our securities during certain blackout periods prior to the filing of our financial statements. Dividend expenses for 2003 also included $386,984 of non-cash deemed dividends associated with the issuance of the Series D Convertible Preferred stock. Again this was due to the fact that the conversion price on the Series D was lower than the market price when the shares of Series D were issued.

Liquidity and Capital Resources

During the twelve-month period ended December 31, 2005 we incurred a net loss of $6.9 million and used $7.0 million of cash for operating activities. Primarily as a result of our continuing losses and lack of liquidity our independent registered public accounting firm modified their opinion on our December 31, 2005 Consolidated Financial Statement to contain a paragraph wherein they expressed a substantial doubt about our ability to continue as a going concern. We have taken steps to improve our current liquidity and provide the growth capital necessary to fund our plan for 2006 and for future growth. Our efforts to raise additional capital are discussed below.

As of December 31, 2005, we had cash and cash equivalents of $4,229,150, compared to cash and cash equivalents of $1,789,808 on December 31, 2004. Our contractual obligations as of December 31, 2005 totaled $6,774,599, as detailed below.

The Company s principal cash requirements are for operating expenses, including employee costs, the costs related to research and development, advertising costs, the cost of outside services including those providing contract manufacturing, accounting, legal, engineering and electrical contracting services, and the funding of inventory and accounts receivable, and capital expenditures. The

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Company has financed its operations since inception primarily through the private placement of its common and preferred stock, as well as through various forms of secured debt.

The following table summarizes, for the periods indicated, selected items in our consolidated statement of cash flows:

Year ended December 31	2005	2004	2003
Net cash used in operating activities	$ (6,956,642)	$ (4,039,058)	$ (2,830,117)
Net cash provided by (used in) investing activities	(2,181,846)	(149,603)	896,728
Net cash provided by financing activities	11,577,830	3,511,446	2,844,508
Net Increase (Decrease) in Cash and Cash Equivalents	2,439,342	(677,215)	911,119
Cash and Cash Equivalents, at beginning of period	1,789,808	2,467,023	1,555,904
Cash and Cash Equivalents, at end of period	$ 4,229,150	$ 1,789,808	$ 2,467,023

2005 Compared to 2004

Net cash increased $2,439,342 during the year ended December 31, 2005, while net cash declined $677,215 during the year ended December 31, 2004.

Operating Activities

The cash consumed by operating activities increased $2,917,584 or 72.2% to $6,956,642 during the twelve-month period ended December 31, 2005 as compared to consuming $4,039,058 during the twelve-month period ended December 31, 2004. The loss from operations was the primary contributor to the cash consumed in operating activities in both years. The increase in cash consumed in operating activities in 2005 was largely the result of the acquisition of Maximum Performance Group in May 2005, which consumed approximately $2.5 million of cash for operating activities. Most of the remaining increase was related to a decline in accounts payable at our other companies, meaning that we used cash to pay down such payables.

Investing Activities

Investing activities consumed $2,181,846 in 2005, and increased $2,032,243 from the $149,603 consumed in 2004. During 2005 we used $1,632,972 for the acquisition of Maximum Performance Group, including $1,632,078 paid to the selling shareholders, and $137,386 of transaction costs less cash acquired of $136,492. We also invested $478,249 in VNPP assets and purchased furniture, equipment and vehicles totaling $70,625 during 2005. During 2004 we invested $135,512 in VNPP assets and $14,091 in manufacturing and office equipment.

Financing Activities

Financing activities generated $11,577,830 during the year ended December 31, 2005 as compared to generating $3,511,446 during the year ended December 31, 2004. In April of 2005, we raised $5,625,000 through the private placement of 6,250,000 shares of our common stock. We incurred $211,787 in expenses related to this issuance. In November of 2005 we borrowed $5 million under a secured convertible term loan and incurred $293,836 in expenses related to the transaction. During the year we also drew $2 million on our revolving line of credit and made scheduled payments of $385,000

on a term loan, $36,000 on our mortgage, $95,349 on amounts owed to the selling shareholders of Maximum Performance Group and approximately $25,000 on various auto loans and capitalized leases.

During 2004, we raised $11,000,000 through the issuance of a package of securities that included shares of our common stock and common stock warrants. We used $7,000,006 of the net proceeds from this issuance to effectuate a redemption and exchange offer for our Series A, Series C and Series D Convertible Preferred Stock. We incurred expenses related to these transactions of $910,393. During the period we also made scheduled principal payments on our mortgage and auto loan of $39,155 and received $461,000 in net proceeds from the exercise of warrants to purchase shares of our common and preferred stock.

2004 Compared to 2003

Net cash declined $677,215 during the year ended December 31, 2004 while net cash increased $911,119 during the year ended December 31, 2003.

Operating Activities

The cash consumed by operating activities increased $1,208,941 or 42.7% to $4,039,058 during the twelve-month period ended December 31, 2004 as compared to consuming $2,830,117 during the twelve-month period ended December 31, 2003. The cash consumed by operating activities in both periods are largely the result of losses from operations. The increase in cash used in operating activities during 2004 was primarily attributable to the increase in SG&A expense and lower gross profit realized during the year, partially offset by the elimination of the loss from discontinued operations.

Investing Activities

Investing activities consumed $149,603 during the 2004 compared to generating cash of $896,728 during 2003. The increase in investing activities for 2004 primarily reflects the costs of building and installing equipment for the ComEd VNPP program. These capitalized costs will be amortized over the term of the underlying contract with ComEd. During 2003, we sold certain assets and transferred certain liabilities of our Power Management business, generating cash proceeds of $929,032.

Financing Activities

Financing activities generated cash of $3,511,446 during 2004 as compared to generating cash of $2,844,508 during 2003. During 2004, we raised $11,000,000 through the issuance of a package of securities that included shares of our common stock and common stock warrants. We used $7,000,006 of the net proceeds from this issuance to effectuate a redemption and exchange offer for our Series A, Series C and Series D Convertible Preferred Stock. We incurred expenses related to these transactions of $910,393. During the period we also made scheduled principal payments on our mortgage and auto loan of $39,155 and received $461,000 in net proceeds from the exercise of warrants to purchase shares of our common and preferred stock.

During 2003 we raised $1,000,000 in gross proceeds through the issuance of a convertible term note to Laurus Funds. These proceeds were partially offset by issuance costs totaling $308,228. In November 2003 Laurus converted $52,346 in principal of the note into shares of our common stock. We also raised gross proceeds of $1.5 million from the issuance of our Series D Convertible Preferred Stock and $1,669,914 from the issuance of 1,815,125 shares of our common stock in three separate private placements during 2003. The proceeds from these private placements of our common stock were partially offset by issuance costs of $297,462. During 2003, various holders of warrants exercised their rights under the warrants generating $197,000 in cash. We used a portion of the proceeds generated from the

sale of our Power Management segment to repay $298,000 in equipment loans and to pay down to zero the outstanding balance on our revolving line of credit of $500,000. We also prepaid $47,000 on our mortgage as an inducement for the lender to refinance the mortgage and extend the maturity until February 1, 2005. We made scheduled payments during 2003 of $33,000 on our mortgage, $51,500 on our equipment loan, and $7,014 on various auto loans. We also received a payment of $798 from a board member that represented the short-swing profit inadvertently earned when he purchased shares of our stock within six months of selling shares, which is a violation of section 16(b) of the Securities Exchange Act of 1934.

LIQUIDITY

Our primary sources of liquidity are our available cash reserves and borrowing capacity under our working capital line.

During fiscal 2005, operating activities consumed cash of $7.0 million. We are in the process of implementing changes that we hope will reduce cash consumed by operating activities to a level of less than $3 million during 2006. We will also require cash during 2006 to satisfy scheduled debt amortization of approximately $659,000 and any required payments on our revolving credit line. In January 2006 we were required to repay approximately $872,000 on the revolving credit line due to the decline in our borrowing base. We may be required to make additional repayments if our borrowing base declines further. Conversely, we will be able to re-borrow on the revolving line of credit if our borrowing base increases. In order to assure adequate liquidity throughout 2006, we plan to attempt to raise an additional $3 to $5 million through a private placement of our equity, though there is no assurance that we will be successful in raising this additional capital.

We currently have a $2 million secured convertible working capital line with Laurus Master Fund, Ltd. (Laurus). As of December 31, 2005 we had borrowed the $2,000,000 available under the facility. The shift in our focus during 2003 and 2004 away from commercial sales to utility programs resulted in a significant reduction in the amount of receivables generated. As of December 31, 2004 eligible receivables would have supported borrowings of approximately $89,000 under the facility. To address the problem created by our low borrowing base, we negotiated an amendment to the Laurus credit facility in February 2005, which among other things granted us an overadvance on the working capital line though December 2005. On February 28, 2005 we borrowed the full $2 million available under the facility without the requirement that we have eligible receivables to support the advance. As of December 31, 2005 when the overadvance period ended, it was determined that we only had eligible receivables to support borrowings of $1,128,248 under the facility, as a result we repaid $871,752 on the line in January 2006. We can re-borrow any portion of this repayment if our borrowing base increases in future periods. For a more detailed description of this credit facility and the amendment, please see note 10 of our consolidated financial statements.

Our ability to continue the development, manufacturing and expansion of sales of our products, including the EnergySaver, the GlobalCommander and the eMAC, will require the continued commitment of significant funds. The actual timing and amount of our future funding requirements will depend on many factors, including the amount and timing of future revenues, the level and amount of product marketing and sales efforts, the magnitude of research and development, and our ability to improve margins on our products.

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During the last five fiscal years we have raised net proceeds of $34.0 million through the issuance of shares of our common and preferred stock and notes, which has allowed us to continue to execute our business plan. Most of these funds have been consumed by operating activities, either to fund our losses or for working capital requirements. As of December 31, 2005 our cash balance was $4,229,150. In an attempt to move the Company to a position where it can start to generate positive cash flow our management has set the following key strategies for cash flow improvement in 2006:

Focus on increasing the commercial sales of our products. Key to this strategy is the integration of the Electric City and MPG sales forces with the intent that the integrated sales force will sell all of our products to current, prior and future customers. We believe that this change will increase our base of commercial opportunities and allow us to offer a broader array of energy solutions to our customers thereby increasing the value of each customer relationship. This reorganization of our sales staffs will involve the cross training of all of our sales people in the sale of the EnergySaver, eMAC and other energy conservation products and services. We also plan to hire additional sales people in an attempt to expand our commercial sales efforts.

Expand and improve the product line through internal development or acquisition. An expanded product line would allow us to offer additional solutions to our customers, thereby increasing the value of each customer relationship.

Aggressively manage our costs in order to conserve cash. We made some progress in reducing our costs during the last several years, but we plan to focus on eliminating redundant operations and leveraging the synergies available as a result of the acquisition of MPG to further reduce our costs.

Sell our Building Automation Controls business. The sale of this business will allow us to focus exclusively on the sale of our Energy Technology products and services and will reduce the cash consumed in future periods.

Secure additional capital to continue to fund operations until the business turns cash flow positive. Our ability to raise additional capital in the future will depend a great deal on our ability to make progress toward the goals outline above.

We believe that if we are successful in achieving these priorities we should have sufficient liquidity to allow us to operate until our operations turn cash flow positive. If we are not able to achieve some or all of these priorities we may begin to experience a liquidity shortage in the latter half of 2006 which could force us to scale back our growth plans, or in the worst case cease operations.

If we raise additional capital (which may require stockholder approval), our existing stockholders will likely experience dilution of their present equity ownership position and voting rights, depending upon the number of shares issued and the terms and conditions of the issuance. The new equity securities will likely have rights, preferences or privileges senior to those of our common stock.

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Contractual Obligations

Our obligations to make future payments under contracts as of December 31, 2005 are as follows:

		Payments due by period			
Contractual Obligations	**Total**	**Less than 1 year**	**1 to 3 years**	**3 to 5 years**	**More than 5 years**
Long-term debt *(1)*	**$ 5,873,702**	**$ 654,695**	**$ 1,578,657**	**$ 3,640,350**	**$**
Capital leases	**4,739**	**4,386**	**353**		
Operating leases	**371,158**	**113,553**	**134,506**	**123,099**	
Employment agreements	**525,000**	**225,000**	**300,000**		
Total	**$ 6,774,599**	**$ 997,634**	**$ 2,013,516**	**$ 3,763,449**	**$**

(1) Excludes floating rate interest on the long-term debt. Interest payments required during 2006, based on current interest rates, are projected to be $515,000.

Recent Accounting Pronouncements

In December 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 123(R), Share-Based Payment . This statement revises FASB Statement No. 123, Accounting for Stock-Based Compensation and supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees. SFAS No. 123(R) focuses primarily on the accounting for transactions in which an entity obtains employee services in share-based payment transactions. SFAS No. 123(R) requires companies to recognize in the statement of operations the cost of employee services received in exchange for awards of equity instruments based on the grant-date fair value of those awards (with limited exceptions). This Statement is effective as of the first reporting period that begins after June 15, 2005. Accordingly, we will adopt SFAS 123(R) in our first quarter of fiscal 2006. We are currently evaluating the provisions of SFAS 123(R) and have not yet determined the impact that this Statement will have on our results of operations or financial position. In March 2005, the SEC staff issued Staff Accounting Bulletin No. 107 (SAB 107) to give guidance on the implementation of SFAS 123R. We will consider SAB 107 during implementation of SFAS 123R.

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections A Replacement of APB Opinion No. 20 and FASB Statement No. 3 (SFAS No. 154). SFAS No. 154 requires the retrospective application to prior periods financial statements of changes in accounting principle, unless it is impractical to determine either the period-specific effects or cumulative effect of the accounting change. SFAS No. 154 also requires that a change in depreciation, amortization, or depletion method for long-lived non-financial assets be accounted for as a change in accounting estimate affected by a change in accounting principle. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005.

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Item 7A. Quantitative and Qualitative Disclosures

The only significant exposure the Company has to market risk is the risk of changes in market interest rates. The interest rates on the Company s debt facilities are variable and change with changes in the prime rate. The interest rates on the Company s convertible term loans floats at between 1.75% and 2.00% over the prime rate, subject to floors of between 6.0% and 6.75%. The interest rate on our revolving loan is equal to prime plus 1.75%. The interest rate on the Company s mortgage is equal to the prime rate plus 1/2%. As of December 31, 2005, the prime rate was 7.25%. If the prime rate were to increase 1 percentage point, the aggregate annual interest cost on the mortgage, term loans and revolving loan would increase by approximately $80,000.

Item 8. Financial Statements and Supplemental Data

Index to Financial Statements

F-1 Report of Independent Registered Public Accounting Firm

F-2 F-3 Consolidated Balance Sheets as of December 31, 2005 and December 31, 2004

F-4 Consolidated Statements of Operations for the years ended December 31, 2005, 2004 and 2003

F-5 Statements of Stockholders Equity for the years ended December 31, 2005, 2004 and 2003