

Andalay Solar, Inc.  
Form 10-Q  
August 12, 2014

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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, DC 20549

FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the quarterly period ended June 30, 2014

or

Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 001-33695

Andalay Solar, Inc.  
(Exact name of registrant as specified in its charter)

Delaware  
(State or other jurisdiction of  
incorporation or organization)

90-0181035  
(I.R.S. Employer Identification No.)

2071 Ringwood Ave., Unit C, San Jose, CA  
(Address of principal executive offices)

95008  
(Zip Code)

(408) 402-9400  
(Registrant's telephone number, including area code)

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

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

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

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

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

As of August 11, 2014, 241,278,204 shares of the issuer's common stock, par value \$0.001 per share, were outstanding (including non-vested restricted shares).

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## PART I - FINANCIAL INFORMATION

## Item 1. Financial Statements.

Andalay Solar, Inc.  
Condensed Consolidated Balance Sheets

	June 30, 2014 (unaudited)	December 31, 2013
Assets		
Current assets:		
Cash	\$92,621	\$150,081
Accounts receivable, net	601,041	567,523
Other receivables	—	21,378
Inventory	923,268	786,636
Prepaid expenses and other current assets	134,740	317,510
Total current assets	1,751,670	1,843,128
Property and equipment, net	5,629	13,854
Patents, net	1,188,019	1,244,712
Other assets, net	146,980	163,711
Assets of discontinued operations – long-term	200,000	200,000
Total assets	\$3,292,298	\$3,465,405
Liabilities, Redeemable Convertible Preferred Stock and Stockholders' Deficit		
Current liabilities:		
Accounts payable	\$3,108,410	\$4,199,511
Accrued liabilities	105,274	89,730
Accrued warranty	352,916	344,990
Credit facility	500,000	500,000
Capital lease obligations – current portion	—	299
Derivative liability – embedded conversion feature	317,240	177,927
Current portion of long-term debt	43,631	129,839
Convertible notes – short-term	150,000	60,000
Liabilities of discontinued operations	931,773	967,928
Total current liabilities	5,509,244	6,470,224
Convertible notes, less current portion (net of discount)	810,213	382,084
Total liabilities	6,319,457	6,852,308
Commitments and contingencies (Note 17)		
Series C convertible redeemable preferred stock, \$0.001 par value; 0 and 87 issued and outstanding as of June 30, 2014 and December 31, 2013, respectively	—	163,998
Series D convertible redeemable preferred stock, \$0.001 par value; 90 and 860 shares issued and outstanding as of June 30, 2014 and December 31, 2013, respectively	37,505	858,565
Stockholders' deficit:		
Series B convertible redeemable preferred stock, \$0.001 par value; 0 and 467 shares issued and outstanding as of June 30, 2014 and December 31, 2013, respectively	—	146,224

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Common stock, \$0.001 par value; 500,000,000 shares authorized; 217,350,775 and 116,339,293 shares issued and outstanding as of June 30, 2014 and December 31, 2013, respectively	217,351	116,339
Additional paid-in capital	80,828,238	78,717,997
Accumulated deficit	(84,110,253)	(83,390,026)
Total stockholders' deficit	(3,064,664 )	(4,409,466 )
Total liabilities, redeemable convertible preferred stock and stockholders' deficit	\$3,292,298	\$3,465,405

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

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Andalay Solar, Inc.  
Condensed Consolidated Statements of Comprehensive Loss  
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Net revenue	\$306,919	\$130,046	\$449,401	\$211,240
Cost of goods sold	296,640	151,726	432,028	239,468
Gross profit (loss)	10,279	(21,680 )	17,373	(28,228 )
Operating expenses				
Sales and marketing	75,332	302,063	138,716	602,458
General and administrative	537,382	509,673	1,141,546	1,221,097
Total operating expenses	612,714	811,736	1,280,262	1,823,555
Loss from continuing operations	(602,435 )	(833,416 )	(1,262,889 )	(1,851,783 )
Other income (expense)				
Interest income (expense), net	(113,874 )	(64 )	(190,959 )	(5,363 )
Adjustment to the fair value of embedded derivatives	84,868	—	(16,683 )	—
Adjustment to the fair value of common stock warrants	—	2	—	9
Settlement of prior debt owed	—	420,000	769,148	420,000
Total other income (expense), net	(29,006 )	419,938	561,506	414,646
Loss before provision for income taxes and discontinued operations	(631,441 )	(413,478 )	(701,383 )	(1,437,137 )
Provision for income taxes	—	—	—	—
Net loss from continuing operations	(631,441 )	(413,478 )	(701,383 )	(1,437,137 )
Net income from discontinued operations, net of tax (Note 3)	—	4,672	—	7,597
Net loss	(631,441 )	(408,806 )	(701,383 )	(1,429,540 )
Preferred stock dividend	(4,390 )	(42,309 )	(18,844 )	(95,529 )
Preferred deemed dividend	—	(104,000 )	—	(374,000 )
Net loss attributable to common stockholders	\$(635,831 )	\$(555,115 )	\$(720,227 )	\$(1,899,069 )
Net loss attributable to common stockholders per common share (basic and diluted)	\$(0.00 )	\$(0.01 )	\$(0.00 )	\$(0.04 )
Weighted average shares used in computing loss per common share:	191,427,247	54,754,456	161,593,368	43,962,863

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



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Andalay Solar, Inc.  
Condensed Consolidated Statements of Changes in Redeemable Convertible Preferred Stock and Stockholders' Deficit  
(Unaudited)

	Series C Convertible Redeemable Preferred Stock		Series D Convertible Redeemable Preferred Stock		Series B Convertible Redeemable Preferred Stock		Common Stock		Additional Paid-in Capital	Accumula Deficit
	Number of Shares	Amount	Number of Shares	Amount	Number of Shares	Amount	Number of Shares	Amount		
Balance as of January 1, 2014	87	\$163,998	860	\$858,565	467	\$146,224	116,339,293	\$116,339	\$78,717,997	\$(83,390,
Issuance of common stock pursuant to registration statement	—	—	—	—	—	—	33,614,947	33,615	716,385	—
Issuance of common stock u p o n conversion of note payable	—	—	—	—	—	—	3,157,172	3,157	59,237	—
Conversion of Series B Convertible Redeemable preferred stock to common stock	—	—	—	—	(467)	(146,224)	21,020,015	21,020	125,204	—
Conversion of Series C Convertible Redeemable preferred stock to common stock	(87)	(163,998)	—	—	—	—	4,333,350	4,333	159,665	—
Conversion of Series D Convertible Redeemable preferred stock to common stock	—	—	(770)	(821,060)	—	—	38,500,000	38,500	782,560	—
Convertible Redeemable	—	—	—	—	—	—	640,160	640	18,204	(18,844)

Preferred Stock dividends paid in common stock											
Placement agent and registration fees and other direct costs	—	—	—	—	—	—	—	—	(36,616)	)	—
Convertible note embedded derivative and warrants: accretion of note to face value	—	—	—	—	—	—	—	—	170,767		
Grants of restricted stock, net of forfeitures and upon exercise or expiration of warrants	—	—	—	—	—	—	(254,162)	)	(253)	)	(5,996)
Stock-based compensation	—	—	—	—	—	—	—	—	120,831		
Net loss	—	—	—	—	—	—	—	—	—		(701,383)
Balance as of June 30, 2014	—	\$—	90	\$37,505	—	\$—	217,350,775	\$217,351	\$80,828,238		\$(84,110,000)

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

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Andalay Solar, Inc.  
Condensed Consolidated Statements of Cash Flows  
(Unaudited)

	Six Months Ended June	
	30,	
	2014	2013
Cash flows from operating activities		
Net loss	\$(701,383 )	\$(1,429,540)
Adjustments to reconcile net loss to net cash used in operations:		
Depreciation	8,225	20,250
Amortization	56,693	55,647
Bad debt expense	4,492	72,578
Unrealized (gain) loss on fair value adjustment of common stock warrants	—	(9 )
Unrealized (gain) loss on fair value of embedded derivatives	16,683	—
Accretion of interest on convertible note	79,866	—
Non-cash stock-based compensation expense	120,831	13,454
Non-cash settlement of prior debt owed	(769,148 )	—
Accrued interest payable	44,696	—
Changes in assets and liabilities:		
Accounts receivable	(38,010 )	250,475
Other receivables	21,378	121,954
Inventory	(136,632 )	167,524
Prepaid expenses and other current assets	182,770	166,307
Assets of discontinued operations – short term	—	10,896
Other assets	16,731	(19,108 )
Accounts payable	(171,953 )	323,795
Accrued liabilities and accrued warranty	23,470	(67,153 )
Liabilities of discontinued operations	(36,155 )	(39,241 )
Net cash used in operating activities	(1,277,446)	(352,171 )
Cash flows from financing activities		
Borrowing on convertible notes payable	600,000	—
Proceeds from issuance of common stock	750,000	—
Repayment notes payable	(86,850 )	—
Repayments on capital lease obligations	(299 )	(2,447 )
Proceeds from convertible redeemable preferred stock offering	—	500,000
Payment of placement agent and registration fees and other direct costs	(36,616 )	(55,919 )
Employee taxes paid for vesting of restricted stock	(6,249 )	(302 )
Net cash provided by financing activities	1,219,986	441,332
Net increase (decrease) in cash	(57,460 )	89,161
Cash		
Beginning of period	150,081	127,385
End of period	\$92,621	\$216,546
Supplemental cash flows disclosures:		
Cash paid during the period for interest	\$38,834	\$5,363
Supplemental disclosure of non-cash financing activity:		
Conversion of preferred stock to common stock	\$1,31,282	\$1,542,844

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Embedded derivative on convertible note issued	\$122,630	\$—
Grant of warrants on issue of convertible note	\$170,767	\$—
Preferred deemed dividend	\$—	\$374,000
Preferred stock dividends paid in common stock	\$18,844	\$95,529
Preferred stock issued for payment of financial advisor fees	\$—	\$120,000
Conversion of convertible note to common stock	\$62,394	\$—
Convertible note issued to financial advisor in exchange for accounts payable	\$150,000	\$—

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

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Andalay Solar, Inc.  
Notes to Condensed Consolidated Financial Statements  
June 30, 2014  
(Unaudited)

1. Basis of Presentation and Description of Business

Basis of Presentation — Interim Financial Information

The accompanying condensed consolidated financial statements are unaudited and have been prepared in accordance with generally accepted accounting principles for interim financial information. They should be read in conjunction with the consolidated financial statements and related notes to the consolidated financial statements of Andalay Solar, Inc. (“we”, “us”, “our” or the “Company”), formerly Westinghouse Solar, Inc. and Akeena Solar, Inc., for the years ended December 31, 2013 and 2012 appearing in our Form 10-K. The June 30, 2014 unaudited interim condensed consolidated financial statements included in this Quarterly Report on Form 10-Q have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission (“SEC”). Certain information and note disclosures normally included in annual financial statements filed with our Annual Report on Form 10-K have been condensed or omitted as permitted by those rules and regulations. In the opinion of management, all adjustments, consisting of normal recurring accruals, necessary for a fair statement of the results of operations for the interim periods presented have been reflected herein. The results of operations for interim periods are not necessarily indicative of the results to be expected for the entire year.

Description of Business

We are a designer and manufacturer of solar power systems and solar panels with integrated microinverters (which we call AC solar panels). We design, market and sell these solar power systems to solar installers and do-it-yourself customers in the United States, Canada, the Caribbean and South America through distribution partnerships, our dealer network and retail outlets. Our products are designed for use in solar power systems for residential and commercial rooftop customers. Prior to September 2010, we were also in the solar power installation business.

We were incorporated in February 2001 as Akeena Solar, Inc. in the State of California and elected at that time to be taxed as an S corporation. During June 2006, we reincorporated in the State of Delaware and became a C corporation. On August 11, 2006, we entered into a reverse merger transaction with Fairview Energy Corporation, Inc. (“Fairview”). Pursuant to the Merger, the stockholders of the Company received one share of Fairview common stock for each issued and outstanding share of The Company’s common stock. The Company’s common shares were also adjusted from \$0.01 par value to \$0.001 par value at the time of the Merger. On May 17, 2010, we entered into an exclusive worldwide license agreement with Westinghouse, Inc, which permitted us to manufacture, distribute and market solar panels under the Westinghouse name and in connection therewith, on April 6, 2011, we changed our name to Westinghouse Solar, Inc. On August 23, 2013, the license agreement with Westinghouse, Inc. was terminated and on September 19, 2013, we changed our name to our current name, Andalay Solar, Inc.

On May 7, 2012, we entered into a merger agreement with CBD Energy Limited, an Australian corporation (“CBD”). We had originally targeted completion of the merger during the third quarter of 2012, however the target date for completion had been repeatedly delayed, and the necessary registration statement had yet to be completed and filed. The uncertainty resulted in a disruption in our supply relationships, leading to a significant decline in our revenue and the implementation of significant cost reductions including the layoff of employees during the time we pursued the merger. Given the continued delays and uncertainty of whether and when the closing conditions for the merger as set for in the merger agreement would be satisfied, we terminated the merger agreement with CBD effective July 18, 2013. We are committed to focus our attention on rebuilding our core business, expanding our current product

offerings and exploring strategic opportunities.

Our Corporate headquarters is located at 2071 Ringwood Ave. Unit C, San Jose, CA 95131. Our telephone number is (408) 402-9400. Additional information about Andalay Solar is available on our website at <http://www.andalaysolar.com>. The information on our web site is not incorporated herein by reference.

## 2. Significant Accounting Policies

### Liquidity and Financial Position

We currently face challenges meeting the working capital needs of our business. Our primary requirements for working capital are to fund purchases for solar panels and microinverters, and to cover our payroll and lease expenses. We have incurred net losses and negative cash flows from operations for the quarter ended June 30, 2014 and for each of the years ended December 31, 2013 and 2012. During recent years, we have undertaken several equity and debt financing transactions to provide the capital needed to sustain our

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business. We have dramatically reduced our headcount and other variable expenses. As of June 30, 2014, we had approximately \$93,000 in cash on hand. We intend to address ongoing working capital needs through sales of remaining inventory, along with raising additional debt and equity financing. In January 2013, our board of directors approved actions to dramatically reduce our variable operating costs, including a 12 person employee headcount reduction effective January 15, 2013, for the period through the anticipated merger closing with CBD, which merger was terminated in July 2013. No restructuring charges or severance payments were incurred. Our revenue levels remain difficult to predict, and we anticipate that we will continue to sustain losses in the near term, and we cannot assure investors that we will be successful in reaching break-even.

During 2012, because of our cash position and liquidity constraints, we were late in making payments to both of our former panel suppliers, Suntech and Lightway. We currently have no unshipped orders from these suppliers. In May 2013, we entered into a new supply agreement for assembly of our proprietary modules with Environmental Engineering Group Pty Ltd (“EEG”), an assembler of polycrystalline modules located in Australia. In August 2013, we began receiving product from EEG and began shipping product to customers during the third calendar quarter of 2013. In September 2013, we entered into a second supply agreement for assembly of our proprietary modules with Tianwei New Energy Co, Ltd., a panel supplier located in China. We began receiving product from Tianwei in February 2014 and stopped as of June 2014. In July 2014, we entered into a supply agreement for assembly of our proprietary modules with Auxin Solar, Inc., a panel supplier located in the United States. We expect to begin receiving product from Auxin in September 2014. Although we believe we can find alternative suppliers for solar panels manufactured to our specifications, our operations would be disrupted unless we are able to rapidly secure alternative sources of supply, our inventory and revenue could diminish significantly, causing disruption to our operations.

The accompanying consolidated financial statements have been prepared assuming we will continue as a going concern. Our significant operating losses, negative cash flow from operations, and challenges in rapidly securing alternative sources of supply for solar panels, raise substantial uncertainty about our ability to continue as a going concern. The accompanying financial statements do not include any adjustments that might result from the outcome of this uncertainty, and contemplate the realization of assets and the settlement of liabilities and commitments in the normal course of business. There can be no assurance that we will be able to raise additional funds on commercially reasonable terms, if at all. There is uncertainty to our anticipated revenue levels and to the timing of cash receipts, which are needed to support our operations. It also worsens the market conditions for seeking equity and debt financing. We currently anticipate that we will retain all of our earnings, if any, for development of our business and do not anticipate paying any cash dividends on common stock in the foreseeable future.

## Securities Purchase Agreement

On February 25, 2014, we entered into a securities purchase agreement with a certain institutional accredited investor relating to the sale and issuance of a (i) convertible note in the principal amount of \$200,000 that matures February 25, 2016 and (ii) five- year warrant (with a cashless exercise feature under certain circumstances) to purchase 5,000,000 shares of our common stock at an exercise price of \$0.02 per share, subject to adjustment under certain circumstances. On March 18, 2014, we issued under the Securities Purchase Agreement we entered into with the institutional investor on February 25, 2014 a (i) convertible note in the principal amount of \$300,000 that matures March 18, 2016 and (ii) five –year warrant (with a cashless exercise feature under certain circumstances) to purchase 7,500,000 shares of our common stock at an exercise price of \$0.02 per share, subject to adjustment under certain circumstances. The convertible notes bears interest at the rate of 8% per annum compounded annually, are payable at maturity and the principal and interest outstanding under the convertible notes are convertible into shares of our common stock, at any time after issuance, at the option of the purchaser, at a conversion price equal to \$0.02 per share, subject to adjustment upon the happening of certain events, including stock dividends, stock splits and the issuance of common stock equivalents at a price below the conversion price. Subject to us fulfilling certain conditions, including beneficial ownership limits, the convertible notes are subject to mandatory conversion if the closing price of

our common stock for any 20 consecutive days commencing six months after the issue date of the convertible notes equals or exceeds \$0.04 per share. Unless waived in writing by the purchaser, no conversion of the convertible notes can be effected to the extent that as a result of such conversion the purchaser would beneficially own more than 9.99% in the aggregate of our issued and outstanding common stock immediately after giving effect to the issuance of common stock upon conversion.

#### Equity Purchase Agreement

On January 23, 2014, we entered into a new Equity Purchase Agreement with Southridge Partners II, LP (Southridge), that superseded our prior Equity Purchase Agreement with Southridge that was entered into on November 25, 2013 (the "Prior Equity Purchase Agreement"). The terms of the new Equity Purchase Agreement are identical to those of the Prior Equity Purchase Agreement other than that the New Equity Purchase Agreement provides that the Agreement may not be amended by either party. Pursuant to the New Equity Purchase Agreement and as provided in the Prior Equity Purchase Agreement, Southridge has committed to purchase up to \$5,000,000 worth of our common stock, over a period of time terminating on the earlier of: (i) 18 months from the effective date of the registration statement to be filed by us for the New Equity Purchase Agreement; or (ii) the date on which Southridge has purchased an aggregate maximum purchase price of \$5,000,000 pursuant to the New Equity Purchase Agreement; Southridge's commitment to



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purchase our common stock is subject to various conditions, including, but not limited to, limitations based on the trading volume of our common stock. On March 11, 2014, we filed a Registration Statement on Form S-1/A to register 35 million shares of common stock related to our Equity Purchase Agreement with Southridge and on March 21, 2014, the Securities and Exchange Commission declared the Registration Statement effective. On March 26, 2014, we submitted an initial take-down request of \$300,000 to Southridge pursuant to the terms of the Equity Purchase Agreement of which partial proceeds of \$100,000 was received on March 31, 2014 and \$200,000 on April 16, 2014. On April 17, 2014, we issued 8,079,800 shares of our common stock in a Section 3(a) (10) proceeding that generated proceeds in the amount of \$250,000 in full settlement of a claim (see Note 17. Commitments and Contingencies). On June 4, 2014, June 18, 2014 and July 8, 2014, we submitted additional take-down requests for \$100,000, \$100,000 and \$125,000, respectively, pursuant to the terms of the Equity Purchase Agreement. We issued a total of 31,760,578 shares of our common stock at an average price of \$0.02 per share pursuant to the terms of the Equity Purchase Agreement. We have approximately 3.2 million shares remaining under our effective Form S-1 and available pursuant to the terms of our Equity Purchase Agreement following our take-downs through August 11, 2014.

### Settlement of Potential Claims Agreement

On January 22, 2014, we entered into a Settlement of Potential Claims Agreement with ASC Recap LLC (ASCR). Pursuant to the Agreement, ASCR has offered to purchase (and in one (1) case has already purchased) approximately \$3.7 million of our prior debt owed to four creditors (Creditors) for past due services at a substantial discount to face value to which we have agreed to issue to ASCR certain shares of our common stock in a §3(a)(10) 1933 Act proceeding. The shares of our common stock that we have agreed to issue to ASCR in full payment for, and as a release of any debt it purchases from the Creditors, is anticipated to have, upon issuance, a market value equal to approximately 25% of the principal amount of our outstanding debt. In the case of the debt ASCR already purchased from one (1) Creditor, we entered into a Settlement Agreement and Stipulation on February 26, 2014 that was filed with the Circuit Court of the Second Judicial Circuit, Leon County, Florida pursuant to which we agreed, subject to court approval, to issue shares of our common stock that generate proceeds in the amount of \$250,000 in full settlement of the claim in the amount of \$1,027,705 that ASCR acquired from one Creditor (the value of the stock that we have agreed to issue was two hundred and fifty percent (250%) of the discounted purchase price ASCR paid to purchase the debt from the Creditor, and approximately 25% of the original amount we owed to the Creditor), resulting in a gain on settlement of \$769,148, net of expenses. On March 24, 2014, the Circuit Court of the Second Judicial Circuit, Leon County, Florida, approved the §3(a)(10) 1933 Act proceeding and Settlement Agreement and Stipulation and in April 2014, we issued 8,079,800 shares of common stock at an average price of \$0.031 for the full settlement of the agreement with ASCR. The stock to be issued by us and the purchase of the debt by ASCR of the remaining three Creditors is subject to the acceptance of offers by the Creditors.

### Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

### Revenue Recognition

Revenue from sales of products is recognized when: (1) persuasive evidence of an arrangement exists, (2) delivery has occurred or services have been rendered, (3) the sale price is fixed or determinable, and (4) collection of the related receivable is reasonably assured. We recognize revenue when the solar power systems are shipped to the customer.

### Cash and Cash Equivalents

We consider all highly liquid investments with maturities of three months or less, when purchased, to be cash equivalents. We maintain cash and cash equivalents which consist principally of demand deposits with high credit quality financial institutions. At certain times, such amounts exceed FDIC insurance limits. We have not experienced any losses on these investments and, as of June 30, 2014 and December 31, 2013, there were no cash equivalents.

#### Accounts Receivable

Accounts receivable consist of trade receivables. We regularly evaluate the collectibility of our accounts receivable. An allowance for doubtful accounts is maintained for estimated credit losses, and such losses have historically been minimal and within our expectations. We consider a number of factors when estimating credit losses, including the aging of a customer's account, creditworthiness of specific customers, historical trends and other information.

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## Discontinued Operations

Discontinued operations are presented and accounted for in accordance with Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) ASC 360, “Impairment or Disposal of Long-Lived Assets,” (“ASC 360”). When a qualifying component of the Company is disposed of or has been classified as held for sale, the operating results of that component are removed from continuing operations for all periods presented and displayed as discontinued operations if: (a) elimination of the component’s operations and cash flows from the Company’s ongoing operations has occurred (or will occur) and (b) significant continuing involvement by the Company in the component’s operations does not exist after the disposal transaction.

On September 10, 2010, we announced that we were exiting the solar panel installation business. The exit from the installation business was essentially completed by the end of 2010, other than potential warranty payments related to past installations. (See “Manufacturer and Installation Warranties”). The exit from the installation business was therefore classified as discontinued operations for all periods presented under the requirements of ASC 360.

## Manufacturer and Installation Warranties

The manufacturer directly warrants the solar panels and inverters for a range from 15 to 25 years. We warrant the balance of system components of our products against defects in material and workmanship for five years. We assist our customers in the event of a claim under the manufacturer warranty to replace a defective solar panel or inverter. The warranty liability for the material and the workmanship of the balance of system components of approximately \$353,000 as of June 30, 2014 and \$345,000 at December 31, 2013, is included within “Accrued warranty” in the accompanying consolidated balance sheets.

The liability for our manufacturing warranty consists of the following:

	June 30, 2014	December 31, 2013
Beginning accrued warranty balance	\$344,990	\$329,680
Reduction for labor payments and claims made under the warranty	—	(4,400 )
Accruals related to warranties issued during the period	7,926	19,710
Ending accrued warranty balance	\$352,916	\$344,990

We previously recorded a provision for warranty liability related to our discontinued installation operations. We provided for a 5-year or a 10-year warranty on the installation of a system and all equipment and incidental supplies other than solar panels and inverters that are covered under the manufacturer warranty. The liability for the installation warranty of approximately \$932,000 as of June 30, 2014 and \$968,000 as of December 31, 2013 is included within “Liabilities of Discontinued Operations” in the accompanying condensed consolidated balance sheets. Defective solar panels or inverters are covered under the manufacturer warranty. In the event that a panel or inverter needs to be replaced, we will replace the defective item within the manufacturer’s warranty period (between 5-25 years).

## Patent Costs

We capitalize external legal costs and filing fees associated with obtaining or defending our patents. Upon issuance of new patents or successful defense of existing patents, we amortize these costs using the straight line method over the shorter of the legal life of the patent or its economic life. We believe the remaining useful life we assign to these patents, approximately 10.5 years as of June 30, 2014, are reasonable. We periodically review our patents to determine whether any such cost have been impaired and are no longer being used. To the extent we are no longer using certain patents, the associated costs will be written off at that time.

## Significant Accounting Policies and Estimates

There have been no material developments or changes to the significant accounting policies discussed in our 2013 Annual Report on Form 10-K or accounting pronouncements issued or adopted, except as described below.

#### Recent Accounting Pronouncements

In May 2014, as part of its ongoing efforts to assist in the convergence of U.S. GAAP and International Financial Reporting Standards (“IFRS”), the Financial Accounting Standards Board (“FASB”) issued ASU 2014-09, “Revenue from Contracts with Customers.” The new guidance sets forth a new five-step revenue recognition model which replaces the prior revenue recognition guidance in its entirety and is intended to eliminate numerous industry-specific pieces of revenue recognition guidance that have historically existed in U.S. GAAP. The underlying principle of the new standard is that a business or other organization will recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects what it expects in exchange for the goods or

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services. The standard also requires more detailed disclosures and provides additional guidance for transactions that were not addressed completely in the prior accounting guidance. The ASU provides alternative methods of initial adoption and is effective for annual and interim periods beginning after December 15, 2016. We are currently evaluating the impact that this standard will have on our consolidated financial statements.

## 3. Discontinued Operations

On September 10, 2010, we announced that we were exiting the solar panel installation business and we were expanding our distribution business to include sales of our Andalay Solar Power Systems directly to dealers in California. The exit from the installation business was essentially completed by the end of 2010. The assets and liabilities of discontinued operations are presented separately under the captions “Assets of discontinued operations,” “Liabilities of discontinued operations” and “Long-term liabilities of discontinued operations,” respectively, in the accompanying condensed consolidated balance sheets as of June 30, 2014 and December 31, 2013, and consist of the following:

	June 30, 2014	December 31, 2013
Assets of discontinued operations:		
Security deposit – escrow account for installation jobs	\$200,000	\$200,000
Total assets of discontinued operations	\$200,000	\$200,000
	June 30, 2014	December 31, 2013
Liabilities of discontinued operations:		
Accrued warranty	\$931,773	\$967,928
Total current liabilities	\$931,773	\$967,928

We entered into a Supply and Warranty Agreement and Master Assignment Agreement with Real Goods Solar, Inc. (Real Goods), pursuant to which Real Goods has agreed to perform certain warranty work. The terms of the agreement provide that an escrow account be established as a source of funds from which to satisfy our obligation to pay Real Goods for its fees and reimburse it for its expenses for this warranty work. In March 2011, we entered into an Escrow Agreement with Real Goods and deposited \$200,000 into an escrow account. The amount is reflected in long-term assets of discontinued operations in the balance sheet. The escrow deposit will be released to us in the amount of \$40,000, or one-fifth of the remaining escrow funds, per year after each of the fifth through the ninth anniversary of the escrow agreement.

## 4. Accounts Receivable

Accounts receivable consists of the following:

	June 30, 2014	December 31, 2013
Trade accounts	\$611,786	\$575,375
Less: Allowance for bad debts	(7,391 )	(2,899 )
Less: Allowance for returns	(3,354 )	(4,953 )
	\$601,041	\$567,523

The following table summarizes the allowance for doubtful accounts as of June 30, 2014 and December 31, 2013:

	Balance at Beginning	Provisions, net	Write-Off/ Recovery	Balance at End of
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	of Period			Period
Six months ended June 30, 2014	\$2,899	\$4,492	\$—	\$7,391
Year ended December 31, 2013	\$108,750	\$92,224	\$(198,325 )	\$2,899

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## 5. Inventory

Inventory consists of the following:

	June 30, 2014	December 31, 2013
Finished goods	\$871,763	\$654,970
Work in process	51,505	131,666
	\$923,268	\$786,636

Included in inventory as of December 31, 2013, is a \$5,000 credit related to a pricing adjustment from a supply agreement.

Inventory is stated at the lower of cost (on an average basis) or market value. We determine cost based on our weighted-average purchase price and include both the costs of acquisition and the shipping costs in our inventory. We regularly review the cost of inventory against its estimated market value and record a lower of cost or market write-down to cost of goods sold, if any inventory has a cost in excess of estimated market value.

## 6. Property and Equipment, Net

Property and equipment, net consist of the following:

	June 30, 2014	December 31, 2013
Office equipment	\$436,051	\$436,051
Leasehold improvements	123,278	123,278
Vehicles	17,992	17,992
	577,321	577,321
Less: Accumulated depreciation and amortization	(571,692 )	(563,467 )
	\$5,629	\$13,854

Depreciation expense for the three months ended June 30, 2014 and 2013 was approximately \$3,000 and \$10,000, respectively. Depreciation expense for the six months ended June 30, 2014 and 2013 was approximately \$8,000 and \$20,000, respectively.

## 7. Accrued Liabilities

Accrued liabilities consist of the following:

	June 30, 2014	December 31, 2013
Accrued salaries, wages, benefits and bonus	\$49,577	\$45,456
Sales tax payable	2,713	4,409
Accrued accounting and legal fees	15,300	—
Customer deposit payable	20,395	580
Accrued interest	9,324	6,288
Other accrued liabilities	7,965	32,997
	\$105,274	\$89,730

## 8. Convertible Notes Payable and Credit Facility

Convertible Notes payable

On August 30, 2013, we entered into a securities purchase agreement with certain institutional accredited investors relating to the sale and issuance of a convertible note in the principal amount of \$200,000 that matures August 29, 2015 (the "Convertible Note"). Subsequently, on November 25, 2013 and December 19, 2013, we entered into additional securities purchase agreements with the same institutional accredited investors relating the sale and issuance of convertible notes in the principal amount of \$200,000 and \$250,000, respectively, which mature on November 25, 2015 and December 19, 2015. On January 27, 2014, we issued a convertible note in the principal amount of \$100,000 that matures January 27, 2016 under the Securities Purchase Agreement we entered into with an accredited investor on December 19, 2013. In connection with the issuance of the December 19, 2013 convertible note, we also issued 6,250,000 warrants to purchase shares of our common stock at a price of \$0.02 per share. On February 25, 2014, we entered into a Securities Purchase Agreement with the same accredited investor related to the sale and issuance of a convertible note in the principal amount of \$200,000 that matures February 25, 2016. In connection with the issuance of the February 25, 2014 convertible note, we issued 5,000,000 warrants to purchase shares of our common stock at a price of \$0.02 per share. On March 18, 2014, we issued a convertible note in the principal amount of \$300,000 that matures March 18, 2016 under the Securities Purchase Agreement we entered into with an accredited investor on February 25, 2014. In connection with the issuance of the March 18, 2013 convertible



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note, we also issued 7,500,000 warrants to purchase shares of our common stock at a price of \$0.02 per share. Each of the Convertible Notes bear interest at the rate of 8% per annum compounded annually, are payable at maturity and the principal and interest outstanding under the convertible notes are convertible into shares of our common stock, at any time after issuance, at the option of the purchaser, at a conversion price equal to \$0.02 per share, subject to adjustment upon the happening of certain events, including stock dividends, stock splits and the issuance of common stock equivalents at a price below the conversion price. Subject to our fulfilling certain conditions, including beneficial ownership limits, the convertible notes are subject to a mandatory conversion if the closing price of our common stock for any 20 consecutive days commencing six months after the issue date of the convertible notes equal or exceeds \$0.04. Unless waived in writing by the purchaser, no conversion of the convertible notes can be effected to the extent that as a result of such conversion the purchaser would beneficially own more than 9.99% in the aggregate of our issued and outstanding common stock immediately after giving effect to the issuance of common stock upon conversion.

We have the option of repaying the outstanding principal amount of the convertible notes, in whole or in part, by paying the purchaser a sum of money equal to one hundred and twenty percent (120%) of the principal together with accrued but unpaid interest upon 30 days notice, subject to certain beneficial ownership limits. For so long as we have any obligation under the convertible notes, we have agreed to certain restrictions regarding, among other things, incurrence of additional debt, liens, amendments to charter documents, repurchase of stock, payment of cash dividends, affiliated transactions. We are also prohibited from entering into certain variable priced agreements until the convertible notes are repaid in full.

Because of certain down-round protection in the conversion rate of the convertible notes, we determined that the derivative liability related to the embedded conversion feature met the criteria for bifurcation. Accordingly, we recognized an aggregate liability of approximately \$123,000 on the three issuance dates during the six months ended June 30, 2014. This was in addition to the carrying value of the derivative liability on three previously recorded derivatives of approximately \$178,000. The derivative liability is carried at fair value with changes in the fair value reflected in the "Adjustment to the fair value of embedded derivatives" line item of our Condensed Consolidated Statements of Operations. We recognized a non-cash benefit for the three months ended June 30, 2014 of approximately \$85,000 and a non-cash charge for the six months ended June 30, 2014, of approximately \$17,000 on a total of six convertible notes.

In addition, the relative fair value of the warrants issued in the December 2013 convertible note issuance of \$250,000, were allocated to Additional Paid-in Capital. Such value was determined assuming volatility of 149.1%, a risk free interest rate of 0.7% and an expected term of 4.1 years. The resulting debt discount from the derivative liability and warrant issuance of \$109,000 is being accreted to interest using the effective interest method. The relative fair value of the warrants issued in the February 2014 convertible note issuance of \$200,000, were allocated to Additional Paid-in Capital. Such value was determined assuming volatility of 169.1, a risk free interest rate of 0.7% and an expected term of 4.1 years. The resulting debt discount from the derivative liability and warrant issuance of \$101,000 is being accreted to interest using the effective interest method. The relative fair value of the warrants issued in the March 2014 convertible note issuance of \$300,000, were allocated to additional paid-in capital. Such value was determined assuming volatility of 168.8%, a risk free interest rate of 0.8% and an expected term of 4.1 years. The resulting debt discount from the derivative liability and warrant issuance of \$154,000 is being accreted to interest using the effective interest method.

On November 1 and December 1, 2013, and on January 1, February 1 and March 1, 2014, we issued convertible notes to our financial advisory firm in the principal amount of \$30,000 each for a total of \$150,000, which mature on October 31 and November 30 and December 31, 2014, and on January 31 and February 28, 2015, respectively. On April 1, May 1 and June 1, 2014, we issued convertible notes to our financial advisory firm in the principal amount of \$20,000 each, for a total of \$60,000, which mature on March 31, April 30 and May 31, 2015, respectively. Each of

the Convertible Notes bear interest at the rate of 8% per annum compounded annually, are payable at maturity and the principal and interest outstanding under the convertible notes are convertible into shares of our common stock, at any time after issuance, at the option of the purchaser, at a conversion price equal to \$0.02. Unless waived in writing by the purchaser, no conversion of the convertible notes can be effected to the extent that as a result of such conversion the purchaser would beneficially own more than 9.99% in the aggregate of our issued and outstanding common stock immediately after giving effect to the issuance of common stock upon conversion. On May 1 and June 1, 2014, the November 1 and December 1, 2013 convertible notes in the principal amount of \$60,000, along with accrued interest of \$2,414, were converted into 3,157,172 shares of our common stock.

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Below is a table showing the convertible notes payable, the beneficial conversion feature and fair value of the warrants as of June 30, 2014 and December 31, 2013:

	June 30, 2014	December 31, 2013
Convertible notes payable cash proceeds	\$1,250,000	\$650,000
Convertible notes payable issued for financial advisory services	150,000	60,000
Less: Derivative liability	(366,519 )	(243,889 )
Less: Relative fair value of warrants	(224,390 )	(53,623 )
Accreted interest	101,755	21,889
Accrued interest	49,367	7,707
Convertible notes payable, net	960,213	442,084
Less current portion	(150,000 )	(60,000 )
	\$810,213	\$382,084

## Line of credit

On September 30, 2013, we entered into a loan and security agreement with Alpha Capital Anstalt and Collateral Services, LLC to provide financing, on a discretionary basis, for one year, against our accounts receivable and inventory. The maximum amount that can be borrowed under the Agreement is \$500,000. We have the right to borrow up to 80% of our eligible accounts receivable, not in excess of \$200,000, 50% of the value of our raw materials in inventory, 65% of our finished goods inventory and 95% of cash, but not in the aggregate amount in excess of \$300,000. The advances are secured by a lien on all of our assets. All advances under the agreement bear interest at a per annum rate of 12% and monthly interest shall be a minimum of \$500. At the time of initial funding we paid a loan fee of 50 shares of our Series D Preferred Shares to the lender, in addition to other payments for legal fees. In addition, we paid the collateral agent an initial fee of \$5,000 and have agreed to pay an administrative fee to the collateral agent of 0.5% per month of the daily balance during the preceding month or \$500 whichever is less. In the event that of a prepayment, we are obligated to pay a prepayment fee in an amount equal to one-half of one percent (0.5%) of \$500,000. On September 30, 2013, we requested and received an initial borrowing under the Agreement totaling \$350,000. Subsequently, on October 21, 2013, we requested and received an additional \$100,000 and on November 20, 2013, we requested and received an additional \$50,000. As of June 30, 2014, the balance outstanding under our line of credit was \$500,000.

## 9. Stockholders' Deficit

We have 501,000,000 shares of capital stock authorized under our certificate of incorporation, consisting of 500,000,000 shares of common stock and 1,000,000 shares of preferred stock. As of June 30, 2014, we have authorized (i) 2,000 shares of Series A Convertible Preferred Stock, par value \$0.001, all of which have been converted or cancelled and none of which remain outstanding, (ii) 4,000 shares of Series B 4% Convertible Preferred Stock, par value \$0.001, all of which have been converted, (iii) 1,175 shares of our Series C 8% Convertible Preferred Stock, par value \$0.001, none of which remain outstanding, and (iv) 1,180 shares of our Series D 8% Convertible Preferred Stock, par value \$0.001, of which 90 shares remain outstanding.

On March 11, 2014, we filed a Registration Statement on Form S-1/A to register 35 million shares of common stock related to our Equity Purchase Agreement with Southridge and on March 21, 2014, the Securities and Exchange Commission declared the Registration Statement effective. On March 26, 2014, we submitted an initial take-down request of \$300,000 to Southridge pursuant to the terms of the Equity Purchase Agreement of which partial proceeds of \$100,000 was received on March 31, 2014 and \$200,000 on April 16, 2014. On April 17, 2014, issued 8,079,800 shares of our common stock in a Section 3(a) (10) proceeding that generated proceeds in the amount of \$250,000 in

full settlement of a claim (see Note 17. Commitments and Contingencies). On June 4, 2014, June 18, 2014 and July 8, 2014, we submitted additional take-down requests for \$100,000, \$100,000 and \$125,000, respectively, pursuant to the terms of the Equity Purchase Agreement. We issued a total of 31,760,578 shares of our common stock at an average price of \$0.02 per share pursuant to the terms of the Equity Purchase Agreement. We have approximately 3.2 million shares remaining under our effective Form S-1 and available pursuant to the terms of our Equity Purchase Agreement following our take-downs through August 11, 2014.

Pursuant to the terms of our Equity Purchase Agreement, a placement fee of 1 million shares of unregistered common stock was due to Southridge pursuant to the terms of the Equity Purchase Agreement. As of March 31, 2014, we issued 500,000 shares of unregistered common stock due upon the declaration of effectiveness of our Form S-1/A by the Securities and Exchange Commission of our Form S-1/A. In April 2014, we issued the remaining 500,000 shares of unregistered common stock to Southridge upon the completion of our initial take-down request under the Equity Purchase Agreement. The sales of the above securities were deemed to be exempt from registration under the Securities Act in reliance upon Section 4(a) (2) of the Securities Act as transactions by an issuer not involving any public offering. The recipients of the securities in each of these transactions represented their intentions to acquire the securities for investment only and not with a view to or for sale in connection with any distribution thereof, and appropriate legends were placed upon the stock certificates issued in these transactions.

#### 10. Convertible Redeemable Preferred Stock and Preferred Deemed Dividend

The holders of our Series C Preferred are entitled to receive, and we are obligated to pay, cumulative dividends at the rate per share (as a percentage of the stated value per share) of 8% per annum, payable quarterly on March 31, June 30, September 30 and December 31. Dividends are payable in cash or in shares of newly issued common stock, depending on whether we have cash available for lawful payment of dividends and whether we satisfy certain conditions for the alternative to pay the dividends in shares.

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Our Series C Preferred generally is non-voting, provided that our holders of Series C Preferred have rights of approval with regard to amendments to our Certificate of Incorporation or to the Certificate of Designation that would adversely affect the rights of our Series C Preferred. Our Series C Preferred provides for a number of negative covenants applicable to us, including restrictions on the amount of our indebtedness (generally, to an amount not to exceed \$5 million) and related liens, and restrictions on our use of cash to redeem or to pay dividends with respect to our common stock or other junior securities. In various “triggering event” circumstances set forth in the Series C Certificate of Designation, the holders of our Series C Preferred have rights to demand the redemption of their shares, for cash or for shares of our common stock, depending on the nature of the triggering event.

On October 18, 2012, we entered into a securities purchase agreement with certain institutional accredited investors relating to the sale and issuance of up to 1,245 shares of our newly created Series C Preferred Stock, for aggregate proceeds of up to \$1,245,000. At the initial closing, we sold and issued 750 shares of Series C Preferred, for initial aggregate proceeds of \$750,000. On November 2, 2012, we provided to the purchasers of our Series C Preferred Stock a draw down notice under the Purchase Agreement. As a result of the draw down, we sold an aggregate of 350 additional shares of our Series C Preferred to the purchasers for aggregate proceeds of \$350,000. Based on the closing price of our common stock as reported on the OTCQB Marketplace (OTCQB) on November 2, 2012 (which was \$0.08 per share), the 350 shares of Series C Preferred issued pursuant to the draw down was convertible into 4,375,000 shares of our common stock. As a result of the contingent conversion feature on the Series C Preferred, which reduced the conversion price from \$0.155 to \$0.08 per share on the total 750 shares of Series C Preferred Stock issued and outstanding at November 2, 2012, and which resulted in an increase in the number of common shares issuable, we recognized a preferred deemed dividend of \$363,000.

On January 24, 2013, we provided to the purchasers of our Series C Preferred Stock a draw down notice under the purchase agreement. The purchasers agreed to accept the new draw down notice and thereby extend our right to exercise a “put” to sell additional Series C Preferred beyond the securities purchase agreement’s prior expiration date of December 31, 2012. As a result of the draw down, we sold an aggregate of 75 additional shares of Series C Preferred to the purchasers for aggregate proceeds of \$75,000. Based on the closing price of our common stock as reported on the OTCQB Marketplace on January 24, 2013 (which was \$0.05 per share), the 75 shares of Series C Preferred to be issued pursuant to the draw down would be convertible into 1,500,000 shares of our common stock. As a result of the contingent conversion feature on the Series C Preferred, which reduced the conversion price from \$0.08 to \$0.05 per share on the total 720 shares of Series C Preferred Stock issued and outstanding at January 24, 2013, and which resulted in an increase in the number of common shares issuable, we recognized additional preferred deemed dividends of \$270,000.

As a result of the January 24, 2013 draw down notice, the conversion price of the Series C Preferred issued under the initial closing was reduced from \$0.08 per share of common stock to become equal to \$0.05. As a result of the May 13, 2013 draw down notice, the conversion price of the Series C Preferred was further reduced from \$0.05 per share of common stock to \$0.03 per share. With the May 13, 2013 draw down, and after recent conversions of our Series C Preferred, there were 87 shares of Series C Preferred that remain outstanding. As a result of our August 30, 2013 financing, the conversion price of the Series C Preferred was further reduced from \$0.03 per share of common stock to \$0.02 per share.

On February 15, 2013, we entered into a securities purchase agreement with an institutional accredited investor relating to the sale and issuance of up to 1,180 shares of our newly created Series D Preferred Stock at a price per share equal to the stated value, which is \$1,000 per share, for aggregate proceeds of up to \$1,000,000. At the initial closing, concurrent with entering the agreement, we issued 150 shares of Series D Preferred, for initial aggregate proceeds of \$150,000. After the initial closing, the securities purchase agreement permits the purchaser to exercise a “call” right to purchase additional Series D Preferred in multiple draw downs from time to time until December 31,

2013, subject to certain limits, terms and conditions. In March 2013, the Company and investors entered into a letter agreement to the securities purchase agreement dated as of February 15, 2013, modifying the number of shares of Series D Preferred Stock to be issued upon settlement of any purchaser draw downs made on or after March 18, 2013, equal to the purchaser investment amount divided by the stated value multiplied by a number agreed upon by the Company and the purchaser, which shall not be higher than 1.67. Subsequently, on March 21, 2013, we issued 167 shares of Series D Preferred for aggregate proceeds of \$100,000. On May 13, 2013, the Company and investors entered into a letter agreement amendment to the securities purchase agreement dated as of February 15, 2013, modifying the number of shares of Series D Preferred Stock that may be issued upon draw downs made on or after May 13, 2013, equal to the purchaser investment amount divided by the stated value multiplied by a number agreed upon by the Company and the purchaser, which shall not be higher than 3.34. The corresponding conversion price into underlying shares of our common stock is \$0.03 per share. On May 13, 2013, we issued 583 shares of Series D Preferred to an investor for aggregate proceeds of \$175,000. As a result of the contingent conversion feature on the Series C Preferred, which reduced the conversion price from \$0.05 to \$0.03 per share on the total 260 shares of Series C Preferred Stock issued and outstanding as of May 13, 2013, and which resulted in an increase in the number of common shares issuable, we recognized additional preferred deemed dividends of \$104,000. On August 30, 2013, we entered into an agreement to sell \$200,000 in convertible notes. As a result of the sale of these convertible notes and as a result of the contingent conversion feature on the Series C Preferred and Series D Preferred, which reduced the conversion price from \$0.03 to \$0.02 per share on the Series C and from \$0.10 to \$0.02 per share on the Series D on the total 147 shares and 930 shares, respectively, of Series C Preferred Stock and Series D Preferred Stock issued and

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outstanding as of August 30, 2013, and which resulted in an increase in the number of common shares issuable, we recognized additional preferred deemed dividends of \$36,000 on the Series C Preferred Stock and \$465,000 on the Series D Preferred Stock. The net loss attributable to common shareholders reflects both the net loss and the deemed dividend. As a result of the \$500,000 loan and security agreement entered into on September 30, 2013, we issued to the lender 50 shares of our Series D Preferred stock for the \$50,000 loan origination fee.

During the six months ended June 30, 2014, the remaining 467 shares of Series B Preferred Stock were converted into 21,020,015 shares of common stock and the remaining 87 shares of Series C Preferred Stock were converted into 4,333,350 shares of common stock. Also during the six months ended June 30, 2014, 770 shares of Series D Preferred Stock were converted into 38,500,000 shares of common stock, leaving 90 shares outstanding. Subsequent to June 30, 2014, the remaining 90 shares of Series D Preferred Stock were converted into 4,500,000 shares of common stock.

See Note 12 for a discussion of the accounting treatment of the stock warrant transactions described above.

11. Stock Option Plan and Stock Incentive Plan

On August 8, 2006, we adopted the Akeena Solar, Inc. 2006 Stock Incentive Plan (the “Stock Plan”) pursuant to which shares of common stock are available for issuance to employees, directors and consultants under the Stock Plan as restricted stock and/or options to purchase common stock. The Stock Plan allows for issuance of up to 50,000,000 shares and there were 46,219,653 shares available for issuance under the Stock Plan as of June 30, 2014.

Restricted stock and options to purchase common stock may be issued under the Stock Plan. The restriction period on restricted stock grants generally expires at a rate of 25% per year over four years, unless decided otherwise by our Compensation Committee. Options to purchase common stock generally vest and become exercisable as to one-third of the total amount of shares subject to the option on each of the first, second and third anniversaries from the date of grant. Options to purchase common stock generally have a 5-year term.

We use the Black-Scholes-Merton Options Pricing Model (Black-Scholes) to estimate fair value of our employee and our non-employee director stock-based awards. Black-Scholes requires various judgmental assumptions, including estimating stock price volatility, expected option life and forfeiture rates. If we had made different assumptions, the amount of our deferred stock-based compensation, stock-based compensation expense, gross margin, net loss and net loss per share amounts could have been significantly different. We believe that we have used reasonable methodologies, approaches and assumptions to determine the fair value of our common stock, and that our deferred stock-based compensation and related amortization were recorded properly for accounting purposes. If any of the assumptions we used change significantly, stock-based compensation expense may differ materially in the future from that recorded in the current period.

We measure compensation expense for non-employee stock-based compensation under ASC 505-50, “Equity-Based Payments to Non-Employees.” The fair value of the option issued is used to measure the transaction, as this is more reliable than the fair value of the services received. The estimated fair value is measured utilizing Black-Scholes using the value of our common stock on the date that the commitment for performance by the counterparty has been reached or the counterparty’s performance is complete (generally the vesting date). The fair value of the equity instrument is charged directly to expense and additional paid-in capital.

We recognized stock-based compensation expense of approximately \$105,000 and \$131,000 during the three months ended June 30, 2014 and 2013, respectively, and we recognized stock-based compensation expense of approximately \$271,000 and \$133,000 during the six months ended June 30, 2014 and 2013, respectively, relating to compensation expense calculated based on the fair value at the time of grant for restricted stock and based on Black-Scholes for stock options granted under the Stock Plan. Stock-based compensation expense for the three and six months ended

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June 30, 2014, included \$60,000 and \$150,000, respectively, related to the issuance of convertible notes for our financial advisor.

The following table sets forth a summary of restricted stock activity for the six months ended June 30, 2014:

	Number of Restricted Shares	Weighted-Average Grant Date Fair Value
Outstanding and not vested beginning balance as of January 1, 2014	1,890,952	\$ 0.05
Granted	—	\$ —
Forfeited/cancelled	—	\$ —
Released/vested	(1,257,334)	\$ 0.04
Outstanding and not vested as of June 30, 2014	633,618	\$ 0.06



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Restricted stock is valued at the grant date fair value of the common stock and expensed over the requisite service period or vesting period. We estimate forfeitures when recognizing stock-based compensation expense for restricted stock, and the estimate of forfeitures is adjusted over the requisite service period should actual forfeitures differ from such estimates. As of June 30, 2014 and December 31, 2013, there was approximately \$22,000 and \$71,000, respectively, of unrecognized stock-based compensation expense associated with the granted but unvested restricted stock. Stock-based compensation expense relating to these restricted shares is being recognized over a weighted-average period of 0.4 years. The total fair value of shares vested during the six months ended June 30, 2014 and 2013, was approximately \$31,000 and \$665, respectively. Tax benefits resulting from tax deductions in excess of the compensation cost recognized (excess tax benefits) are classified as financing cash flows on our consolidated statements of cash flows. During the three and six months ended June 30, 2014 and 2013, there were no excess tax benefits relating to restricted stock and therefore there is no impact on the accompanying consolidated statements of cash flows.

The following table sets forth a summary of stock option activity for the six months ended June 30, 2014:

	Number of Shares Subject to Option	Weighted-Average Exercise Price
Outstanding as of January 1, 2014	6,618,233	\$ 0.11
Granted	9,000,000	\$ 0.02
Forfeited/cancelled/expired	(12,500 )	\$ (7.40 )
Exercised	—	\$ —
Outstanding as of June 30, 2014	15,605,733	\$ 0.05
Exercisable as of June 30, 2014	2,338,983	\$ 0.22

Stock options are valued at the estimated fair value grant date or the measurement date and expensed over the requisite service period or vesting period. The weighted-average volatility was based upon the historical volatility of our common stock price. There were no stock options issued during the three and six month period ended June 30, 2013. The fair value of stock option grants during the three and six months ended June 30, 2014 was estimated using the Black-Scholes option-pricing model with the following assumptions:

	Three Months Ended June 30,			Six Months Ended June 30,		
	2014	2013	2014	2013	2013	2013
Weighted-average volatility	186.8	% —	186.8	% —	—	—
Expected dividends	0.0	% —	0.0	% —	—	—
Expected life	4.0	—	4.0	—	—	—
Weighted-average risk-free interest rate	1.2	% —	1.2	% —	—	—

The weighted-average remaining contractual term for the stock options outstanding (vested and expected to vest) and exercisable as of June 30, 2014 and December 31, 2013, was 4.6 years and 4.7 years, respectively. The total estimated fair value of stock options vested during the six months ended June 30, 2014 and 2013 was approximately \$29,000 and \$29,000, respectively. The aggregate intrinsic value of stock options outstanding as of June 30 2014 was zero.

We estimate forfeitures when recognizing stock-based compensation expense for stock options and the estimate of forfeitures is adjusted over the requisite service period should actual forfeitures differ from such estimates. As of June 30, 2014 and December 31, 2013, there was approximately \$262,000 and \$81,000, respectively, of unrecognized stock-based compensation expense associated with stock options granted. Stock-based compensation expense relating

to these stock options is being recognized over a weighted-average period of 3.0 years. Tax benefits resulting from tax deductions in excess of the compensation cost recognized (excess tax benefits) is classified as financing cash flows on our consolidated statements of cash flows. During the three and six months ended June 30, 2014, there were no excess tax benefits relating to stock options and therefore there is no impact on the accompanying consolidated statements of cash flows.

## 12. Stock Warrants and Warrant Liability

During March 2009, in connection with an equity financing, we issued Series E Warrants to purchase 334,822 shares of common stock at an exercise price of \$5.36 per share. The fair value of the warrants was estimated using Black-Scholes with the following weighted average assumptions: risk-free interest rate of 2.69%, an expected life of five years; an expected volatility factor of 112% and a dividend yield of 0.0%. The value assigned to these warrants was approximately \$1.0 million, of which \$1.0 million was

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reflected as common stock warrant liability with an offset to additional paid-in capital as of the offering close date. The fair value of the warrants decreased to zero as of December 31, 2013.

On December 19, 2013 and February 25, 2014, we entered into securities purchase agreements with certain institutional accredited investors relating to the sale and issuance of a (i) convertible notes in the principal amount of \$250,000, \$200,000 and \$300,000 that mature on December 19, 2015, February 25, 2016 and March 19, 2016, respectively and (ii) five- year warrants (with a cashless exercise feature under certain circumstances) to purchase 6,250,000, 5,000,000 and 7,500,000 shares, respectively, of our common stock at an exercise price of \$0.02 per share, subject to adjustment under certain circumstances. See Note 8 for further discussion of the issuance of the convertible note.

The following table summarizes the Warrant activity for the six months ended June 30, 2014:

	Warrants for Number of Shares	Weighted-Average Exercise Price
Outstanding at December 31, 2013	9,648,045	\$ 0.49
Issued	12,500,000	0.02
Exercised	—	—
Cancelled/expired	—	—
Outstanding at June 30, 2014	22,148,045	\$ 0.23

The majority of our warrants outstanding are not exercisable for six months from the date of issuance and are exercisable for either 4.5 years or 5 years thereafter. Our outstanding warrants expire on various dates between December 2014 and March 2019.

### 13. Earnings Per Share

On January 1, 2009, we adopted ASC 260 (formerly Financial Accounting Standards Board Staff Position (“FSP”) Emerging Issues Task Force (“EITF 03-6-1”) (“ASC 260”), Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities (the “Staff Position”), which states that unvested share-based payment awards that contain non-forfeitable rights to dividends or dividend equivalents are considered participating securities and shall be included in the computation of net income (loss) per share pursuant to the two-class method described in ASC 260 (formerly Statement of Financial Accounting Standards (“SFAS”) No. 128), Earnings Per Share.

In accordance with the ASC 260, basic net income (loss) per share is computed by dividing net income (loss), excluding net income (loss) attributable to participating securities, by the weighted average number of shares outstanding less the weighted average unvested restricted shares outstanding. Diluted net income (loss) per share is computed by dividing net income (loss), excluding net income (loss) attributable to participating securities, by the denominator for basic net income (loss) per share and any dilutive effects of stock options, restricted stock, convertible notes and warrants.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Basic:				
Numerator:				
Net loss	\$(631,441 )	\$(408,806 )	\$(701,383 )	\$(1,429,540 )
	(4,390 )	(146,309 )	(18,844 )	(469,529 )

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Preferred deemed dividend and preferred stock dividend

Less: Net loss allocated to participating securities	2,890	137	5,268	713
	\$(632,941 )	\$(554,978 )	\$(714,959 )	\$(1,898,356 )

Denominator:

Weighted-average shares outstanding	192,301,250	54,772,776	162,784,761	43,984,812
Weighted-average unvested restricted shares outstanding	(874,003 )	(18,320 )	(1,191,393 )	(21,949 )
Denominator for basic net loss per share	191,427,247	54,754,456	161,593,368	43,962,863

Basic net loss per share attributable to common stockholders

	\$(0.00 )	\$(0.01 )	\$(0.00 )	\$(0.04 )
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The following table sets forth potential shares of common stock at the end of each period presented that are not included in the calculation of diluted net loss per share because to do so would be anti-dilutive:

	June 30, 2014	December 31, 2013
Stock options outstanding	15,605,733	5,368,233
Unvested restricted stock	633,618	1,890,952
Warrants to purchase common stock	22,148,045	9,648,045
Preferred stock convertible into common stock	4,500,000	68,353,582

## 14. Concentration of Risk

## Supplier Relationships

Historically, we obtained virtually all of our solar panels from Suntech and Lightway. During 2012, because of our cash position and liquidity constraints, we were late in making payments to both of these suppliers. On March 30, 2012, pursuant to our Supply Agreement with Lightway, we issued 1,900,000 shares of our common stock to Lightway in partial payment of our past due account payable to them. At the time of issuance, the shares were valued at \$1,045,000. On May 1, 2012, Suntech filed a complaint for breach of contract, goods sold and delivered, account stated and open account against us in the Superior Court of the State of California, County of San Francisco. Suntech alleged that it delivered products and did not receive full payment from us. On July 31, 2012, we and Suntech entered into a settlement of this dispute. Because of our inability to make scheduled settlement payments, on March 15, 2013, Suntech entered a judgment against us in the amount of \$946,438. As of June 30, 2014, Suntech has not sought to enforce its judgment. As of June 30, 2014, we have included in accounts payable in our condensed consolidated balance sheets a balance due to Suntech America of \$946,438. We currently have no unshipped orders from Suntech or Lightway.

In May 2013, we entered into a new supply agreement for assembly of our proprietary modules with Environmental Engineering Group Pty Ltd (“EEG”), an assembler of polycrystalline modules located in Australia. In August 2013, we began receiving product from EEG and began shipping product to customers during the third calendar quarter of 2013. In September 2013, we entered into a second supply agreement for assembly of our proprietary modules with New Energy Co, Ltd. (“Tianwei”), a panel supplier located in China. We began receiving product from Tianwei in February 2014 and stopped as of June 2014. In July 2014, we entered into a supply agreement for assembly of our proprietary modules with Auxin Solar, Inc., a panel supplier located in the United States. We expect to begin receiving product from Auxin in September 2014. Although we believe we can find alternative suppliers for solar panels manufactured to our specifications, our operations would be disrupted unless we are able to rapidly secure alternative sources of supply, our inventory and revenue could diminish significantly, causing disruption to our operations.

## Customer Relationships

The relative magnitude and the mix of revenue from our largest customers have varied significantly quarter to quarter. During the six months ended June 30, 2014, six customers have accounted for significant revenues, varying by period, to our company: Sustainable Environmental Enterprises (“SEE”), a leading provider of renewable energy and development projects located in New Orleans, Louisiana, Saddleback Cellars (“Saddleback”), a Napa County winery, Lennox International Inc. (“Lennox”), a global leader in the heating and air conditioning markets, Lowe’s Companies, Inc. (“Lowe’s”), a nationwide home improvement retail chain, WDC Solar, Inc. (“WDC”), a leading construction, integration and installation of commercial, residential and utility scale solar installations in the Washington D.C. area and Shoreline Electric (“Shoreline”) a provider of residential and commercial electrical services in Southern California. For the six months ended June 30, 2014, the percentages of sales to SEE, Lennox, Lowe’s, WDC and Shoreline are as

follows:

	Six Months Ended June			
	2014		30, 2013	
Sustainable Environmental Enterprises	3.7	%	49.4	%
Saddleback Cellars	12.3	%	—	
Lennox International Inc.	0.1	%	13.2	%
Lowe's Companies, Inc.	3.2	%	0.9	%
WDC Solar, Inc.	13.5	%	—	
Shoreline Electric	10.1	%	—	

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EE accounted for approximately \$517,000, or 84.4%, of our gross accounts receivable as of June 30, 2014. As of the date hereof, the \$517,000 receivable from SEE is past due. SEE has indicated that the past-due payment is late due to a processing delay of a rebate owed to it from the State of Louisiana and expects that full payment will be made in a few weeks upon its receipt of the rebate. Notwithstanding, no assurance can be given by us as to when a rebate will be issued to SEE by the State of Louisiana or as to when or to what extent payment will be received by us if it isn't issued timely. WDC accounted for 10.3% of our gross accounts receivable balance as of June 30, 2014. We had no receivable balance from Saddleback, Lowe's, Lennox, or Shoreline as of June 30, 2014 and we had no receivable balance from Saddleback, Lennox, Lowe's, WDC or Shoreline as of December 31, 2013.

We maintain reserves for potential credit losses and such losses, in the aggregate, have generally not exceeded management's estimates. Our top three vendors accounted for approximately 64% and 41% of purchases as of June 30, 2014 and December 31, 2013, respectively. As of June 30, 2014 and December 31, 2013, accounts payable included amounts owed to our top three suppliers of approximately \$972,000 and \$1.1 million, respectively.

## 15. Fair Value Measurement

We use a fair-value approach to value certain assets and liabilities. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or liability. We use a fair value hierarchy, which distinguishes between assumptions based on market data (observable inputs) and an entity's own assumptions (unobservable inputs). The hierarchy consists of three levels:

- Level one — Quoted market prices in active markets for identical assets or liabilities;
- Level two — Inputs other than level one inputs that are either directly or indirectly observable; and
- Level three — Unobservable inputs developed using estimates and assumptions, which are developed by the reporting entity and reflect those assumptions that a market participant would use.

Determining which category an asset or liability falls within the hierarchy requires significant judgment. We evaluate our hierarchy disclosures each quarter. Assets and liabilities measured at fair value on a recurring basis are summarized as follows:

Liabilities	Level 1	Level 2	Level 3	June 30, 2014
Fair value of derivative liability – embedded conversion feature	—	—	\$317,240	\$317,240
Total	\$—	\$—	\$317,240	\$317,240

Liabilities	Level 1	Level 2	Level 3	December 31, 2013
Fair value of derivative liability – embedded conversion feature	—	—	\$177,927	\$177,927
Total	—	—	\$177,927	\$177,927

On August 30, 2013, November 25, 2013, December 19, 2013, January 27, 2014, February 25, 2014, and March 18, 2014 we entered into securities purchase agreements relating to the sale and issuance of convertible notes in the principal amounts of \$200,000, \$200,000, \$250,000, \$100,000, \$200,000 and \$300,000. Each of the Convertible Notes are convertible into shares of our common stock, at any time after issuance, at the option of the purchaser, at a conversion price equal to \$0.02 per share, subject to adjustment upon the happening of certain events, including stock dividends, stock splits and the issuance of common stock equivalents at a price below the conversion price. Subject to our fulfilling certain conditions, including beneficial ownership limits, the convertible notes are subject to a mandatory conversion if the closing price of our common stock for any 20 consecutive days commencing six months after the issue date of the convertible notes equal or exceeds \$0.04 per share. The terms of the convertible notes meet the criteria for the bifurcation of an embedded derivative. Therefore, we recorded the fair value of the embedded derivative liability as of the issuance date for each of the convertible notes for an aggregate fair value of \$366,519.

We use a model based on Monte Carlo simulation to value the embedded conversion feature of our notes payable that are subject to fair value liability accounting. The determination of the fair value as of the reporting date is affected by our stock price as well as assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to, expected stock price volatility over the term of the security and risk-free interest rate. In addition, the model uses multiple Monte Carlo



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simulations requiring the input of an expected life for the securities for which we have estimated and expectations of the timing and amount of future financing we may require. The fair value of the embedded conversion feature liability is revalued each balance sheet date utilizing our Monte Carlo simulation-based model computations with the decrease or increase in fair value being reported in the statement of comprehensive loss as other income or expense, respectively. The primary factors affecting the fair value of the embedded conversion feature liability are our stock price and volatility. In addition, the use of a Monte Carlo simulation-based model requires the input of highly subjective assumptions, and other reasonable assumptions could provide differing results.

Our reported net loss was \$720,000 for the six months ended June 30, 2014. If the closing stock price of our common stock had been 10% lower, our net loss would have been approximately \$37,000 lower. If the closing stock price of our common stock had been 10% higher, our net loss would have been approximately \$36,000 higher. If our volatility assumption on June 30, 2014 had been 10% lower, our net loss would have been approximately \$27,000 lower and if our volatility assumption had been 10% higher, our net loss would have been approximately \$18,000 higher.

The following table shows the changes in Level 3 liabilities measured at fair value on a recurring basis for the six months ended June 30, 2014:

	Derivative Liability – Embedded Conversion Feature	Total Level 3
Beginning balance – January 1, 2014	\$ 177,927	\$ 177,927
Issuances	122,630	122,630
Total realized and unrealized gains or losses	16,683	16,683
Ending balance – June 30, 2014	\$ 317,240	\$ 317,240

## 16. Income Taxes

Deferred income taxes arise from timing differences resulting from income and expense items reported for financial account and tax purposes in different periods. A deferred tax asset valuation allowance is recorded when it is more likely than not that deferred tax assets will not be realized. During the three and six months ended June 30, 2014, there was no income tax expense or benefit for federal and state income taxes in the accompanying condensed consolidated statements of operations due to our net loss and a valuation allowance on the resulting deferred tax asset. Our deferred tax asset has a 100% valuation allowance.

## 17. Commitments and Contingencies

## Litigation

On February 21, 2014, ASCR filed with the Circuit Court of the Second Judicial Circuit, Leon County, Florida (the “Court”) an amended complaint and demand for payment of the debt it acquired from one of our creditors. On February 26, 2014, we entered into a Settlement Agreement and Stipulation with ASCR that was filed with the Court pursuant to which we agreed, subject to court approval, to issue shares of our common stock in a Section 3(a) (10) proceeding that generate proceeds in the amount of \$250,000 in full settlement of a claim in the amount of \$1,027,705 that ASCR acquired from one Creditor (the value of the stock that we agreed to issue was two hundred and fifty percent (250%) of the discounted purchase price ASCR paid to purchase the debt from the Creditor, and approximately 25% of the original amount we owed to the Creditor), resulting in settlement of prior debt owed of \$769,148. On March 24, 2014, the Circuit Court of the Second Judicial Circuit, Leon County, Florida, approved the §3(a)(10) 1933 Act

proceeding and Settlement Agreement and Stipulation and in April 2014, we issued 8,079,800 shares of common stock at an average price of \$0.031 for the full settlement of the agreement with ASCR.

On May 1, 2012, Suntech America, Inc., a Delaware corporation (“Suntech America”), filed a complaint for breach of contract, goods sold and delivered, account stated and open account against us in the Superior Court of the State of California, County of San Francisco. Suntech America alleged that it delivered products and did not receive full payment from us. On July 31, 2012, we and Suntech entered into a settlement of this dispute. Because of our inability to make scheduled settlement payments, on March 15, 2013, Suntech entered a judgment against us in the amount of \$946,438. As of June 30, 2014, Suntech has not sought to enforce its judgment. As of June 30, 2014, we have included in our condensed consolidated balance sheets a balance due to Suntech America of \$946,438.

We are also involved in other litigation from time to time in the ordinary course of business. In the opinion of management, the outcome of such proceedings will not materially affect our financial position, results of operations or cash flows.

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18. Subsequent Events

On July 8, 2014, we submitted a take-down request for \$125,000 pursuant to the terms of the Equity Purchase Agreement. We issued a total 7,102,273 shares of our common at an average price of \$0.02 per share pursuant to the terms of the Equity Purchase Agreement.

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

All references to the "Company," "we," "our," and "us" refer to Andalay Solar, Inc. and its subsidiaries ("Andalay Solar").

The following discussion highlights what we believe are the principal factors that have affected our financial condition and results of operations as well as our liquidity and capital resources for the periods described. This discussion should be read in conjunction with our financial statements and related notes appearing elsewhere in this Quarterly Report and in our Annual Report on Form 10-K. This discussion contains "forward-looking statements," including but not limited to expectations regarding revenue growth, net sales, gross profit, operating expenses and performance objectives, and statements using the terms "believes," "expects," "will," "could," "plans," "anticipates," "estimates," "predicts," "intends," "potential," "continue," "should," "may," or the negative of these terms or similar expressions. These forward-looking statements are subject to risks and uncertainties that may cause our actual results to differ materially from those expressed or implied by these forward-looking statements. Such risks and uncertainties include, without limitation, the risks described below in Item 1A. of Part II of this Quarterly Report. Further information on potential risk factors that could affect our future business and financial results and financial condition can be found in our periodic filings with the Securities and Exchange Commission (the "SEC"). We undertake no obligation to update any of these forward-looking statements.

Company Overview

We are a designer and manufacturer of integrated solar power systems and solar panels with integrated microinverters (which we call AC solar panels). We design, market and sell these solar power systems to solar installers and do-it-yourself customers in the United States, Canada, the Caribbean and South America through distribution partnerships, our dealer network and retail outlets. Our products are designed for use in solar power systems for residential and commercial rooftop customers. Prior to September 2010, we were also in the solar power installation business.

In September 2007, we introduced our "plug and play" solar panel technology (under the brand name "Andalay"), which we believe significantly reduces the installation time and costs, and provides superior reliability and aesthetics, when compared to other solar panel mounting products and technology. Our panel technology offers the following features: (i) mounts closer to the roof with less space in between panels; (ii) no unsightly racks underneath or beside panels; (iii) built-in wiring connections; (iv) approximately 70% fewer roof-assembled parts and approximately 50% less roof-top labor required; (v) approximately 25% fewer roof attachment points; (vi) complete compliance with the National Electric Code and UL wiring and grounding requirements. We have five U.S. patents (Patent No. 7,406,800, Patent No. 7,832,157, Patent No. 7,866,098, Patent No. 7,987,614 and Patent No. 8,505,248) that cover key aspects of our Andalay solar panel technology, as well as U.S. Trademark No. 3481373 for registration of the mark "Andalay." In addition to these U.S. patents, we have 7 foreign patents. Currently, we have 12 issued patents and 15 other pending U.S. and foreign patent applications that cover the Andalay technology working their way through the USPTO and foreign patent offices.

In February 2009, we announced a strategic relationship with Enphase, a leading manufacturer of microinverters, to develop and market solar panel systems with ordinary AC house current output instead of high voltage DC output. We introduced Andalay AC panel products and began offering them to our customers in the second quarter of 2009. Andalay AC panels cost less to install, are safer, and generally provide higher energy output than ordinary DC panels. Andalay AC panels deliver 5-25% more energy compared to ordinary panels, produce safe household AC power, and have built-in panel level monitoring, racking, wiring, grounding and microinverters. With 80% fewer parts and 5 – 25% better performance than ordinary DC panels, we believe Andalay AC panels are an ideal solution for solar installers and do-it-yourself customers.

As a result of our announced exit from the solar panel installation business, our installation business has been reclassified in our financial statements as discontinued operations. The exit from the installation business was essentially completed by the end of the fourth quarter of 2010.

#### Concentration of Risk

Financial instruments that potentially subject us to credit risk are comprised of cash and cash equivalents, which are maintained at high quality financial institutions. As of June 30, 2014 and December 31, 2013, we had no deposits in excess of the Federal Deposit Insurance Corporation limit of \$250,000.

#### Supplier Relationships

Historically, we obtained virtually all of our solar panels from Suntech and Lightway. During 2012, because of our cash position and liquidity constraints, we were late in making payments to both of these suppliers. On March 30, 2012, pursuant to our Supply Agreement with Lightway, we issued 1,900,000 shares of our common stock to Lightway in partial payment of our past due account

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payable to them. At the time of issuance, the shares were valued at \$1,045,000. On May 1, 2012, Suntech filed a complaint for breach of contract, goods sold and delivered, account stated and open account against us in the Superior Court of the State of California, County of San Francisco. Suntech alleged that it delivered products and did not receive full payment from us. On July 31, 2012, we and Suntech entered into a settlement of this dispute. Because of our inability to make scheduled settlement payments, on March 15, 2013, Suntech entered a judgment against us in the amount of \$946,438. As of June 30, 2014, Suntech has not sought to enforce its judgment. As of June 30, 2014, we have included in accounts payable in our Condensed Consolidated Balance Sheets a balance due to Suntech America of \$946,438. We currently have no unshipped orders from Suntech or Lightway.

In May 2013, we entered into a new supply agreement for assembly of our proprietary modules with Environmental Engineering Group Pty Ltd (“EEG”), an assembler of polycrystalline modules located in Australia. In August 2013, we began receiving product from EEG and began shipping product to customers during the third calendar quarter of 2013. In September 2013, we entered into a second supply agreement for assembly of our proprietary modules with Tianwei New Energy Co, Ltd. (“Tianwei”), a panel supplier located in China. We began receiving product from Tianwei in February 2014 and stopped as of June 2014. In July 2014, we entered into a supply agreement for assembly of our proprietary modules with Auxin Solar, Inc., a panel supplier located in the United States. We expect to begin receiving product from Auxin in September 2014. Although we believe we can find alternative suppliers for solar panels manufactured to our specifications, our operations would be disrupted unless we are able to rapidly secure alternative sources of supply, our inventory and revenue could diminish significantly, causing disruption to our operations.

## Customer Relationships

The relative magnitude and the mix of revenue from our largest customers have varied significantly quarter to quarter. During the six months ended June 30, 2014, six customers have accounted for significant revenues, varying by period, to our company: Sustainable Environmental Enterprises (“SEE”), a leading provider of renewable energy and development projects located in New Orleans, Louisiana, Saddleback Cellars (“Saddleback”), a Napa County winery, Lennox International Inc. (“Lennox”), a global leader in the heating and air conditioning markets, Lowe’s Companies, Inc. (“Lowe’s”), a nationwide home improvement retail chain, WDC Solar, Inc. (“WDC”), a leading construction, integration and installation of commercial, residential and utility scale solar installations in the Washington D.C. area and Shoreline Electric (“Shoreline”) a provider of residential and commercial electrical services in Southern California. For the six months ended June 30, 2014, the percentages of sales to SEE, Lennox, Lowe’s, WDC and Shoreline are as follows:

	Six Months Ended June			
	2014		2013	
Sustainable Environmental Enterprises	3.7	%	49.4	%
Saddleback Cellars	12.3	%	—	
Lennox International Inc.	0.1	%	13.2	%
Lowe’s Companies, Inc.	3.2	%	0.9	%
WDC Solar, Inc.	13.5	%	—	
Shoreline Electric	10.1	%	—	

SEE accounted for approximately \$517,000, or 84.4%, of our gross accounts receivable as of June 30, 2014. As of the date hereof, the \$517,000 receivable from SEE is past due. SEE has indicated that the past-due payment is late due to

a processing delay of a rebate owed to it from the State of Louisiana and expects that full payment will be made in a few weeks upon its receipt of the rebate. Notwithstanding, no assurance can be given by us as to when a rebate will be issued to SEE by the State of Louisiana or as to when or to what extent payment will be received by us if it isn't issued timely. WDC accounted for 10.3% of our gross accounts receivable balance as of June 30, 2014. We had no receivable balance from Saddleback, Lowe's, Lennox, or Shoreline as of June 30, 2014 and we had no receivable balance from Saddleback, Lennox, Lowe's, WDC or Shoreline as of December 31, 2013.

We maintain reserves for potential credit losses and such losses, in the aggregate, have generally not exceeded management's estimates. Our top three vendors accounted for approximately 64% and 41% of purchases as of June 30, 2014 and December 31, 2013, respectively. As of June 30, 2014 and December 31, 2013, accounts payable included amounts owed to our top three suppliers of approximately \$972,000 and \$1.1 million, respectively.

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Three Months Ended June 30, 2014 as Compared to Three Months Ended June 30, 2013

## Results of Operations

The following table sets forth, for the periods indicated, certain information related to our operations, expressed in dollars and as a percentage of net revenue:

	Three Months Ended June 30,					
	2014			2013		
Net revenue	\$306,919	100.0	%	\$130,046	100.0	%
Cost of goods sold	296,640	96.7	%	151,726	116.7	%
Gross profit (loss)	10,279	3.3	%	(21,680)	(16.7)	%
Operating expenses						
Sales and marketing	75,332	24.5	%	302,063	232.3	%
General and administrative	537,382	175.1	%	509,673	391.9	%
Total operating expenses	612,714	199.6	%	811,736	624.2	%
Loss from continuing operations	(602,435)	(196.3)	%	(833,416)	(640.9)	%
Other income (expense)						
Interest (expense), net	(113,874)	(37.1)	%	(64)	(0.1)	%
Adjustment to the fair value of embedded derivatives	84,868	27.7	%	—	0.0	%
Adjustment to the fair value of common stock warrants	—	0.0	%	2	0.0	%
Settlement of prior debt owed	—	0.0	%	420,000	323.0	%
Total other expense, net	(29,006)	(9.5)	%	419,938	322.9	%
Loss before provision for income taxes and discontinued operations	(631,441)	(205.7)	%	(413,478)	(317.9)	%
Provision for income taxes	—	0.0	%	—	0.0	%
Net loss from continuing operations (Note 3)	(631,441)	(205.7)	%	(413,478)	(317.9)	%
Net income (loss) from discontinued operations, net of tax	—	0.0	%	4,672	3.6	%
Net loss	(631,441)	(205.7)	%	(408,806)	(314.4)	%
Preferred stock dividend	(4,390)	(1.4)	%	(42,309)	(32.5)	%
Preferred deemed dividend	—	0.0	%	(104,000)	(80.0)	%
Net loss attributable to common stockholders	\$(635,831)	(207.2)	%	\$(555,115)	(426.9)	%
Net loss attributable to common stockholders per common share (basic and diluted)	\$(0.00)			\$(0.01)		
Weighted average shares used in computing loss per common share (basic and diluted)	191,427,247			54,754,456		

## Net revenue

We generate revenue from the sale of solar power systems. For the three months ended June 30, 2014, we generated \$307,000 of revenue, an increase of \$177,000, or 136.0%, compared to \$130,000 of revenue for the three months ended June 30, 2013. The increase in revenue was due to an increase in watts sold, partially offset by a decrease in our average selling price per watt.

## Cost of goods sold



Cost of goods sold as a percent of revenue for the three months ended June 30, 2014, was 96.7% of net revenue, compared to 116.7% for the three months ended June 30, 2013. Gross profit for the three months ended June 30, 2014 was \$10,000, or 3.3% of revenue, compared to gross loss of \$22,000 or 16.7% of revenue for the same period in 2013. The increase in gross margin in the three months ended June 30, 2014 compared to the three months ended June 30, 2013, was due to lower solar module costs and lower inventory overhead allocations due to increase in revenue.

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### Sales and marketing expenses

Sales and marketing expenses for the three months ended June 30, 2014 were \$75,000, or 24.5% of net revenue as compared to \$302,000, or 232.3% of net revenue during the same period of the prior year. The \$227,000 decrease in sales and marketing expenses for the three months ended June 30, 2014 compared to the same period in 2013 was primarily due to decreases in licensing fees owed to Westinghouse Electric Corporation of \$250,000, partially offset by an increase in \$18,000 in payroll and commission expense. The decrease in licensing fees was due to the termination of the licensing agreement with Westinghouse Electric. The increase in payroll costs was due to higher headcount.

### General and administrative expenses

General and administrative expenses for the three months ended June 30, 2014 were \$537,000, or 175.1% of net revenue as compared to \$510,000, or 391.9% of net revenue during the same period of the prior year. The increase in general and administrative expense for the three months ended June 30, 2014 compared to the same period in 2013, was due primarily to an increase in legal and professional fees of \$101,000 and payroll and benefits expense of \$64,000, partially offset by a decline in bad debt expense of \$40,000, rent expense of \$29,000 and research and development costs of \$23,000. The increase in legal and professional fees was primarily due to higher legal fees incurred in the current year. The increase in payroll and benefits expense was due to higher headcount. The decrease in rent was due to the consolidation of our administrative offices with our warehouse and the decrease in research and development costs was due to lower prototype parts and material.

### Interest expense, net

During the three months ended June 30, 2014, net interest expense was approximately \$114,000 compared with net interest expense of \$64 for the same period in 2013. The increase in interest expense was associated with the increase in notes payable and convertible debt.

### Adjustment to the fair value of embedded derivatives

During the three months ended June 30, 2014, we recorded mark-to-market adjustments to reflect the fair value of embedded derivatives, resulting in an unrealized gain of \$85,000 in our condensed consolidated statements of operations.

### Adjustment to the fair value of common stock warrants

During the three months ended June 30, 2013, we recorded mark-to-market adjustments to reflect the fair value of outstanding common stock warrants accounted for as a liability, resulting in an unrealized gain of \$2 in our condensed consolidated statements of operations.

### Income taxes

During the three months ended June 30, 2014 and 2013, there was no income tax expense or benefit for federal and state income taxes reflected in our condensed consolidated statements of operations due to our net loss and a valuation allowance on the resulting deferred tax asset.

### Net loss from continuing operations

Net loss from continuing operations for the three months ended June 30, 2014 was \$631,000, compared to a net loss from continuing operations of \$413,000 for the three months ended June 30, 2013.

Net income (loss) from discontinued operations

As a result of the exit from the installation business on September 7, 2010, we recorded net income of \$5,000 from the discontinuance of our installation business segment for the three months ended June 30, 2013.

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Six Months Ended June 30, 2014 as Compared to Six Months Ended June 30, 2013

## Results of Operations

The following table sets forth, for the periods indicated, certain information related to our operations, expressed in dollars and as a percentage of net revenue:

	Six Months Ended June 30,					
	2014			2013		
Net revenue	\$449,401	100.0	%	\$211,240	100.0	%
Cost of goods sold	432,028	96.1	%	239,468	113.4	%
Gross profit (loss)	17,373	3.9	%	(28,228 )	(13.4 )	%
Operating expenses						
Sales and marketing	138,716	30.9	%	602,458	285.2	%
General and administrative	1,141,546	254.0	%	1,221,097	578.1	%
Total operating expenses	1,280,262	284.9	%	1,823,555	863.3	%
Loss from continuing operations	(1,262,889 )	(281.0 )	%	(1,851,783 )	(876.6 )	%
Other income (expense)						
Interest (expense), net	(190,959 )	(42.5 )	%	(5,363 )	(2.5 )	%
Adjustment to the fair value of embedded derivatives	(16,683 )	(3.7 )	%	—	0.0	%
Adjustment to the fair value of common stock warrants	—	0.0	%	9	0.0	%
Settlement of prior debt owed	769,148	171.1	%	420,000	198.8	%
Total other expense, net	561,506	124.9	%	414,646	196.3	%
Loss before provision for income taxes and discontinued operations	(701,383 )	(156.1 )	%	(1,437,137 )	(680.3 )	%
Provision for income taxes	—	0.0	%	—	0.0	%
Net loss from continuing operations (Note 3)	(701,383 )	(156.1 )	%	(1,437,137 )	(680.3 )	%
Net income (loss) from discontinued operations, net of tax	—	0.0	%	7,597	3.6	%
Net loss	(701,383 )	(156.1 )	%	(1,429,540 )	(676.7 )	%
Preferred stock dividend	(18,844 )	(4.2 )	%	(95,529 )	(45.2 )	%
Preferred deemed dividend	—	0.0	%	(374,000 )	(177.0 )	%
Net loss attributable to common stockholders	\$(720,227 )	(160.3 )	%	\$(1,899,069 )	(899.0 )	%
Net loss attributable to common stockholders per common share (basic and diluted)	\$(0.00 )			\$(0.04 )		
Weighted average shares used in computing loss per common share (basic and diluted)	161,593,368			43,962,863		

## Net revenue

We generate revenue from the sale of solar power systems. For the six months ended June 30, 2014, we generated \$449,000 of revenue, an increase of 238,000, or 112.7%, compared to \$211,000 of revenue for the six months ended June 30, 2013. The increase in revenue was due to an increase in watts sold, partially offset by a decrease in our average selling price per watt.

## Cost of goods sold

Cost of goods sold as a percent of revenue for the six months ended June 30, 2014, was 96.1% of net revenue, compared to 113.4% for the six months ended June 30, 2013. Gross profit for the six months ended June 30, 2014 was \$17,000, or 3.9% of revenue, compared to gross loss of \$28,000 or 13.4% of revenue for the same period in 2013. The increase in gross margin in the six months ended June 30, 2014 compared to the six months ended June 30, 2013, was due to lower solar module costs and lower inventory overhead allocations due to increase in revenue.

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### Sales and marketing expenses

Sales and marketing expenses for the six months ended June 30, 2014 were \$139,000, or 30.9% of net revenue as compared to \$602,000, or 285.2% of net revenue during the same period of the prior year. The \$464,000 decrease in sales and marketing expenses for the six months ended June 30, 2014 compared to the same period in 2013 was primarily due to decreases in licensing fees owed to Westinghouse Electric Corporation of \$500,000, partially offset by an increase in \$28,000 in stock compensation expense. The decrease in licensing fees was due to the termination of the licensing agreement with Westinghouse Electric. The increase in stock compensation expense was due to grants of restricted stock to certain sales and marketing employees.

### General and administrative expenses

General and administrative expenses for the six months ended June 30, 2014 were \$1.1 million, or 254.0% of net revenue as compared to \$1.2 million, or 578.1% of net revenue during the same period of the prior year. The decrease in general and administrative expense for the six months ended June 30, 2014 compared to the same period in 2013, was due primarily to a decrease in bad debt expense of \$68,000, a decrease in insurance expense of \$59,000 and a decrease in rent expense of \$56,000, partially offset by an increase in stock compensation expense of \$109,000, payroll and benefits of \$60,000, professional fees of \$17,000 and recruitment fees of \$17,000. The decrease in bad debt was primarily due to an increase in bad debt in the prior year and the decrease in insurance and rent expense was due to the consolidation of our administrative offices with our warehouse. The increase in stock compensation, payroll and benefits and recruitment fees was primarily due to expenses incurred in the replacement of our CEO. The increase in professional fees was primarily due to an increase in accounting fees.

### Interest expense, net

During the six months ended June 30, 2014, net interest expense was approximately \$191,000 compared with net interest expense of \$5,000 for the same period in 2013. The increase in interest expense was associated with the increase in notes payable and convertible debt.

### Adjustment to the fair value of embedded derivatives

During the six months ended June 30, 2014, we recorded mark-to-market adjustments to reflect the fair value of embedded derivatives, resulting in an unrealized loss of \$17,000 in our condensed consolidated statements of operations.

### Adjustment to the fair value of common stock warrants

During the six months ended June 30, 2013, we recorded mark-to-market adjustments to reflect the fair value of outstanding common stock warrants accounted for as a liability, resulting in an unrealized gain of \$9 in our condensed consolidated statements of operations.

### Settlement of prior debt owed

During the six months ended June 30, 2014, we recorded a gain in other income of \$769,000 as a result of a favorable settlement on a prior debt owed to a creditor.

### Income taxes

During the six months ended June 30, 2014 and 2013, there was no income tax expense or benefit for federal and state income taxes reflected in our condensed consolidated statements of operations due to our net loss and a valuation allowance on the resulting deferred tax asset.

#### Net loss from continuing operations

Net loss from continuing operations for the six months ended June 30, 2014 was \$701,000, compared to a net loss from continuing operations of \$1.4 million for the six months ended June 30, 2013.

#### Net income (loss) from discontinued operations

As a result of the exit from the installation business on September 7, 2010, we recorded net income of \$8,000 from the discontinuance of our installation business segment for the six months ended June 30, 2013.

#### Liquidity and Capital Resources

We currently face challenges meeting the working capital needs of our business. Our primary requirements for working capital are to fund purchases for solar panels and microinverters, and to cover our payroll and lease expenses. For the six months ended June 30, 2014 and for each of the two years in the period ended December 31, 2013, we have incurred net losses and negative cash flows from operations. During the recent years, we have undertaken several equity and debt financing transactions to provide the capital needed to sustain our business. We have dramatically reduced our headcount and other variable expenses. As of June 30, 2014, we had approximately \$93,000 in cash on hand. We intend to address ongoing working capital needs through sales of products, along with raising additional debt and equity financing. In January 2013, our board of directors approved actions to dramatically reduce our variable operating costs, including a 12 person employee headcount reduction effective January 15, 2013, for the period through the anticipated merger closing with CBD, which merger was terminated in July 2013. No restructuring charges or severance payments

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were incurred. Our revenue levels remain difficult to predict, and we anticipate that we will continue to sustain losses in the near term, and we cannot assure investors that we will be successful in reaching break-even.

During 2012, because of our cash position and liquidity constraints, we were late in making payments to both of our former panel suppliers, Suntech and Lightway. We currently have no unshipped orders from these suppliers. In May 2013, we entered into a new supply agreement for assembly of our proprietary modules with Environmental Engineering Group Pty Ltd (“EEG”), an assembler of polycrystalline modules located in Australia. In August 2013, we began receiving product from EEG and began shipping product to customers during the third calendar quarter of 2013. In September 2013, we entered into a second supply agreement for assembly of our proprietary modules with Tianwei New Energy Co, Ltd. (“Tianwei”), a panel supplier located in China. We began receiving product from Tianwei in February 2014 and stopped as of June 2014. In July 2014, we entered into a supply agreement for assembly of our proprietary modules with Auxin Solar, Inc., a panel supplier located in the United States. We expect to begin receiving product from Auxin in September 2014. Although we believe we can find alternative suppliers for solar panels manufactured to our specifications, our operations would be disrupted unless we are able to rapidly secure alternative sources of supply, our inventory and revenue could diminish significantly, causing disruption to our operations.

The accompanying condensed consolidated financial statements have been prepared assuming we will continue as a going concern. Our significant operating losses, negative cash flow from operations, and challenges in rapidly securing alternative sources of supply for solar panels, raise substantial uncertainty about our ability to continue as a going concern. The accompanying financial statements do not include any adjustments that might result from the outcome of this uncertainty, and contemplate the realization of assets and the settlement of liabilities and commitments in the normal course of business. There can be no assurance that we will be able to raise additional funds on commercially reasonable terms, if at all. The current economic downturn adds uncertainty to our anticipated revenue levels and to the timing of cash receipts, which are needed to support our operations. It also worsens the market conditions for seeking equity and debt financing. As a result of our delisting from the Nasdaq Capital Market in September 2012, we are no longer eligible to file new registration statements on Form S-3, which may make it more costly and more difficult for us to obtain additional equity financing. We currently anticipate that we will retain all of our earnings, if any, for development of our business and do not anticipate paying any cash dividends on common stock in the foreseeable future.

Despite our recent financings, we have insufficient cash to operate our business at the current level for the next twelve months and insufficient cash to achieve our business goals. The success of our business plan is contingent upon us increasing sales and obtaining additional financing. We intend to fund operations through debt and/or equity financing arrangements such as the Equity Purchase Agreement with Southridge and the loan and security agreement discussed below; however there can be no assurance that we will continue to meet the conditions necessary to be able to use the Equity Line under the Equity Purchase Agreement (described below) or the loan and security agreement (described below). Other than the Equity Line and the loan and security agreement described below, we do not have any formal commitments or arrangements for the sales of stock or the advancement or loan of funds at this time. There can be no assurance that any additional financing will be available to us on acceptable terms, or at all.

On January 22, 2014, we entered into a Settlement of Potential Claims Agreement (the “ASCR Agreement”) with ASC Recap LLC (ASCR), an entity affiliated with Southridge. Pursuant to the ASCR Agreement, ASCR has offered to purchase (and in one (1) case has already purchased) approximately \$3.7 million of our prior debt owed to four creditors (“Creditors”) for past due services at a substantial discount to face value to which we have agreed to issue to ASCR certain shares of its common stock in a §3(a)(10) 1933 Act proceeding. The shares of common stock that we have agreed to issue to ASCR in full payment for, and as a release of any debt it purchases from the Creditors, is anticipated to have, upon issuance, a market value equal to approximately 25% of the principal amount of our outstanding debt. In the case of the debt ASCR already purchased from one (1) Creditor, we entered into a Settlement



Agreement and Stipulation on February 26, 2014 that was filed with the Circuit Court of the Second Judicial Circuit, Leon County, Florida pursuant to which we agreed, subject to court approval, to issue shares of our common stock that generate proceeds in the amount of \$250,000 in full settlement of a claim in the amount of \$1,027,705 that ASCR acquired from one Creditor (the value of the stock that we agreed to issue was two hundred and fifty percent (250%) of the discounted purchase price ASCR paid to purchase the debt from the Creditor, and approximately 25% of the original amount we owed to the Creditor). On March 24, 2014, the Circuit Court of the Second Judicial Circuit, Leon County, Florida, approved the §3(a)(10) 1933 Act proceeding and Settlement Agreement and Stipulation and in April 2014, we issued 8,079,800 shares of common stock at an average price of \$0.031 for the full settlement of the agreement with ASCR. The stock to be issued by us and the purchase of the debt by ASCR of the remaining three Creditors is subject to the acceptance of offers by the Creditors and court approval of the terms of the settlement.

#### Registration statement

On March 11, 2014, we filed a Registration Statement on Form S-1/A to register 35 million shares of common stock related to our Equity Purchase Agreement with Southridge and on March 21, 2014, the Securities and Exchange Commission declared the Registration Statement effective. On March 26, 2014, we submitted an initial take-down request of \$300,000 to Southridge pursuant to the terms of the Equity Purchase Agreement of which partial proceeds of \$100,000 was received on March 31, 2014 and \$200,000 on April 16, 2014. On June 4, 2014, June 18, 2014 and July 8, 2014, we submitted additional take-down requests for \$100,000, \$100,000

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and \$125,000, respectively, pursuant to the terms of the Equity Purchase Agreement. We issued a total of 31,760,578 shares of our common stock at an average price of \$0.02 per share pursuant to the terms of the Equity Purchase Agreement. We have approximately 3.2 million shares remaining under our effective Form S-1 and available pursuant to the terms of our Equity Purchase Agreement following our take-downs through August 11, 2014.

Convertible notes payable

On August 30, 2013, we entered into a securities purchase agreement with certain institutional accredited investors relating to the sale and issuance of a convertible note in the principal amount of \$200,000 that matures August 29, 2015 (the "Convertible Note"). Subsequently, on November 25, 2013 and December 19, 2013, we entered into additional securities purchase agreements with the same institutional accredited investors relating the sale and issuance of convertible notes in the principal amount of \$200,000 and \$250,000, respectively, which mature on November 25, 2015 and December 19, 2015. On January 27, 2014, we issued a convertible note in the principal amount of \$100,000 that matures January 27, 2016 under the Securities Purchase Agreement we entered into with an accredited investor on December 19, 2013. In connection with the issuance of the December 19, 2013 convertible note, we also issued 6,250,000 warrants to purchase shares of our common stock at a price of \$0.02 per share. On February 25, 2014, we entered into a Securities Purchase Agreement with the same accredited investor related to the sale and issuance of a convertible note in the principal amount of \$200,000 that matures February 25, 2016. In connection with the issuance of the February 25, 2014 convertible note, we issued 5,000,000 warrants to purchase shares of our common stock at a price of \$0.02 per share. On March 18, 2014, we entered into a Securities Purchase Agreement we entered into with the same accredited investor related to the sale and issuance of a convertible note in the principal amount of \$300,000 that matures March 18, 2016. In connection with the March 18, 2014 convertible note, we issued a five-year warrant to purchase 7,500,000 shares of our common stock at an exercise price of \$.02. Each of the Convertible Notes bear interest at the rate of 8% per annum compounded annually, are payable at maturity and the principal and interest outstanding under the convertible notes are convertible into shares of our common stock, at any time after issuance, at the option of the purchaser, at a conversion price equal to \$0.02 per share, subject to adjustment upon the happening of certain events, including stock dividends, stock splits and the issuance of common stock equivalents at a price below the conversion price. Subject to our fulfilling certain conditions, including beneficial ownership limits, the convertible notes are subject to a mandatory conversion if the closing price of our common stock for any 20 consecutive days commencing six months after the issue date of the convertible notes equal or exceeds \$0.04. Unless waived in writing by the purchaser, no conversion of the convertible notes can be effected to the extent that as a result of such conversion the purchaser would beneficially own more than 9.99% in the aggregate of our issued and outstanding common stock immediately after giving effect to the issuance of common stock upon conversion.

We have the option of repaying the outstanding principal amount of the convertible notes, in whole or in part, by paying the purchaser a sum of money equal to one hundred and twenty percent (120%) of the principal together with accrued but unpaid interest upon 30 days notice, subject to certain beneficial ownership limits. For so long as we have any obligation under the convertible notes, we have agreed to certain restrictions regarding, among other things, incurrence of additional debt, liens, amendments to charter documents, repurchase of stock, payment of cash dividends, affiliated transactions. We are also prohibited from entering into certain variable priced agreements until the convertible notes are repaid in full.

Because of certain down-round protection in the conversion rate of the convertible notes, we determined that the derivative liability related to the embedded conversion feature met the criteria for bifurcation. Accordingly, we recognized an aggregate liability of \$123,000 on the three issuance dates during the six months ended June 30, 2014. This was in addition to the carrying value of the derivative liability on three previously recorded derivatives of \$178,000. The derivative liability is carried at fair value with changes in the fair value reflected in the "Adjustment to

the fair value of embedded derivatives” line item of our condensed consolidated statements of operations. We recognized a non-cash benefit for the three months ended June 30, 2014 of \$85,000 and a non-cash charge for the six months ended June 30, 2014 of \$17,000 on a total of six convertible notes.

In addition, the relative fair value of the warrants issued in the December 2013 convertible note issuance of \$250,000, were allocated to additional paid-in capital. Such value was determined assuming volatility of 149.1%, a risk free interest rate of 0.7% and an expected term of 4.1 years. The resulting debt discount from the derivative liability and warrant issuance of \$109,000 is being accreted to interest using the effective interest method. The relative fair value of the warrants issued in the February 2014 convertible note issuance of \$200,000, were allocated to Additional Paid-in Capital. Such value was determined assuming volatility of 169.1, a risk free interest rate of 0.7% and an expected term of 4.1 years. The resulting debt discount from the derivative liability and warrant issuance of \$101,000 is being accreted to interest using the effective interest method. The relative fair value of the warrants issued in the March 2014 convertible note issuance of \$300,000, were allocated to additional paid-in capital. Such value was determined assuming volatility of 168.8%, a risk free interest rate of 0.8% and an expected term of 4.1 years. The resulting debt discount from the derivative liability and warrant issuance of \$154,000 is being accreted to interest using the effective interest method.

On November 1 and December 1, 2013, and on January 1, February 1 and March 1, 2014, we issued convertible notes to our financial advisory firm in the principal amount of \$30,000 each for a total of \$150,000, which mature on October 31 and November 30 and

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December 31, 2014, and on January 31 and February 28, 2015, respectively. On April 1, May 1 and June 1, 2014, we issued convertible notes to our financial advisory firm in the principal amount of \$20,000 each, for a total of \$60,000, which mature on March 31, April 30 and May 31, 2015, respectively. Each of the Convertible Notes bear interest at the rate of 8% per annum compounded annually, are payable at maturity and the principal and interest outstanding under the convertible notes are convertible into shares of our common stock, at any time after issuance, at the option of the purchaser, at a conversion price equal to \$0.02. Unless waived in writing by the purchaser, no conversion of the convertible notes can be effected to the extent that as a result of such conversion the purchaser would beneficially own more than 9.99% in the aggregate of our issued and outstanding common stock immediately after giving effect to the issuance of common stock upon conversion. On May 1 and June 1, 2014, the November 1 and December 1, 2013 convertible notes in the principal amount of \$60,000, along with accrued interest of \$2,414, were converted into 3,157,172 shares of our common stock.

### Line of credit

On September 30, 2013, we entered into a loan and security agreement with Alpha Capital Anstalt and Collateral Services, LLC to provide financing, on a discretionary basis, for one year, against our accounts receivable and inventory. The maximum amount that can be borrowed under the Agreement is \$500,000. We have the right to borrow up to 80% of our eligible accounts receivable, not in excess of \$200,000, 50% of the value of our raw materials in inventory, 65% of our finished goods inventory and 95% of cash, but not in the aggregate amount in excess of \$300,000. The advances are secured by a lien on all of our assets. All advances under the agreement bear interest at a per annum rate of 12% and monthly interest shall be a minimum of \$500. At the time of initial funding we paid a loan fee of 50 shares of our Series D Preferred Shares to the lender, in addition to other payments for legal fees. In addition, we paid the collateral agent an initial fee of \$5,000 and have agreed to pay an administrative fee to the collateral agent of 0.5% per month of the daily balance during the preceding month or \$500 whichever is less. In the event that of a prepayment, we are obligated to pay a prepayment fee in an amount equal to one-half of one percent (0.5%) of \$500,000. On September 30, 2013, we requested and received an initial borrowing under the Agreement totaling \$350,000. Subsequently, on October 21, 2013, we requested and received an additional \$100,000 and on November 20, 2013, we requested and received an additional \$50,000. As of June 30, 2014, the balance outstanding under our line of credit was \$500,000.

### Cash flow analysis

Our primary capital requirement is to fund purchases of solar panels and inverters. Significant sources of liquidity are cash on hand, cash flows from operating activities, working capital and proceeds from equity financings. As of June 30, 2014, we had approximately \$93,000 in cash on hand.

Cash used in operating activities was approximately \$1.3 million for the six months ended June 30, 2014. Cash provided by operating activities was primarily due our net loss adjusted for non-cash items of \$1.2 million, a \$172,000 decrease in accounts payable, a \$137,000 increase in inventory and a \$38,000 increase in accounts receivable, partially offset by a \$183,000 decrease in prepaid expenses and other current assets. The increases and decreases in assets and liabilities were primarily due to the timing of payments and receipts.

Cash provided by financing activities was approximately \$1.2 million for the six months ended June 30, 2014. During the six months ended June 30, 2014, we received \$600,000 in proceeds from borrowings on long-term debt and \$750,000 in proceeds from an equity offering, less \$37,000 in payment of placement agent fees and payment of \$87,000 in notes payable.

### Application of Critical Accounting Policies and Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires estimates and assumptions that affect the reporting of assets, liabilities, sales and expenses, and the disclosure of contingent assets and liabilities. Note 2 to our consolidated financial statements for the years ended December 31, 2013 and 2012 as filed in our Annual Report on Form 10-K provides a summary of our significant accounting policies, which are all in accordance with generally accepted accounting policies in the United States. Certain of our accounting policies are critical to understanding our consolidated financial statements, because their application requires management to make assumptions about future results and depends to a large extent on management's judgment, because past results have fluctuated and are expected to continue to do so in the future.

The application of the accounting policies described in the following paragraphs is highly dependent on critical estimates and assumptions that are inherently uncertain and highly susceptible to change. For all these policies, we caution that future events rarely develop exactly as estimated, and the best estimates routinely require adjustment. On an ongoing basis, we evaluate our estimates and assumptions, including those discussed below.

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**Revenue recognition.** Revenue from sales of products is recognized when: (1) persuasive evidence of an arrangement exists, (2) delivery has occurred or services have been rendered, (3) the sale price is fixed or determinable, and (4) collection of the related receivable is reasonably assured. We recognize revenue when the solar power systems are shipped to the customer.

**Inventory.** Inventory is stated at the lower of cost (on an average basis) or market value. We determine cost based on our weighted-average purchase price and include both the costs of acquisition and the shipping costs in our inventory. We regularly review the cost of inventory against its estimated market value and record a lower of cost or market write-down to cost of goods sold, if any inventory has a cost in excess of estimated market value. Our inventory generally has a long life cycle and obsolescence has not historically been a significant factor in its valuation.

**Long-lived assets.** We periodically review our property and equipment and identifiable intangible assets for possible impairment whenever facts and circumstances indicate that the carrying amount may not be fully recoverable. Assumptions and estimates used in the evaluation of impairment may affect the carrying value of long-lived assets, which could result in impairment charges in future periods. Significant assumptions and estimates include the projected cash flows based upon estimated revenue and expense growth rates and the discount rate applied to expected cash flows. In addition, our depreciation and amortization policies reflect judgments on the estimated useful lives of assets.

**Patent costs.** We capitalize external legal costs and filing fees associated with obtaining or defending our patents. Upon issuance of new patents or successful defense of existing patents, we amortize these costs using the straight line method over the shorter of the legal life of the patent or its economic life. We believe the remaining useful life we assign to these patents, approximately 10.5 years as of June 30, 2014, are reasonable. We periodically review our patents to determine whether any such cost have been impaired and are no longer being used. To the extent we are no longer using certain patents, the associated costs will be written off at that time.

**Stock-based compensation.** We use the Black-Scholes-Merton Options Pricing Model (Black-Scholes) to estimate fair value of our employee and our non-employee director stock-based awards. Black-Scholes requires various judgmental assumptions, including estimating stock price volatility, expected option life and forfeiture rates. We measure compensation expense for non-employee stock-based compensation under Accounting Standards Codification (“ASC”) ASC 505-50, “Equity-Based Payments to Non-Employees.” The fair value of the option issued is used to measure the transaction, as this is more reliable than the fair value of the services received. The estimated fair value is measured utilizing Black-Scholes using the value of our common stock on the date that the commitment for performance by the counterparty has been reached or the counterparty’s performance is complete.

**Warranty provision.** The manufacturer directly warrants the solar panels and inverters for a range from 15 to 25 years. We warrant the balance of system components of our products against defects in material and workmanship for five years. We assist our customers in the event of a claim under the manufacturer warranty to replace a defective solar panel or inverter.

**Common stock warrant liabilities.** In March 2009 and February 2011, we issued warrants to purchase shares of our common stock in connection with certain capital financing transactions. The terms of the warrant agreements related to these two offerings contained a cash-out provision which may be triggered at the option of the warrant holders if we “go private,” is acquired for all cash or upon the occurrence of certain other fundamental transactions involving us. In addition, the terms of the warrant agreement related to the February 2011 offering contain a provision that may require us to reduce the exercise price of the warrants to purchase shares of our common stock upon the occurrence of certain lower-priced future offerings of our equity securities. Under ASC 480, Distinguishing Liabilities from Equity (“ASC 480”), financial instruments that may require the issuer to settle the obligation by transferring assets or to reduce the exercise price of its warrants to purchase shares of its common stock are classified as a liability. Therefore, we have

classified the warrants as liabilities and will record mark-to-market adjustments to reflect the fair value at each period end.

#### Significant Accounting Policies and Estimates

There have been no material changes or developments to the significant accounting policies discussed in our 2013 Annual Report on Form 10-K or accounting pronouncements issued or adopted, except as described below.

#### Recent Accounting Pronouncements

In May 2014, as part of its ongoing efforts to assist in the convergence of U.S. GAAP and International Financial Reporting Standards (“IFRS”), the Financial Accounting Standards Board (“FASB”) issued ASU 2014-09, “Revenue from Contracts with Customers.” The new guidance sets forth a new five-step revenue recognition model which replaces the prior revenue recognition guidance in its entirety and is intended to eliminate numerous industry-specific pieces of revenue recognition guidance that have historically existed in U.S. GAAP. The underlying principle of the new standard is that a business or other organization will recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects what it expects in exchange for the goods or services. The standard also requires more detailed disclosures and provides additional guidance for transactions that were not addressed completely in the prior accounting guidance. The ASU provides alternative methods of initial adoption and is effective for annual and interim periods beginning after December 15, 2016. We are currently evaluating the impact that this standard will have on our consolidated financial statements.

#### Seasonality

Our quarterly operating results may vary significantly from quarter to quarter as a result of seasonal changes in weather as well as changes in state or federal subsidies.

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Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market risk represents the risk of changes in the value of market risk sensitive instruments caused by fluctuations in interest rates, foreign exchange rates and commodity prices. Changes in these factors could cause fluctuations in our results of operations and cash flows.

Interest Rate Risk

As of June 30, 2014, we had \$1.4 million borrowed under convertible notes, and \$500,000 outstanding under a line of credit. Our convertible notes bears interest at a rate of 8% per year and our line of credit bears interest at a rate of 12% per year. The interest rate under these notes are fixed for the life of the agreements, therefore, any change in market interest rates will not have an impact on the amount of our interest expense.

Foreign Currency Exchange Risk

We do not have any foreign currency exchange risk as purchases of our solar panels from manufacturers outside the United States and sales of our solar panels to Canada are denominated in U.S. currency.

Item 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our Chief Executive Officer and our Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures as of June 30, 2014. Based upon that evaluation, our Chief Executive Officer and our Chief Financial Officer concluded that our disclosure controls and procedures were effective at the reasonable assurance level as of the end of the period covered by this report. In designing and evaluating our disclosure controls and procedures, we and our management recognize that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and that our management necessarily is required to apply its judgment in evaluating and implementing possible controls and procedures. In addition, the design of any control system is based in part upon certain assumptions about the likelihood of future events.

The term “disclosure controls and procedures,” as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC’s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company’s management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure.

Quarterly Evaluation of Changes in Internal Control Over Financial Reporting

Our management, with the participation of our Chief Executive Officer and our Chief Financial Officer, also conducted an evaluation of our internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) to determine whether any change occurred during the second fiscal quarter of 2014 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting. Based on that evaluation, our management concluded that there was no such change during the fiscal quarter ended June 30, 2014





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PART II  
OTHER INFORMATION

Item 1. Legal Proceedings

Litigation

On February 21, 2014 ASCR filed with the Circuit Court of the Second Judicial Circuit, Leon County, Florida (the “Court”) an amended complaint and demand for payment of the debt it acquired from one of our creditors. On February 26, 2014, we entered into a Settlement Agreement and Stipulation with ASCR that was filed with the Court pursuant to which we agreed, subject to court approval, to issue shares of our common stock in a Section 3(a) (10) proceeding that generate proceeds in the amount of \$250,000 in full settlement of a claim in the amount of \$1,027,705 that ASCR acquired from one Creditor (the value of the stock that we agreed to issue was two hundred and fifty percent (250%) of the discounted purchase price ASCR paid to purchase the debt from the Creditor, and approximately 25% of the original amount we owed to the Creditor). On March 24, 2014, the Circuit Court of the Second Judicial Circuit, Leon County, Florida, approved the §3(a)(10) 1933 Act proceeding and Settlement Agreement and Stipulation and in April 2014, we issued 8,079,800 shares of common stock at an average price of \$0.031 for the full settlement of the agreement with ASCR.

On May 1, 2012, Suntech America, Inc., a Delaware corporation (Suntech America), filed a complaint for breach of contract, goods sold and delivered, account stated and open account against us in the Superior Court of the State of California, County of San Francisco. Suntech America alleged that it delivered products and did not receive full payment from us. On July 31, 2012, we and Suntech entered into a settlement of this dispute. Because of our inability to make scheduled settlement payments, on March 15, 2013, Suntech entered a judgment against us in the amount of \$946,438. As of June 30, 2014, Suntech has not sought to enforce its judgment. As of June 30, 2014, we have included in our condensed consolidated balance sheets a balance due to Suntech America of 946,438.

We are also involved in other litigation from time to time in the ordinary course of business. In the opinion of management, the outcome of such proceedings will not materially affect our financial position, results of operations or cash flows.

Item 1A. Risk Factors

Our Quarterly Report on Form 10-Q, and information we provide in our press releases, telephonic reports and other investor communications, may contain forward-looking statements with respect to anticipated future events and our projected financial performance, operations and competitive position that are subject to risks and uncertainties that could cause our actual results to differ materially from those forward-looking statements and our expectations. Future economic and industry trends that could potentially affect revenue, profitability, and growth remain difficult to predict. The factors underlying our forecasts and forward-looking statements are dynamic and subject to change. As a result, any forecasts or forward-looking statements speak only as of the date they are given and do not necessarily reflect our outlook at any other point in time.

Risks Relating to Our Business

We will need additional capital in the future to fund our business, and financing may not be available.

We expect our currently available capital resources and cash flows from operations to be insufficient to meet our working capital and capital expenditure requirements. Our cash requirements will depend on numerous factors, including the amount of our sales, the timing and levels of products purchased, pricing, payment terms and credit

limits from manufacturers, the availability and terms of asset-based credit facilities, the timing and level of our accounts receivable collections, and our ability to manage our business towards profitability.

We expect to need to raise additional funds through public or private debt or equity financings or enter into new asset-based or other credit facilities, but such financings will likely dilute our stockholders. Although we have recently entered into a loan and security agreement with Alpha Capital Anstalt (the “Lender”) and Collateral Services, LLC for the Lender’s provision of financing for one year, against our accounts receivable and inventory, the loans to be made by the Lender are discretionary, they are based upon our accounts receivable and inventory and we must comply with certain conditions in order to obtain funding and therefore, there can be no assurance that such loans will be made. The Equity Purchase Agreement that we entered into with Southridge Partners II, LP (“Southridge”) on January 23, 2014 (the “Equity Purchase Agreement”) also contains conditions that must be met prior to funding and therefore there can be no assurance that such conditions will be met when funding is needed. We cannot assure you that any additional financing that we may need will be available on terms favorable to us, or at all. Our loss of S-3 eligibility in September 2012 due to our Nasdaq delisting and limited availability of authorized and unissued common stock may make it more difficult to raise such funds. In addition, on July 19, 2013 we announced the termination of the agreement and plan of merger which contemplated a merger in which CBD Energy Limited (“CBD”) would become our parent company. This event may diminish our access to additional financing. If adequate funds are not available or are not available on acceptable terms, we may not be able to take advantage of business opportunities, develop new products or otherwise respond to competitive pressures. In any such case, our business, operating results or financial condition could be materially adversely affected.

If we default on our secured loan with the Lender, we could lose all of our assets

Our loan and security agreement with the Lender and Collateral Services, LLC is secured by all of our assets. The agreement contains both affirmative and negative covenants, including covenants regarding incurrence of indebtedness, liens, mergers and acquisitions, subject to materiality and other qualifications and exceptions customary for a credit facility of this size and type. Our obligations under the agreement may be accelerated upon the occurrence of an event of default in accordance with the terms of the Agreement, which includes customary events of default, including payment defaults, the inaccuracy of representations or warranties, cross-defaults related to material indebtedness, bankruptcy and insolvency related defaults, defaults relating to certain other matters, and loss of perfected lien status. If we fail to comply with these covenants or if we fail to make certain payments under the secured loans when due, the Lender could declare our loans in default. If we default on the loan, the Lender has the right to seize our assets that secure the loan, which would force us to suspend all operations.

We have a history of losses and there can be no assurance that we will generate or sustain positive earnings.

For the six months ended June 30, 2014, we had a net loss of \$701,000 and for the years ended December 31, 2013 and 2012, we had a net loss of \$2,830,047 and \$8,622,393, respectively. We cannot be certain that our business strategy will ever be successful. Our likelihood of success must be considered in light of the problems, expenses, difficulties, complications and delays frequently encountered in connection with any emerging business operations. If we fail to address any of these risks or difficulties adequately, our business will likely suffer. Future revenues and profits, if any, will depend upon various factors, including the success, if any, of our expansion plans, marketability of our instruments and services, our ability to maintain favorable relations with manufacturers and

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customers, and general economic conditions. There is no assurance that we can operate profitably or that we will successfully implement our plans. There can be no assurance that we will ever generate positive earnings.

Our financial statements had been prepared assuming that we will continue as a going concern.

Our significant operating losses, negative cash flow from operations, and challenges in rapidly securing alternative sources of supply for solar panels, raise substantial uncertainty about our ability to continue as a going concern. The consolidated financial statements for the years ended December 31, 2013 and 2012 do not include any adjustments that might result from the outcome of this uncertainty, and contemplate the realization of assets and the settlement of liabilities and commitments in the normal course of business. The report of our independent registered public accounting firm for the years ended December 31, 2013 and 2012 included an explanatory paragraph expressing substantial doubt about our ability to continue as a going concern in their audit report included herein. If we cannot generate the required revenues and gross margin to achieve profitability or obtain additional capital on acceptable terms, we will need to substantially revise our business plan or cease operations and an investor could suffer the loss of a significant portion or all of his investment in our company. As a result of our delisting from the Nasdaq Capital Market in September 2012, we are no longer eligible to file new registration statements on Form S-3, which may make it more costly and more difficult for us to obtain additional equity financing. We currently anticipate that we will retain all of our earnings, if any, for development of our business and do not anticipate paying any cash dividends on common stock in the foreseeable future.

We are dependent upon our solar panel suppliers for regular shipments of products; however we have not been timely in payment to them in recent periods, which has resulted in disruption in our supply of products. If we do not quickly establish replacement sources of supply, our operations will be further adversely affected.

Historically, we obtained virtually all of our solar panels from Suntech and Lightway. During 2012, because of our cash position and liquidity constraints, we were late in making payments to both of these suppliers. On March 30, 2012, pursuant to our Supply Agreement with Lightway, we issued 1,900,000 shares of our common stock to Lightway in partial payment of our past due account payable to them. At the time of issuance, the shares were valued at \$1,045,000. On May 1, 2012, Suntech filed a complaint for breach of contract, goods sold and delivered, account stated and open account against us in the Superior Court of the State of California, County of San Francisco. Suntech alleged that it delivered products and did not receive full payment from us. On July 31, 2012, we and Suntech entered into a settlement of this dispute. Because of our inability to make scheduled settlement payments, on March 15, 2013, Suntech entered a judgment against us in the amount of \$946,438. As of June 30, 2014, Suntech has not sought to enforce its judgment. As of June 30, 2014, we have included in accounts payable on our Consolidated Balance Sheets a balance due to Suntech America of \$946,438. We currently have no unshipped orders from Suntech or Lightway.

In May 2013, we entered into a new supply agreement for assembly of our proprietary modules with Environmental Engineering Group Pty Ltd (“EEG”), an assembler of polycrystalline modules located in Australia. In August 2013, we began receiving product from EEG and began shipping product to customers during the third calendar quarter of 2013. In September 2013, we entered into a second supply agreement for assembly of our proprietary modules with Tianwei New Energy Co, Ltd., (“Tianwei”) a panel supplier located in China. We began receiving product from Tianwei in February 2014 and stopped as of June 2014. In July 2014, we entered into a supply agreement for assembly of our proprietary modules with Auxin Solar, Inc., a panel supplier located in the United States. We expect to begin receiving product from Auxin in September 2014. Although we believe we can find alternative suppliers for solar panels manufactured to our specifications, our operations would be disrupted unless we are able to rapidly secure alternative sources of supply, our inventory and revenue could diminish significantly, causing disruption to our operations.

We are dependent upon our key suppliers for the components used in our systems and we must arrange for cost competitive manufacturing of our proprietary solar panels in order to grow our business; our suppliers are dependent upon the continued availability and pricing of silicon and other raw materials used in solar modules.

Historically, we obtained virtually all of our solar panels from Suntech and Lightway. During 2012, because of our cash position and liquidity constraints, we were late in making payments to both of these suppliers. We currently have no unshipped orders from Suntech or Lightway. In May 2013, we entered into a new supply agreement for assembly of our proprietary modules with Environmental Engineering Group Pty Ltd (“EEG”), an assembler of polycrystalline modules located in Australia. In August 2013, we began receiving product from EEG and began shipping product to customers during the third calendar quarter of 2013. In September 2013, we entered into a second supply agreement for assembly of our proprietary modules with Tianwei, a panel supplier located in China. We began receiving product from Tianwei beginning in February 2014 and stopped as of June 2014. In July 2014, we entered into a supply agreement for assembly of our proprietary modules with Auxin Solar, Inc., a panel supplier located in the United States. We expect to begin receiving product from Auxin in September 2014.

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It is critical to the growth of our revenue that our products be high quality while offered at competitive pricing. We believe that we will need to reduce the unit production cost of our products over time to obtain and maintain our ability to offer competitively priced products. Our ability to achieve cost reductions will depend on our ability to maintain favorable supplier contracts and to increase sales volumes so we can achieve economies of scale. We cannot provide assurance that we will be able to achieve any such production cost reductions. If we fail to negotiate better terms and maintain our relationships with our current suppliers or develop new supplier relationships, we may not achieve production cost reductions necessary to competitively price our products, which could adversely affect or limit our sales and growth.

We are currently subject to market prices for the components that we purchase, which are subject to fluctuation beyond our control. An increase in the price of components used in our systems could result in an increase in costs to our customers and could have a material adverse effect on our revenues and demand for our products.

Interruptions in our ability to procure needed components for our systems, whether due to discontinuance by our suppliers, delays or failures in delivery, shortages caused by inadequate production capacity or unavailability, financial failure, manufacturing quality, or for other reasons, would adversely affect or limit our sales and growth. There is no assurance that we will continue to find qualified manufacturers on acceptable terms and, if we do, there can be no assurance that product quality will continue to be acceptable, which could lead to a loss of sales and revenues.

The U.S. Government imposed tariffs on solar panels manufactured in China causing the prices we pay for solar panels to increase. This could cause customer demand for our products to decrease.

In early 2012, a group of solar panel manufacturers with domestic U.S. production facilities requested the U.S. Government to impose tariffs on the import of solar panels manufactured in China, based on allegations of unfair competition and of subsidization of prices for Chinese-made solar panels by the Chinese Government. In March 2012, the United States Commerce Department issued a preliminary decision imposing tariffs between 2.9% and 4.73%. In May 2012, a further decision by the Commerce Department was issued providing for a provisional tariff averaging 31% on 61 Chinese manufacturers caused by “dumping” solar panels into the U.S. market at prices below their actual cost. On October 11, 2012, the Commerce Department announced its final decision on these tariffs affirming its preliminary findings that modules containing cells of Chinese origin are subject to anti-dumping and countervailing duties (AD/CVD) when imported into the United States. The AD rates to be applied at the border range from 7.78% to 21.19% for participating respondents and up to 239.42% for non-participants. The CVD rates range from 14.78 to 15.97%. The AD and CVD rates will be applied collectively. The final step in the proceedings occurred on November 7, 2012, when the International Trade Commission (ITC) rendered a final affirmative injury determination concluding that the subject Chinese imports caused injury to U.S. manufacturers of crystalline-silicon solar cells and modules. The ITC also decided that the AD and CVD duties should not apply retroactively and rendered a negative "critical circumstances" determination. Thus, the effective dates were March 26, 2012 for CVD duties and May 25, 2012 for AD duties. Given the large current market share of solar panels manufactured in China, the imposition of these tariffs will have had far reaching, industry-wide effects, and have been disruptive to many established supply relationships. In fact, the imposition of these tariffs have caused prices for solar power systems in the United States to increase and resulted in reduced market demand for the purchase of solar power systems.

On December 31, 2013, SolarWorld America Industries, Inc. requested the U.S. Government to impose tariffs on the import of solar panels manufactured in China with Taiwanese solar cells, based on allegations of unfair competition and of subsidization of prices by the Chinese Government. In February 2014, the U.S. International Trade Commission declared in a unanimous preliminary determination that imports of Chinese panels made with Taiwanese solar cells injure the domestic manufacturing industry. The trade case next moves to the U.S. Commerce Department, which is expected in late March 2014 to make a preliminary determination on anti-subsidy duties for Chinese

products. Then in June 2014, the Commerce Department is scheduled to make a preliminary determination on anti-dumping duties for China and Taiwan. If the Commerce Department imposes the preliminary duties, the U.S. International Trade Commission could act about a year from now to make the tariffs final.

Our historical solar panel suppliers, Suntech and Lightway, both manufactured panels for us in China. As a result, aggregate AD and CVD duties of 30.66% (for Lightway) and 35.97% (for Suntech) were imposed on our purchases. The resulting increase in our product prices harmed our competitive position in selling our products, and adversely affected our results of operations. Our new supply agreement with Tianwei provides for solar modules manufactured in China with Taiwanese solar cells. Based on the outcome of the most recent investigation launched on December 31, 2013, the impositions of tariffs could be imposed that could cause prices for solar power systems in the United States to increase and result in reduced market demand for the purchase of solar power systems.

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We have experienced significant customer concentration in recent periods, and our revenue levels could be adversely affected if any significant customer fails to purchase products from us at anticipated levels.

The relative magnitude and the mix of revenue from our largest customers have varied significantly quarter to quarter. During the six months ended June 30, 2014, six customers have accounted for significant revenues, varying by period, to our company: Sustainable Environmental Enterprises (“SEE”), a leading provider of renewable energy and development projects located in New Orleans, Louisiana, Saddleback Cellars (“Saddleback”), a Napa County winery, Lennox International Inc. (“Lennox”), a global leader in the heating and air conditioning markets, Lowe’s Companies, Inc. (“Lowe’s”), a nationwide home improvement retail chain, WDC Solar, Inc. (“WDC”), a leading construction, integration and installation of commercial, residential and utility scale solar installations in the Washington D.C. area and Shoreline Electric (“Shoreline”) a provider of residential and commercial electrical services in Southern California.

We may fail to realize some or all of the anticipated benefits of our shift to a design and manufacturing business model in California and throughout North America, which may adversely affect the value of our common stock.

The success of our exit from the solar system installation business in California in September 2010, and our shift to focus exclusively on a design and manufacturing business model will depend, in large part, on our ability to successfully expand our distribution channels to include authorized dealers in California, as well as elsewhere in North America, and to accelerate the growth of our design and manufacturing business. California is the largest state in the country for solar products, accounting for approximately 50 percent of the U.S. market. Therefore, we continue to pursue developing distribution channel partners in California and North America.

If we are not able to achieve the expansion of our design and manufacturing business and meet our revenue growth and cost reduction objectives within the anticipated time frame, or at all, the anticipated benefits and cost savings of our change in strategic focus and our restructuring may not be realized or may take longer to realize than expected, and the value of our common stock may be adversely affected.

Specifically, risks in the operations of our business in order to realize the anticipated benefits of the change to a design and manufacturing business model include, among other things:

- failure to arrange for cost competitive manufacturing of our proprietary solar panels;
- failure to find and develop distribution relationships with new channel partners, particularly in California and the North America market;
- failure to successfully manage existing distribution relationships;
- failure to effectively coordinate sales and marketing efforts to communicate the capabilities of our company;
- unpredictability and delays in the timing of projected distribution orders, and resulting accumulation of excess product inventory;
- failure to focus and develop our distribution product and service offerings quickly and effectively;
- failure to successfully develop new products and services on a timely basis that address the market opportunities; and



- unexpected revenue attrition or delays.

In addition, the shift in our business model may result in additional or unforeseen expenses, and the anticipated cost reduction benefits may not be realized.

We are exposed to risks associated with global economy, which increase the uncertainty of project financing for solar installations and the risk of non-payment from customers.

The continuing tight credit markets are contributing to an ongoing slowdown in the solar industry, which may worsen if these economic conditions are prolonged or deteriorate further. The market for installation of solar power systems depends largely on commercial and consumer capital spending. Economic uncertainty exacerbates negative trends in these areas of spending, and may cause customers to push out, cancel, or refrain from placing orders, which may reduce our net sales. Difficulties in obtaining capital and adverse market conditions may also lead to the inability of some customers to obtain affordable financing, including traditional project financing and tax-incentive based financing and home equity based financing, resulting in lower sales to potential customers with liquidity issues, and may lead to an increase of incidents where our customers are unwilling or unable to pay for systems they purchase, and additional bad debt expense for us. Further, these conditions and uncertainty about future economic conditions make it challenging for us to obtain equity and debt financing to meet our working capital requirements to support our business, forecast our operating results, make business decisions, and identify the risks that may affect our business, financial condition and results of operations. If we are unable to timely and appropriately adapt to changes resulting from the difficult macroeconomic environment, our business, financial condition or results of operations may be materially and adversely affected.

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Our technology may encounter unexpected problems or may not be protectable, which could adversely affect our business and results of operations.

Our technology is relatively new and has not been tested in installation settings for a sufficient period of time to prove its long-term effectiveness and benefits. Problems may occur with products or their underlying components that are unexpected and could have a material adverse effect on our business or results of operations. We have been issued several U.S. and foreign patents that cover our Andalay solar panel technology. We have several other pending patent applications covering Andalay technology. Ultimately, we may not be able to realize the benefits from any patent that is issued.

Because our industry is highly competitive and has low barriers to entry, we may lose market share to larger companies that are better equipped to weather a decline in market conditions due to increased competition.

Our industry is highly competitive and fragmented, is subject to rapid change and has low barriers to entry. Competition in the solar power services industry may increase in the future, partly due to low barriers to entry, as well as from other alternative energy sources now in existence or developed in the future. Increased competition could result in price reductions, reduced margins or loss of market share and greater competition for qualified technical personnel. There can be no assurance that we will be able to compete successfully against current and future competitors. If we are unable to compete effectively, or if competition results in a deterioration of market conditions, our business and results of operations would be adversely affected.

Our profitability depends, in part, on our success and brand recognition and we could lose our competitive advantage if we are not able to protect our trademarks and patents against infringement, and any related litigation could be time-consuming and costly.

On August 23, 2013, we received formal notice of termination of our license agreement with Westinghouse Electric Corporation due to the non-payment of past due license fees. As of December 31, 2013, we owed Westinghouse \$1,027,705. On January 22, 2014, we entered into a claim purchase and assignment agreement with Westinghouse Electric and ASC Recap LLC (ASCR) whereby ASCR purchased our debt owed to Westinghouse Electric Corporation at a substantial discount to the face value. While the Westinghouse trademark is an important, world-wide recognized brand, we believe the most important competitive factors relating to our products are their effectiveness, efficiency and consumer cost, i.e., price point, and ultimately to the extent the cost of the Westinghouse license becomes prohibitive, it negatively impacts our cost of goods sold. However, we do not have the ability to accurately estimate the true impact of the loss of the use of such trademark. We have registered the “Andalay” trademark with the United States Patent and Trademark Office related to our panel technology. Use of our trademarks or similar trademarks by competitors in geographic areas in which we have not yet operated could adversely affect our ability to use or gain protection for our brand in those markets, which could weaken our brand and harm our business and competitive position. In addition, any litigation relating to protecting our trademarks and patents against infringement could be time consuming and costly.

We may have warranty obligations to Real Goods Solar, Inc. that could adversely affect our results of operations.

In connection with our exit from the solar system installation business in California, Real Goods Solar, Inc. (Real Goods) agreed to undertake primary, “first responder” responsibility for future warranty service obligations relating to the approximately 800 installations for SunRun that we have previously completed (the “Andalay Installations”). We retain secondary warranty responsibility on the Andalay Installations, in the event that Real Goods fails to perform the warranty. We will reimburse Real Goods for actual warranty service work completed by Real Goods related to these “first responder” installations. Other than solar panels and inverters that are covered under the manufacturer warranty, we provided our customers for Andalay Installations a 5-year or a 10-year warranty. We have accrued, and included

within “Liabilities of Discontinued Operations” in our consolidated balance sheets for December 31, 2013 and 2012, a liability of approximately \$1.0 million and \$1.1 million, respectively, to cover these warranty obligations. That amount is intended to cover both the Andalay Installations and certain installation projects assigned to Real Goods. The terms of the Warranty Agreements provided that we establish an escrow account as a source of funds from which to satisfy our obligation to pay Real Goods for its fees and reimburse it for its expenses for warranty work performed by it pursuant to the Warranty Agreements which are not paid to Real Goods from the company directly. In March 2011, we entered into an Escrow Agreement with Real Goods and deposited \$200,000 into an escrow fund. The amount is reflected in long-term assets of discontinued operations in our consolidated balance sheets. The escrow deposit will be released to us in the amount of \$40,000, or one-fifth of the remaining escrow funds, per year after each of the fifth through the ninth anniversary of the escrow agreement. If Real Goods fails to perform under the assigned warranty coverage, or the actual warranty expenses exceed the amounts we have accrued, we could incur significant unexpected additional expenses, which would adversely affect our results of operations.

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Impairment charges could reduce our results of operations.

In accordance with the provisions of Financial Accounting Standards Board (“FASB”) Accounting Standard Codification (“ASC”) 350, Goodwill and Other Intangible Assets (“ASC 350”), we test intangible assets with indefinite useful lives for impairment on an annual basis, and on an interim basis if an event occurs that might reduce the fair value of the reporting unit below its carrying value. We also assess the fair value of our inventory and other tangible assets as of the end of each reporting period. During the year ended December 31, 2012, we recorded a \$206,000 non-cash inventory write-down, which represented an adjustment to the carrying value of our older, smaller-format solar panels and older micro-inverter inventory to reflect the decline in market prices compared to our original cost, a \$65,000 write-off of accumulated inventory overhead costs and a \$112,000 non-cash inventory write-off of obsolete inventory. We may determine that further asset impairment charges are needed in the future. Although any such impairment charge would be a non-cash expense, further impairment of our tangible or intangible assets could materially increase our expenses and reduce our results of operations.

Our success depends on our key personnel, including our executive officers, and the loss of key personnel or the transition of key personnel, including our Chief Executive Officer, could disrupt our business.

Our success greatly depends on the continued contributions of our senior management and other key sales, marketing and operations personnel. These employees may voluntarily terminate their employment at any time. We may not be able to successfully retain existing personnel or identify, hire and integrate new personnel; and we do not have key person insurance policies in place for these employees. Since May 7, 2012, Margaret Randazzo, our Chief Financial Officer and a director, has acted as our Chief Executive Officer. On April 22, 2014, Steven Chan assumed the role as our Chief Executive Officer and President after Ms. Randazzo announced her resignation as our Chief Executive Officer and Chief Financial Officer effective June 30, 2014. There can be no assurance that we will be able to find a suitable candidate to fill the role of Chief Financial Officer or that there will be a smooth transition. Changes in our key positions can be disruptive and could have a material adverse effect on our operations and business.

If we are unable to attract, train and retain highly qualified personnel, the quality of our services may decline and we may not successfully execute our internal growth strategies.

Our success depends in large part upon our ability to continue to attract, train, motivate and retain highly skilled and experienced employees, including technical personnel. Qualified technical employees periodically are in great demand and may be unavailable in the time frame required to satisfy our customers’ requirements. While we currently have available technical expertise sufficient for the requirements of our business, expansion of our business could require us to employ additional highly skilled technical personnel. We expect competition for such personnel to increase as the market for solar power systems expands.

There can be no assurance that we will be able to attract and retain sufficient numbers of highly skilled technical employees in the future including a successor CFO. The loss of personnel or our inability to hire or retain sufficient personnel at competitive rates of compensation could impair our ability to secure and complete customer engagements and could harm our business.

Unexpected warranty expenses or service claims could reduce our profits.

We maintain a warranty reserve on our balance sheet for potential warranty or service claims that could occur in the future. This reserve is adjusted based on our ongoing operating experience with equipment and installations. It is possible, perhaps due to bad supplier material or defective installations, that we would have actual expenses substantially in excess of the reserves we maintain. Our failure to accurately predict future warranty claims could result in unexpected profit volatility.

## RISKS RELATING TO OUR INDUSTRY

We have experienced technological changes in our industry. New technologies may prove inappropriate and result in liability to us or may not gain market acceptance by our customers.

The solar power industry (and the alternative energy industry, in general) is subject to technological change. Our future success will depend on our ability to appropriately respond to changing technologies and changes in function of products and quality. If we adopt products and technologies that are not attractive to consumers, we may not be successful in capturing or retaining a significant share of our market. In addition, some new technologies are relatively untested and unperfected and may not perform as expected or as desired, in which event our adoption of such products or technologies may cause us to lose money.

A drop in the retail price of conventional energy or non-solar alternative energy sources may negatively impact our profitability.

We believe that an end customer's decision to purchase or install solar power capabilities is primarily driven by the cost and return on investment resulting from solar power systems. Fluctuations in economic and market conditions that affect the prices of conventional

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and non-solar alternative energy sources, such as decreases in the prices of oil and other fossil fuels, could cause the demand for solar power systems to decline, which would have a negative impact on our profitability. Changes in utility electric rates or net metering policies could also have a negative effect on our business.

Existing regulations, and changes to such regulations, may present technical, regulatory and economic barriers to the purchase and use of solar power products, which may significantly reduce demand for our products and services.

New government regulations or utility policies pertaining to solar power systems are unpredictable and may result in significant additional expenses or delays and, as a result, could cause a significant reduction in demand for solar energy systems and our services. For example, there currently exist metering caps in certain jurisdictions which effectively limit the aggregate amount of power that may be sold by solar power generators into the power grid.

Our business depends on the availability of rebates, tax credits and other financial incentives; reduction, elimination or uncertainty of which would reduce the demand for our products and services.

Many states offer incentives to offset the cost of solar power systems. These systems can take many forms, including direct rebates, state tax credits, system performance payments and Renewable Energy Credits (RECs). Moreover, the federal government currently offers a 30% tax credit for the installation of solar power systems. Businesses may also elect to accelerate the depreciation on their system over five years. Uncertainty about the introduction of, reduction in or elimination of such incentives or delays or interruptions in the implementation of favorable federal or state laws could substantially increase the cost of our systems to our customers, resulting in significant reductions in demand for our services, which would negatively impact our sales.

If solar power technology is not suitable for widespread adoption or sufficient demand for solar power products does not develop or takes longer to develop than we anticipate, our sales would decline and we would be unable to achieve or sustain profitability.

The market for solar power products is emerging and rapidly evolving, and its future success is uncertain. Many factors will influence the widespread adoption of solar power technology and demand for solar power products, including:

- cost effectiveness of solar power technologies as compared with conventional and non-solar alternative energy technologies;
- performance and reliability of solar power products as compared with conventional and non-solar alternative energy products;
- capital expenditures by customers that tend to decrease if the U.S. economy slows; and
- availability of government subsidies and incentives.

If solar power technology proves unsuitable for widespread commercial deployment or if demand for solar power products fails to develop sufficiently, we would be unable to generate enough revenue to achieve and sustain profitability. In addition, demand for solar power products in the markets and geographic regions we target may not develop or may develop more slowly than we anticipate.

RISKS RELATING TO OUR COMMON STOCK

We were delisted from the Nasdaq Capital Market and there is a limited trading volume for our common stock on the OTCQB.

In September 2012, our common stock was delisted from the Nasdaq Capital Market. Our common stock, which currently trades on the OTCQB, does not have substantial trading volume. As a result, relatively small trades of our common stock may have a significant impact on the price of our common stock and, therefore, may contribute to the price volatility of our common stock. Because of the limited trading volume in our common stock and the price volatility of our common stock, you may be unable to sell your shares of common stock when you desire or at the price you desire. The inability to sell your shares in a declining market because of such illiquidity or at a price you desire may substantially increase your risk of loss.

In addition, the delisting of our common stock from the Nasdaq Capital Market could materially adversely affect our ability to raise capital on terms acceptable to us or at all and could adversely affect institutional investor interest.

On February 17, 2011, we entered into a Securities Purchase Agreement with accredited investors, pursuant to which we sold to such investors our Series B 4% Convertible Preferred (“Series B Preferred”), and our Series K Warrants. On October 18, 2012, we entered into a Securities Purchase Agreement with accredited investors, pursuant to which we sold to such investors our Series C 8% Convertible Preferred (Series C Preferred). On February 15, 2013, we entered into a Securities Purchase Agreement with accredited

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investors pursuant to which we sold to such investors our Series D 8% Convertible Preferred Stock (Series D Preferred), and together with the Series B and C Preferred (the “Preferred Stock”). The conversion price of the Preferred Stock is subject to adjustment downward in the event that we sell common stock (or securities convertible into or exercisable for shares of common stock) at an effective price below the conversion price of such Preferred Stock. If the price adjustment provisions are triggered, then the number of shares of common stock issuable upon conversion of the Preferred Stock are subject to increase. On each of August 30, 2013 and November 25, 2013, we entered into a securities purchase agreement with a certain institutional accredited investor relating to the sale and issuance of a convertible note in the principal amount of \$200,000 that matures August 29, 2015 and November 25, 2015, respectively, and is convertible into shares of our common stock, at any time after issuance, at the option of the purchaser, at a conversion price equal to \$0.02 per share, subject to adjustment upon the happening of certain events, including stock dividends, stock splits and the issuance of common stock equivalents at a price below the conversion price. On December 19, 2013, we entered into a securities purchase agreement with the same institutional accredited investor relating to the sale and issuance of a (i) convertible note in the principal amount of \$250,000 that matures December 19, 2015, and is convertible into shares of our common stock, at any time after issuance, at the option of the purchaser, at a conversion price equal to \$0.02 per share, subject to adjustment upon the happening of certain events and (ii) five-year warrant exercisable for 6,250,000 shares of common stock at an exercise price of \$0.02 per share, subject to adjustment upon the happening of certain events.

On January 23, 2014, we entered into the Equity Purchase Agreement with Southridge. Pursuant to the Equity Purchase Agreement, Southridge has committed to purchase up to \$5,000,000 worth of our common stock, over a period of time terminating on the earlier of: (i) 18 months from the effective date of the registration statement to be filed by us for the New Equity Purchase Agreement; or (ii) the date on which Southridge has purchased an aggregate maximum purchase price of \$5,000,000 pursuant to the New Equity Purchase Agreement; Southridge’s commitment to purchase our common stock is subject to various conditions, including, but not limited to, limitations based on the trading volume of our common stock.

On January 27, 2014 we entered into a securities purchase agreement with the same institutional accredited investor relating to the sale and issuance of a convertible note in the principal amount of \$100,000 that matures January 27, 2016 and is convertible into shares of our common stock, at any time after issuance, at the option of the purchaser, at a conversion price equal to \$0.02 per share, subject to adjustment upon the happening of certain events. On February 25, 2014, we entered into a securities purchase agreement with the same institutional accredited investor relating to the sale and issuance of a (i) convertible note in the principal amount of \$200,000 that matures February 25, 2016 and is convertible into shares of our common stock, at any time after issuance, at the option of the purchaser, at a conversion price equal to \$0.02 per share, subject to adjustment upon the happening of certain events and (ii) five-year warrant (with a cashless exercise feature under certain circumstances) to purchase 5,000,000 shares of our common stock at an exercise price of \$0.02 per share, subject to adjustment under certain circumstances. On March 18, 2014, we issued under the Securities Purchase Agreement we entered into with the institutional investor on February 25, 2014 a (i) convertible note in the principal amount of \$300,000 that matures March 18, 2016 and (ii) five-year warrant (with a cashless exercise feature under certain circumstances) to purchase 7,500,000 shares of our common stock at an exercise price of \$0.02 per share, subject to adjustment under certain circumstances.

When the investors convert our Preferred Stock and convertible notes or exercise the warrant, our stockholders may experience dilution in the net tangible book value of their common stock. In addition, the sale or availability for sale of the underlying shares or shares sold pursuant to the Equity Purchase Agreement in the marketplace could depress our stock price. As a result, the investors could resell the underlying shares immediately upon issuance, which may result in significant downward pressure on the market price of our stock. In connection with the Series D Preferred and convertible notes, we have granted the purchasers “piggy-back” registration rights to include the underlying shares of common stock issuable upon conversion of the Series D Preferred in future registration statements, if any are filed by us.



In addition, the terms of our Preferred Stock include various agreements and negative covenants on our part, including covenants on our part to maintain and keep available sufficient authorized shares of our common stock to support the conversion in full of our outstanding shares of preferred stock. As a result of our financing on August 30, 2013, the effective conversion price of various shares of outstanding Preferred Stock was adjusted downward to \$0.02 per share of common stock. In the event we fail to comply with those provisions, or if a “change of control” of the Company occurs, it could constitute a “triggering event” (as defined in the Certificates of Designation which designate the rights of the three series of Preferred Stock), and the holders of our Preferred Stock could then demand that all of the outstanding shares of Preferred Stock be redeemed for cash (in certain circumstances generally within our control), or under certain circumstances, for shares of our common stock. Any such demand for redemption in cash could have a material adverse affect on our financial position and liquidity, and any demand for redemption in stock could have a material dilutive effect for our stockholders. In addition, in certain such triggering events, the dividend rate on our outstanding Preferred Stock is subject to increase to 18% per annum thereafter.

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If we fail to meet the new eligibility requirements of the OTC Market Group, we will no longer be eligible to have our common stock quoted on the OTCQB

If we fail to maintain a minimum bid price of \$.01 per share one day per each thirty consecutive days, our stock will no longer be eligible to be traded on the OTCQB and will be traded on the pink sheets. Effective May 1, 2014, the OTC Market Group implemented new eligibility standards for companies traded on the OTCQB that will be gradually phased in over a one year period. Investors of companies that do not meet the eligibility requirements will not have the benefit of the additional disclosure requirements of the OTCQB and trading may be more difficult.

Future sales of common stock by our existing stockholders may cause our stock price to fall.

The market price of our common stock could decline as a result of sales by our existing stockholders of shares of common stock in the market, or the perception that these sales could occur. These sales might also make it more difficult for us to sell equity securities at a time and price that we deem appropriate. As of August 11, 2014, we had 241,278,204 shares of common stock outstanding (which includes 444,611 unvested shares of restricted stock granted to our directors and our employees) and we had warrants to purchase 22,148,045 shares of common stock and options to purchase 15,605,733 shares of common stock outstanding.

All of the shares of common stock issuable upon exercise of our outstanding vested options will be freely tradable without restriction under the federal securities laws unless purchased by our affiliates.

Our stock price may be volatile, which could result in substantial losses for investors.

The market price of our common stock is likely to be highly volatile and could fluctuate widely in response to various factors, many of which are beyond our control, including the following:

- technological innovations or new products and services by us or our competitors;
- announcements or press releases relating to the energy sector or to our business or prospects;
- additions or departures of key personnel;
- regulatory, legislative or other developments affecting us or the solar power industry generally;
- our ability to execute our business plan;
- operating results that fall below expectations;
- volume and timing of customer orders;
- industry developments;
- economic and other external factors; and
- period-to-period fluctuations in our financial results.

In addition, the securities markets have from time to time experienced significant price and volume fluctuations that are unrelated to the operating performance of particular companies. These market fluctuations may also significantly

affect the market price of our common stock.

Our stock is a penny stock and therefore may be less attractive to investors.

Our stock is considered to be a penny stock. The SEC has adopted rules that regulate broker-dealer practices in connection with transactions in penny stocks. Penny stocks are generally equity securities with a market price of less than \$5.00, other than securities registered on certain national securities exchanges or quoted on the NASDAQ system, provided that current price and volume information with respect to transactions in such securities is provided by the exchange or system. The penny stock rules require a broker-dealer, prior to a transaction in a penny stock, to deliver a standardized risk disclosure document prepared by the SEC, that: (a) contains a description of the nature and level of risk in the market for penny stocks in both public offerings and secondary trading; (b) contains a description of the broker's or dealer's duties to the customer and of the rights and remedies available to the customer with respect to a violation of such duties or other requirements of the securities laws; (c) contains a brief, clear, narrative description of a dealer market, including bid and ask prices for penny stocks and the significance of the spread between the bid and ask price; (d) contains a toll-free telephone number for inquiries on disciplinary actions; (e) defines significant terms in the disclosure document or in the conduct of trading in penny stocks; and (f) contains such other information and is in such form, including language, type size and format, as the SEC shall require by rule or regulation.

The broker-dealer also must provide, prior to effecting any transaction in a penny stock, the customer with: (a) bid and offer quotations for the penny stock; (b) the compensation of the broker-dealer and its salesperson in the transaction; (c) the number of shares to which such bid and ask prices apply, or other comparable information relating to the depth and liquidity of the market for such stock; and (d) a monthly account statement showing the market value of each penny stock held in the customer's account.

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In addition, the penny stock rules require that prior to a transaction in a penny stock not otherwise exempt from those rules, the broker-dealer must make a special written determination that the penny stock is a suitable investment for the purchaser and receive the purchaser's written acknowledgment of the receipt of a risk disclosure statement, a written agreement as to transactions involving penny stocks, and a signed and dated copy of a written suitability statement.

These disclosure requirements may have the effect of reducing the trading activity for our common stock. Therefore, stockholders may have difficulty selling our securities.

RISKS RELATING TO OUR COMPANY

The recently terminated Merger Agreement with CBD could have a material adverse effect on our business, results of operations, and financial condition.

On May 7, 2012, we entered into a merger agreement with CBD Energy Limited, an Australian corporation ("CBD"). We had originally targeted completion of the merger during the third quarter of 2012, however the target date for completion had been repeatedly delayed, and the necessary registration statement had yet to be completed and filed. The uncertainty resulted in a disruption in our supply relationships, leading to a significant decline in our revenue and the implementation of significant cost reductions including the layoff of employees during the time we pursued the merger. Given the continued delays and uncertainty of whether and when the closing conditions for the merger as set for in the merger agreement would be satisfied, we terminated the merger agreement with CBD effective July 18, 2013. We are now committed to focus our attention on rebuilding our core business, expanding our current product offerings and exploring strategic opportunities.

If we are unable to successfully rebuild our core business, expand our current product offerings or determine viable strategic opportunities, our business, operating results or financial condition could be materially adversely affected.

We are subject to the reporting requirements of the federal securities laws, which impose additional burdens on us.

We are a public reporting company and, accordingly, subject to the information and reporting requirements of the Exchange Act and other federal securities laws, including compliance with the Sarbanes-Oxley Act of 2002. As a public company, these rules and regulations result in increased compliance costs and make certain activities more time consuming and costly.

Our Certificate of Incorporation authorizes our board to create new series of preferred stock without further approval by our stockholders, which could adversely affect the rights of the holders of our common stock.

Our Board of Directors has the authority to fix and determine the relative rights and preferences of preferred stock. Our Board of Directors also has the authority to issue preferred stock without further stockholder approval. As a result, our Board of Directors could authorize the issuance of new series of preferred stock that would grant to holders the preferred right to our assets upon liquidation, the right to receive dividend payments before dividends are distributed to the holders of common stock and the right to the redemption of the shares, together with a premium, prior to the redemption of our common stock. In addition, our Board of Directors could authorize the issuance of new series of preferred stock that has greater voting power than our common stock or that is convertible into our common stock, which could decrease the relative voting power of our common stock or result in dilution to our existing stockholders.

Our recent increase in our authorized shares of common stock and our issuances of convertible notes could result in future dilution of our common stock.

If we sell additional equity or convertible debt securities, those sales could result in additional dilution to our stockholders. In addition, holder of our convertible notes have the right to convert their notes into shares of our Common Stock, subject to a blocker of 9.99% of our outstanding common stock which will result in substantial dilution to our stockholders. In addition, our increase in the number of authorized shares of common stock to 500,000,000 in September 2013 allows us to issue many more shares of common stock.

Future issuances of common shares may be adversely affected by the Equity Line.

The market price of our common stock could decline as a result of issuances and sales by us, including pursuant to the Equity Line under the Equity Purchase Agreement, or sales by our existing shareholders, of common stock, or the perception that these issuances

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and sales could occur. Sales by our shareholders might also make it more difficult for us to issue and sell common stock at a time and price that we deem appropriate. It is likely that the sale of shares by Southridge will depress the market price of our common stock.

Draw downs under the Equity Purchase Agreement may cause dilution to existing shareholders.

Under the terms of the Equity Purchase Agreement, Southridge has committed to purchase up to \$5,000,000 worth of shares of our common stock. From time to time during the term of the Equity Purchase Agreement, and at our sole discretion, we may present Southridge with a Draw Down Notice requiring Southridge to purchase shares of our common stock. The purchase price to be paid by Southridge will be 90% of the lowest closing bid price during the Valuation Period. On the date the Draw Down Notice is delivered to Southridge, we are required to deliver an estimated amount of shares to Southridge's brokerage account equal to 125% of the Draw Down Amount indicated in the Draw Down Notice divided by the closing bid price of the trading day immediately prior to the date of the Draw Down Notice ("Estimated Shares"). The Valuation Period will begin the first trading day after the Estimated Shares have been delivered to Southridge's brokerage account and have been cleared for trading and terminate on the tenth day thereafter. At the end of the Valuation Period, if the number of Estimated Shares delivered to Southridge is greater than the shares issuable pursuant to a Draw Down, then Southridge is required to return to us the difference between the Estimated Shares and the actual number of shares issuable pursuant to the Draw Down. If the number of Estimated Shares is less than the shares issuable under the Draw Down, then we are required to issue additional shares to Southridge equal to the difference; provided that the number of shares to be purchased by Southridge may not exceed the number of shares that, when added to the number of shares of our common stock then beneficially owned by Southridge, would exceed 9.99% of our shares of common stock outstanding. As a result, our existing shareholders will experience immediate dilution upon the purchase of any of the shares by Southridge. The issue and sale of the shares under the Equity Purchase Agreement may also have an adverse effect on the market price of the common shares. Southridge may resell some, if not all, of the shares that we issue to it under the Equity Purchase Agreement and such sales could cause the market price of the common stock to decline significantly. To the extent of any such decline, any subsequent puts would require us to issue and sell a greater number of shares to Southridge in exchange for each dollar of the put amount. Under these circumstances, the existing shareholders of our company will experience greater dilution. The effect of this dilution may, in turn, cause the price of our common stock to decrease further, both because of the downward pressure on the stock price that would be caused by a large number of sales of our shares into the public market by Southridge, and because our existing stockholders may disagree with a decision to sell shares to Southridge at a time when our stock price is low, and may in response decide to sell additional shares, further decreasing our stock price. If we draw down amounts under the Equity Line when our share price is decreasing, we will need to issue more shares to raise the same amount of funding.

There is no guarantee that we will satisfy the conditions to the Equity Purchase Agreement.

Although the Equity Purchase Agreement provides that we can require Southridge to purchase, at our discretion, up to \$5,000,000 worth of shares of our common stock in the aggregate, there can be no assurances given that we will be able to satisfy the closing conditions applicable for each put. Further, there are limitations on the number of shares in that each draw down amount is limited to the lowest closing bid price during the Valuation Period, subject to the floor. In addition, the number of shares to be purchased by Southridge may not exceed the number of shares that, when added to the number of shares of our common stock then beneficially owned by Southridge, would exceed 9.99% of our shares of common stock outstanding. Other conditions include requiring that the registration statement of which this prospectus forms a part remains effective at all times during the term of the Equity Purchase Agreement, that there is no material adverse change to our business on the date of delivery of a Draw Down Notice and that our common stock continues to trade of the OTCQB. If we fail to satisfy the applicable closing conditions, we will not be able to sell the put shares to Southridge.

There is no guarantee that we will be able to fully utilize the Equity Line.

There are limitations on the number of put shares that may be sold in each put. The number of put shares that Southridge shall be obligated to purchase in a given put shall not exceed the number of shares that, when added to the number of shares of our common stock then beneficially owned by Southridge, would exceed 9.99% of our shares of common stock outstanding. Thus, our ability to access the bulk of the funds available under the Equity Purchase Agreement depends in part on Southridge's resale of stock purchased from us in prior puts. If with regard to a particular put, the share volume limitation is reached, we will not be able to sell the proposed put shares to Southridge. Accordingly, the Equity Line may not be available at any given time to satisfy our funding needs.

Sales of put shares under the Equity Purchase Agreement could result in the possibility of short sales.

Although Southridge has agreed not to enter into any "short sale" (as such term is defined in Rule 200 of Regulation SHO of the Securities Exchange Act of 1934), of our common stock, the sale after delivery of a put notice of such number of shares of common stock reasonably expected to be purchased under a put notice is not deemed a "short sale." Accordingly, Southridge may enter into sales or other arrangements it deems appropriate with respect to shares of our common stock after it receives a put notice under the Equity Purchase Agreement so long as such sales or arrangements do not involve more than the number of put shares expected to be

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purchased under the applicable put notice. Any downward pressure on the market price of our common stock due to the issue and sale of common stock under the Equity Line could encourage short sales. If the market price of our common stock decreases during the put period it will reduce the amount paid by Southridge for the put shares. In a short sale, a prospective seller borrows common shares from a shareholder or broker and sells the borrowed common shares. The prospective seller hopes that the common share market price will decline, at which time the seller can purchase common shares at a lower price for delivery back to the lender. The seller profits when the common share market price declines because it is purchasing common shares at a price lower than the sale price of the borrowed common shares. Such sales could place downward pressure on the market price of the common stock by increasing the number of common shares being sold, which could further contribute to any decline of the market price of the common shares.

There is uncertainty as to number of subscription shares and the amount Southridge will pay for the put shares.

The actual number of shares we will issue in any particular put or in total under the Equity Purchase Agreement is uncertain. Subject to certain limitations in the Equity Purchase Agreement, we have the discretion to give a put notice at any time throughout the term. The number of shares we must issue after giving a put notice will fluctuate based on the market price of the common shares during the put pricing period. Southridge will receive more shares if the market price of our common stock declines. Since the price per share of each put share will fluctuate based on the market price of our common stock during the put pricing period, the actual amount Southridge will pay for the put shares included in any particular put will decrease if the market price of our common stock declines. Based on our current market price of \$0.02, if we put the remaining 3.2 million shares available under the Equity Purchase Agreement to Southridge (ignoring all caps on the number of shares of common stock that Southridge can own), we would receive approximately \$58,000.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

Pursuant to the terms of our Equity Credit Agreement, a placement fee of 1 million shares of unregistered common stock was due to Southridge pursuant to the terms of the Equity Credit Agreement. As of June 30, 2014, we issued 1 million shares of unregistered common stock due upon the declaration of effectiveness of our Form S-1/A by the Securities and Exchange Commission of our Form S-1/A. The sales of the above securities were deemed to be exempt from registration under the Securities Act in reliance upon Section 4(a) (2) of the Securities Act as transactions by an issuer not involving any public offering. The recipients of the securities in each of these transactions represented their intentions to acquire the securities for investment only and not with a view to or for sale in connection with any distribution thereof, and appropriate legends were placed upon the stock certificates issued in these transactions.

Item 3. Defaults upon Senior Securities.

None.

Item 4. Mine Safety Disclosure.

Not Applicable

Item 5. Other Information.

None





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## Item 6. EXHIBITS.

Exhibit Number	Description
3.1	Certificate of Incorporation (incorporated herein by reference to Exhibit 3.1 to our Current Report on Form 8-K, dated August 3, 2006)
3.2	By-laws (incorporated herein by reference to Exhibit 3.2 to our Current Report on Form 8-K, dated August 3, 2006)
3.3	Certificate of Amendment to the Certificate of Incorporation (incorporated herein by reference to Exhibit 3.3 to the August 2006 8-K)
3.4	Certificate of Amendment to the Certificate of Incorporation (incorporated herein by reference to Exhibit 3.4 to our Current Report on Form 10-Q filed on July 30, 2010)
3.5	Certificate of Amendment to the Certificate of Incorporation as filed with the Delaware Secretary of State on April 6, 2011 (incorporated herein by reference to Exhibit 3.5 to our Current Report on Form 10-Q filed on May 10, 2011)
3.6	Amendment to Certificate of Incorporation of the Company, dated September 19, 2013 (incorporated by reference to Exhibit 3.1 to our Current Report on Form 8-K filed on September 23, 2013)
3.7	Correction to amendment to Certificate of Incorporation of the Company, dated September 20, 2013 (incorporated by reference to Exhibit 3.2 to our Current Report on Form 8-K filed on September 23, 2013)
4.1	Certificate of Designation of Preferences, Rights and Limitations with respect to Series B 4% Convertible Preferred Stock (the "Series B Certificate of Designation"), as filed on February 17, 2011 (incorporated by reference to Exhibit 4.2 to our Current Report on Form 8-K filed on February 17, 2011)
4.2	Certificate of Amendment to the Series B Certificate of Designation (incorporated by reference to Exhibit 3(i) to our Current Report on Form 8-K filed on August 24, 2011)
4.3	Certificate of Designation of Preferences, Rights and Limitations of Series C 8% Convertible Preferred Stock, as filed on February 17, 2011 (incorporated by reference to Exhibit 4.1 to our Current Report on Form 8-K filed on October 19, 2012)
4.4	Certificate of Amendment to the Series B Certificate of Designation, dated as of October 18, 2012 (incorporated by reference to Exhibit 4.1 to our Current Report on Form 8-K filed on October 19, 2012)
4.5	Certificate of Designation of Preferences, Rights and Limitations of Series D 8% Convertible Preferred Stock, as filed on February 14, 2013 (incorporated by reference to Exhibit 4.1 to our Current Report on Form 8-K filed on February 15, 2013)
10.1	Employment Agreement, dated April 14, 2014, by and between Steven Chan and Andalay Solar, Inc. ‡ (incorporated by reference to Exhibit 10.1 to our Current Report on Form 8-K filed on April 16, 2014)

10.2 Indemnification Agreement between Steven Chan and Andalay Solar, Inc. (incorporated by reference to ‡Exhibit 10.2 to our Current Report on Form 8-K filed on April 16, 2014).

31 \*Section 302 Certification of Principal Executive and Financial Officer

32 \*Section 906 Certification of Principal Executive and Financial Officer

101.INS \*XBRL Taxonomy Extension Instance Document †

101.SCH \*XBRL Taxonomy Extension Schema Linkbase Document †

101.CAL \*XBRL Taxonomy Extension Calculation Linkbase Document †

101.DEF \*XBRL Taxonomy Extension Definition Linkbase Document †

101.LAB \*XBRL Taxonomy Extension Labels Linkbase Document †

101.PRE \*XBRL Taxonomy Extension Presentation Linkbase Document †

\* filed herewith

‡ Management contract or compensatory plan or arrangement.

† Pursuant to Rule 406T of Regulation S-T, the Interactive Data Files in Exhibit 101 hereto are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.

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SIGNATURES

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

Dated: August 12, 2014

/s/ Steve Chan  
Steve Chan  
Chief Executive Officer and Chief Financial Officer  
(Principal Executive Officer, Principal Financial Officer and  
Principal Accounting Officer)

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## Exhibit Index

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10.1	‡

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\* filed herewith

‡ Management contract or compensatory plan or arrangement.

† Pursuant to Rule 406T of Regulation S-T, the Interactive Data Files in Exhibit 101 hereto are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.

